Role of the Invoice Discounter or Factor

in the Canadian Business Environment

by Peter D. Wendling

Start-up and growing companies often lack the money needed to get quickly established or to take advantage of situations requiring cash flow in order to generate revenue. In many instances, by the time outstanding accounts receivable generated by the company are collected, the opportunity for quick revenue and eventual profit has been lost.

Insufficient cash flow could be resolved, as it has been for many years, if a company utilized its accounts receivable by selling them at a discount, also known as invoice discounting or factoring, to a company specializing in providing working capital financing to Canadian businesses. Invoice discounting or factoring is but one service provided by some Canadian companies offering working capital.

This service is often not utilized for two reasons: The business person is either not aware of the service or, the service is not seen in a favourable light because full knowledge of how it works and its benefits are not known or appreciated.

Factoring is not new. The present day form of factoring or invoice discounting evolved into its present form from its genes: over 300 years ago when English textile mill merchants sold products to customers across the Atlantic. The agents in America would find buyers in America, guarantee payment and collect the proceeds of sale for the textile mill merchant in England. As a result, factoring or invoice discounting was born. The basic

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Editor's Note: This article is geared toward those recently entering the field.

concept has changed little, but it has evolved into probably the most efficient collateral management industry in North America. It is a multibillion dollar industry in both Europe and the United States. It has been in Canada on a smaller scale for some time, and commenced in the garment industry in this country. Over the last 30 years or so it has evolved into what is now a sophisticated, well-organized, client-service-oriented and highly reputable industry.

Advantages of income discounting or factoring

The advantages may be summarized by the cliché of spending money to make money. In addition to the assignor company making money, which may not have been the case without the relationship between the working capital company and its assignor client, other advantages may result.

When a company pays its suppliers before collecting its receivables from its customers, the cash drain may present a financial need. The cash gap could be alleviated by attempting to get cash by quickly selling inventory coupled with avoiding paying suppliers as long as possible. Concentrating on selling fast-moving inventory, giving discounts to early paying customers, as well as negotiating extended credit terms with suppliers, can reduce this cash gap. Some or all of these efforts may not be in the best long-term interest of the business, requiring extra time and effort and, in the end, may not be sufficient to eliminate the problem. Small businesses may also lack the clout to negotiate extended terms from suppliers, and do not have the necessary resources to devote to the expeditious collection of its accounts receivable.

The possible solution: the business sells its good accounts receivable at a discount to the invoice discounter or factor. Certainly this is spending money to make money. The money spent can be translated into the discount taken from the face value of the accounts receivable after collection by the factor.

Mechanics and benefits of factoring or invoice discounting

The money made by the assignor company results from having the necessary cash to actually carry on business which may have been dormant without the cash from the sale of the accounts receivable. Self collection of receivables could result in the decision to sell part of the equity in the company to a third party, or possible insolvency, either of which would not be by choice. The money made results from having the necessary cash to actually carry on business, which may have been effectively inactive or not carried on as vigorously or as productively.

In a typical factoring scenario, the business sells its accounts receivable to a factor and receives up to 90 percent of the face value of the invoices sold. After collection, the factor retains between two percent and five percent per 30 days of nonpayment, of the face value of the invoices. The balance of the collection is then remitted to the client.

The immediate cash as a benefit is obvious. Other benefits include improved credit ratings resulting from prompt repayment of debt and cost savings as a result of reduction of time and money spent managing the collection of receivables. These benefits provide management with more time to focus on growing a successful and better managed business.

The role of the banker

Businesses that factor their receivables often experience rapid growth, which could result in exhausting lines of credit and the capacity to borrow from their bankers. Even if this were not the case, bankers tend to move slowly to either increase lines of credit or to provide short-term cash necessary for its clients to take advantage of those windows of opportunity. On the other hand, the factor moves quickly, reviews the opportunity presented and advances funds in a matter of days, not weeks or months. Banks approve loan applications on the basis of historical financial performance. The factor approves dealing with the potential client, not only on the value of the receivables, but on the client's potential for success.

The banker and the factor should work in concert together for the benefit of their mutual client. In most cases, the banker remains the banker and will continue to have a

first-security interest on the assets of its client, except for the accounts receivable purchased by the factor. This may involve a priority agreement between the bank and the factor. The relationship between the client and the factor should be viewed by the bank as in the best interest of its client. The entry into a priority agreement should not pose a problem.

Goals of the factor

Obviously the factor is in business to make money. However, the relationship between the factor and client enhances the business by removing the collection task from the client. Other benefits may also result. There will be fast-needed cash for the business, the client's credit rating should be better and management will be freed up in order to run a successful business. It should be a short-term relationship necessitated by opportunity. The request could be a bulge or bridge financing. The former may be the result of the client being on the verge of the borrowing limit set by its bank. The latter may be the result of requiring cash while changing banks. In any situation, a good factor should attempt to get in and out quickly after the need of its client has been eliminated.

It is not in the best interest of any Canadian business to pay money even to earn money for any time longer than necessary; nor is it in the best interest of the reputation of the factoring or working capital community to do otherwise.

Client's cost dependent on risk to factor

Assume that a potential client has a viable, profitable business; possesses a significant number of good receivables with a history of payments standard in the relevant industry, with no unusual administrative costs; and agreement has been reached, or dictated, that the factoring will be with recourse back to the client in the event of nonpayment. The risk to the factor appears to be primarily what determines the discount rate. The risk is tied into how it sees its ability to collect and deal with the assigned receivables. In some situations, the risk may be reduced by the client. In others, the client may have little say because of the factor's policy or what the factor has determined in the circumstances. In those situations where the risk may be reduced, the notification or the degree of notification of the assignment to the account debtor is paramount in determining the risk in the eyes of the factor.

The client may be adamant that the account debtor not be notified in any manner of the assignment or sale of its receivables to the factor. On the other hand, the factor is aware that without or before notification the account debtor may continue to pay and deal with its creditor directly and has a right of set-off in respect of unrelated obligations arising subsequent to notification of assignment. The factor is and should be most comfortable with notification of the assignment.

On the assumption that nonnotification is acceptable to the factor, the risk of noncollectability has increased. As stated, the ultimate protection in the eyes of the factor is notification of the assignment coupled with a direction, probably a stamped notation on the invoice that payment must be made directly to the factor at its address, as well as an acknowledgment by the account debtor of the assignment.

Where the client insists on nonnotification, it will continue to collect the receivables, which must by agreement be held in trust for and remitted to the factor. There is a middle ground. Payment may continue to be made to the client, but directed to a new address (that of the factor), without a clear notification that the receivables have been sold or assigned. Further, by agreement, there could be no notification to the account debtor, except in the event of given defaults. The factor will no doubt insist on blanket notifications, which by agreement will not be implemented or given to account debtors unless and until there is default under the terms of the factoring agreement.

If the client is of the opinion that notification will probably not significantly negatively affect its business or business relationships, and is able to rise above the psychological hurdle or stigma, as seen by some, then agreement on full notification should warrant the best discount rate. If the factor agrees, a middle ground as to the nature of notification may be established, taking into consideration the view of the client of the factor concerning the possible harm to its business if there were complete and full notification. ▲

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