Like the financing of instalment receivables, open accounts receivable financing is a mass financing operation. This is of primary importance to any examination of the credit standards and credit appraisal techniques that are adopted by the financing agency. The fact that a great many individual transactions must be handled expeditiously means that a routine procedure is established for checking the credit quality of the collateral. In this respect the policies and procedures followed by factors and commercial finance companies are very much like those adopted in instalment sales financing. The analogy is less close when applied to commercial bank operations.

The internal organization of agencies engaged in financing accounts receivable is determined mainly by the range of the services offered, the volume of the business transacted and the character and extent of activity in other financing fields. Since the concerns operating in the field show considerable differences in these matters, it is difficult to generalize regarding their internal organization and operating procedures. In the following sections, however, certain broad differences between factors, commercial finance companies and commercial banks will be indicated.

Organization and Personnel

We shall describe, first, the general scheme of organization of the factoring company. Obviously the larger the volume of business transacted by a factoring company the more specialized the departments\(^1\) that will be required. Factors usually

\(^1\) The word "department" is used here in the management organization sense. It should be noted that the word is frequently used in the trade to refer to the different mills or accounts for which the factor cashes sales. An "inside" department, in this sense, is one for which the factor provides storage space and showroom facilities in the factor's building; an "outside" department does not use these facilities.
establish a fairly rigid internal organization, the main outlines of which are determined by the several functional aspects of the factoring operation. Since these functions are common to all concerns, there is a general similarity in organization.

The credit department is the crucial department in the whole factoring organization because of the factor's assumption of the credit risk on purchased receivables. Its successful operation depends on supervision by well-qualified credit analysts with intimate knowledge of the factor's clients and the customers served by them, and a clerical staff able to maintain a high degree of accuracy and order in handling a mass of individually small transactions. Also, credit executives must be available to negotiate with clients and customers for carrying through exceptionally large transactions. The work of analyzing the financial statements of clients and providing guidance on financial budgeting is sometimes organized in a special division of the credit department.

Specialization within the credit department is frequently necessary because the factor serves more clients than can be handled by one credit man and may cash receivables for a wide variety of concerns. Although it is difficult to estimate the number of clients served by any particular factor, it appears that this may be as high as 400 or as low as 50; the accounts of various clients doubtless vary considerably with respect to activity and number of receivables involved per $1000 of sales cashed. Since the contract between the factor and his client stipulates that sales and deliveries are to be made only with prior approval of the factor, the credit department must be equipped to act promptly on any request for clearance. Consequently, there is a considerable gain in efficiency when the department is organized to assign certain individuals to the business of certain clients. After a time the credit man gets to know his clients' trade customers and credit problems so well that he can give an immediate decision on a request. Also, the

2 If the account is a selling agent it may represent sales of a number of mills.
factoring companies that have extended their services beyond textiles must employ somewhat different credit standards and procedures, necessitating further specialization in the credit department.

The very large amount of mailing involved in factoring requires a special mail department. This department's existence grows mainly out of the need for careful handling of outgoing invoices represented by cashed sales and the receipt of payments on invoices. In most instances the client mails invoices to customers but this is not always the case; in any event, the factor receives the customer's payment and organizes a department to handle this specific phase of the whole operation. These collections involve an impressive mass of detail.

In addition to these functional divisions of the factoring company there are other functions that may be departmentalized, depending on the size of the company. An accounting department is needed for the verification of invoices and schedules of accounts submitted by the factor's clients; the calculation of discounts and average due dates on accounts purchased; the maintenance of bookkeeping records on invoices purchased and payments, credits and offsets against these accounts; the calculation of the amount of the reserves to be maintained on the accounts of different clients; the keeping of clients' debit and credit balances; the preparation of the statements presented at intervals to the clients. The factor must also maintain a department to watch maturities, to collect delinquent accounts and to prepare and file claims against insolvent debtors. Supervision over these various departments is usually exercised by officers of the factoring concern; other officers participate in the promotion of new business activity, in the maintenance of the concern's banking relations and in the general management of the company.

Despite marked similarities, the organization of the non-notification financing company differs somewhat from that of the factor. This is due principally to differences in the receivables financing services rendered, and to the fact that the commercial finance company is a less specialized financial
agency than the factoring company, both as regards the industrial characteristics of its clients and the types of financing it conducts. Aside from the purchasing of trade accounts the factor's only other credit-extending function is in making loans on merchandise and on receivables assigned by the client under a recourse agreement, but the finance company may buy open accounts, make advances on merchandise, discount instalment sales contracts for manufacturers and dealers in industrial and commercial equipment and, in some cases, discount contracts arising out of instalment sales of consumer goods.

In order to carry on these diversified activities effectively, the finance company is organized in departments according to type of business. For its accounts receivable financing, it maintains a clerical staff to receive schedules of accounts, determine the credit rating of individual accounts, ascertain their cash or loan value, receive payments on accounts previously acquired, and maintain current records of collateral held for each client and records of each of the client's trade customers. There are usually several credit men attached to this division whose function is to make the original investigation of new accounts and examine each schedule as received, and one or more officers authorized to make disbursements. In addition, there must be an accounting or controlling division to prepare monthly statements for clients, legal and collection departments, and a new business division, if the company is large enough for this degree of departmentalization. The auditing force is of strategic importance to the finance company. This may consist of a division or even a separate corporation (operating under name and address different from the finance company in order to maintain the secrecy of the receivables' sale) which sends out audit slips to trade debtors asking for verification of receivables. Under this department there is an outside auditing force responsible for frequent examinations of the clients' records and general progress. Finally, some commercial finance companies now have separate divisions or departments through which they provide general management counsel to their clients.
The magnitude of routine procedures (for example, the\nverification of accounts) may be gauged from the fact that even\nfor one of the smaller commercial finance companies with out-
standing advances of $1 million there will be approximately\n$1.5 million of receivables held at all times, which means\n15,000 separate invoices if the average is $100 each. A com-
pany of this size would employ from 15 to 20 persons in\nall. Another company, doing approximately $30 million in\nreceivables financing annually, reports that it employs 150\npeople.

The organization of accounts receivable departments in\ncommercial banks varies mainly with the amount of business\nhandled and the method of operation followed. A bank having\nonly five or six such accounts handles these along with other\nlending activities and without any special departmentalization.\nSome one of the lending officers will exercise general super-
vision over the accounts, but detailed work is done in the regu-
lar discount department. Credit investigation on accounts is\nmade by the credit department, with possibly one outside man\nresponsible for conducting periodic audits, along with other\nduties.

In a few banks, however, a more formal and definite organ-
ization has been set up. The procedure in these cases follows\nalmost exactly that of the commercial finance company and\nis, in a few cases, incorporated in the instalment credit division.\nCommercial banks in general tend to make less detailed exam-
inations of their accounts than is characteristic of commercial\nfinance companies; thus the organization is correspondingly\nsimplified. Where the volume of loans made is high, say $1\nmillion or more per annum, the senior lending officer in charge\nhas often had finance company experience. The organization\nthat this officer develops—for the promotion of business, mak-
ing credit investigations, keeping records of loans on assigned\naccounts and repayments thereon, verifying assigned accounts\nand calculating interest charges—is necessarily similar to that\nfound in the commercial finance company. However, an ex-
ception to this general description of organization should be
noted. A few banks have adopted procedures that substantially reduce the amount of detail involved in handling receivables loans. In some cases this is done by placing a custodian in the office of the client and, since this makes it possible to shift the location of most of the detailed accounting work, the work performed in the banking office and, correspondingly, the number of persons employed by the bank to service these accounts, is greatly reduced. In other cases the bank takes an over-all assignment of all receivables and, not keeping individual records for trade debtors, has a much simpler organizational plan.

Methods of Acquiring Business

Factors and commercial finance companies, especially the latter, are more aggressive than commercial banks in seeking to expand their receivables business. This is not surprising, since the banks make loans on open accounts as part, and most frequently as an unimportant part, of a broader lending program while the other agencies are specialists in receivables financing. All the factors maintain promotional or new business departments and advertise their readiness to serve as factors, but the relatively heavy concentration of their activities in textiles results in their advertising mainly in specialized textile trade journals. Their industrial specialization, and the fact that nearly all factoring companies have either been established in the field for many years or represent mergers and consolidations of long-established concerns, have made them so well known, and the financing service they render is so conventional, that there is little need for promotional activities of an educational sort.

On the other hand, the commercial finance company is newer in the field and its methods of financing are less well known. Furthermore, its financing "plans" are by no means generally accepted by potential business borrowers and competing financing agencies. Consequently, the commercial finance company must go to considerable effort and expense to explain the character and relative cost of its facilities. Another reason for the more aggressive promotional activities of commercial
finance companies is the fact that their potential borrower market is more widely distributed industrially and calls, therefore, for more widespread advertising effort. One of the large companies, for example, uses spot radio news programs and national weekly news magazines as advertising media. However, most companies depend on field sales effort and the distribution of prepared booklets descriptive of their facilities; officers of these companies maintain that their new business comes to them primarily as a result of established contacts with clients and that their services are generally sought out by the borrowers. Such clients are frequently referred to finance companies by commercial banks that are unwilling to lend on the basis of the security offered.

Some of the commercial finance companies, particularly the small local companies, pay fees to individuals who bring acceptable accounts to their attention. This commission, usually earned by businessmen, lawyers and auditors who are said to have "sold" the accounts, is generally 10 percent of the gross charges to the borrower and continues as long as the account is handled by the finance company. It is analogous to the "finder's" fee paid by investment bankers to persons who bring them new "deals." It should be noted, however, that this practice is not followed by the larger commercial finance companies, and that, in any case, only a few accounts are acquired in this way.

Because of the relatively limited interest of banks in accounts receivable financing, their methods of acquiring such loans differ quite widely from those of finance companies and factors. Except for those few banks that have made special efforts to develop this field, accounts receivable financing is provided either as a convenience for a few customers or as a special device for liquidating or "working out" a loan that was made previously on some other basis. Banks whose activities in accounts receivable financing are of this sort are not at all interested in advertising these facilities. Indeed, some bank officers who have made loans under such circumstances are convinced that the accounts receivable loan is not a satisfactory
asset and that such lending is not a proper bank function. They argue that the borrower who can get funds only on an assignment of accounts receivable is not an acceptable commercial bank risk.

However, an increasing number of banks are sufficiently interested in accounts receivable loans to be making some effort to increase the scope of their activities. Few banks attempt to reach outside their natural trading areas to acquire loans of any type except through correspondent relationships. Commercial banks, therefore, face a markedly different promotional problem from that of the national or regional commercial finance company. A few banks have established sizable departments and carry on rather widespread advertising and field sales promotion activities, but these institutions are exceptional. One bank reports that it has acquired or sought loans by going over rejected loan applications and classifying the businesses in its locality according to relative credit standing, selecting for further study those with a rating considered too low to make them potential borrowers on an unsecured basis. It was found, of course, that most of these concerns would be ineligible as borrowers on any basis. But those that proved to have acceptable receivables in sufficient amount, and seemed able to use additional funds for taking trade purchase discounts, were approached by the bank to become borrowers on a receivables basis.

Finally, commercial bank officers are divided rather sharply as regards the continuing usefulness of accounts receivable financing for a particular firm. Some bank officers view the arrangement as primarily an interim method of financing; the officer expects the borrower within a limited time period either to improve to a point where funds can be advanced on some other basis or to get out of debt to the bank altogether. Of course, this view does not preclude a continued investment by the bank in receivable loans, in spite of an expected rapid turnover in borrowers. On the other hand, some bank officers feel that a business may properly borrow continuously on this basis so long as satisfactory receivables are generated. What-
ever the case, the attitudes of bank officers on questions of this sort are the primary considerations affecting the aggressiveness with which they seek to expand activities in this field of financing.

**Formulation of the Financing Contract**

Since receivables financing—whether it is notification (non-recourse) factoring of sales, or the purchase or assignment of receivables on a non-notification (recourse) basis—usually contemplates not a single loan but a continuing relationship between the parties involved, it is especially important that the conditions to be fulfilled by both parties be carefully and explicitly stated. These terms and conditions are usually stated in a formal contract or loan agreement the nature of which differs for different agencies, reflecting differences in the services offered. These differences are particularly marked when the contract or agreement between factor and client is contrasted with the usual non-notification contract.

**The Factoring Contract**

The contract under which the factor agrees to purchase accounts receivable usually takes the form of a letter to the client giving the details of the arrangement. Its main provisions are substantially uniform among different factoring companies, though there are differences in certain of the provisions.

First, the agreement provides that the factor is to purchase and assume credit risk on all the accounts receivable originated by the client. In view of the assumption of risk, it is essential to stipulate that all sales must be approved in writing by the factor’s credit department and that the invoices must be accepted without dispute by the client’s customer before the assumption of risk goes into effect. While it is the usual practice for the factor to insist on cashing all of the client’s sales, exceptions are found where, for example, a client operates a number of mills producing distinctly different lines of merchandise. Clearly, this practice is followed as a risk-limiting

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*The discussion of contractual arrangements is based on examinations of contract forms made available by several financing agencies and on conversations with their officers.*
device: it prevents the client from withholding sales to superior firms, assures the factor that the average risk undertaken will be lowered by the inclusion of these low-risk sales, and gives the factor's credit department the exclusive privilege of selecting risks. It also avoids the confusion that would arise in customer relations if some invoices were payable to the factor and some to the client. Related to this provision of the factoring contract are others requiring that the factor remit to the client, either upon the latter's request or upon the factor's own initiative, the net proceeds due the client on sales cashed; it is stated in the contract, however, that this does not affect the right of the factor to withhold sufficient funds to maintain a reserve against merchandise returns, claims, allowances, and other offset or "contra" items that may arise out of cashed sales and for which the factor is not responsible.

Second, the factor's contract provides for presentation to the client at stated intervals, usually monthly, of statements referred to as the "account of sales" and "account current." The account of sales is a summary of the sales of the client for any given month and is presented usually between the tenth and fifteenth of the following month. It gives sales cashed, net of returns and allowances and of the discounts allowable to customers, which represents the maximum amount the factor can expect to obtain from purchasers. Since funds are to be supplied to the client prior to the maturity of the sales, the invoices must be given a present value by discounting them, usually at the rate of 6 percent per annum, for a period extending to their average due date \(^4\) plus a ten-day period which provides for ordinary delays in customers' payments and clearance of checks. The client is also charged in the account of sales (by means of a deduction from the net value of the sales) with the factor's commission which is computed on net sales and is charged as of the fifteenth of the month, on the assumption that sales are distributed, and commissions earned,

\(^4\) The average due date is an average of the number of days each receivable has to run from the date on which the account is rendered to the invoice's maturity date, weighted by the amount of the invoice.
Accounts Receivable Financing

equally over the month. This whole calculation produces an amount which is credited to the client as of the date on which the account of sales is computed—usually the last day of the month.

The factor also renders monthly an account current, in which the client is credited with the resultant amount calculated in the account of sales, and in which the client is debited for funds withdrawn by him, remittances made on his behalf or funds supplied to him in excess of those available from purchases of sales, such as advances on merchandise and other items properly chargeable by the factor. Finally, in the account current the factor may charge his client an additional commission or fee of 1 percent of that amount of the returns and allowances to customers on the client’s account that exceeds 10 percent of the client’s sales. This fee is usually computed for a six-months’ period in order to avoid making charges for erratic short-period changes in the amount of returns and allowances. The account current bears interest, pro and con, generally at 6 percent per annum.

The third main provision of the factor’s contract states that the trade receivables are assigned to the factor “in absolute ownership,” which means that the assignment conveys to the factor a property interest in the merchandise sold and enables him to exercise all the rights of an unpaid seller, including rights of replevin, reclamation and stoppage in transit. Also, the contract states that the factor is not liable for any damages arising out of his refusal to approve shipment or delivery of goods.

Fourth, the contract establishes a procedure to be followed in handling customer invoices. These are prepared by the client and mailed out either by client or factor, under the factor’s return address. The invoice carries a notation that it has been sold to a stated factor and is payable to that factor at a stated address; this constitutes “notification.” The client is further required, by contract, to deliver to the factor duplicate invoices for each transaction and official bills of lading, shipping receipts or other satisfactory evidences of shipment or
delivery. Credit for sales cashed can be given only upon receipt of such documents. The obvious purpose of these precautions is that all accounts purchased should represent bona fide approved sales of merchandise actually shipped to the customer or to some delivery point designated by him.

Fifth, the contract usually contains a provision regarding the settlement of disputes between clients and their customers with respect to merchandise sold. The client is required to notify the factor immediately of any merchandise dispute and must try to settle or somehow adjust such differences, notifying the factor of the outcome. If the dispute remains unsettled at the maturing date of the invoice, the factor is permitted to charge the amount back to the client's account together with interest from the due date of the invoice and to deduct any expenses incurred by the factor. Also, the client agrees to give the factor immediate notice of any returned, rejected, or recovered merchandise and to repay the factor for the amount credited to his account that arose out of the original sale of these goods. Pending such payment, the factor actually owns the returned merchandise and reserves the right to dispose of it in order to settle his claim. Furthermore, the factor has right to, and ownership of, any accounts receivable arising from the subsequent sale of returned merchandise.

Sixth, if any remittances are received by the client these must, according to contract terms, be turned over to the factor in whatever form received. In this connection, the factor reserves the right to endorse the client's name on any and all remittances received by him if such endorsement is necessary to effect collection. The client is also required by contract to keep proper books of account regarding sales, claims and losses on merchandise and to give the factor access to these at all reasonable times.

Seventh, in some cases the factor's contract provides for advances of funds on the security of the client's merchandise. The factor, however, reserves the right to determine the amount and term of the advances, evaluate the collateral security and set the ratio of amount advanced to collateral
taken or to the client's sales volume. In connection with the advances the client agrees to take inventory twice a year, or more often, and agrees to do whatever the factor requests in the way of leasing warehouses, placing signs on merchandise, and filing notice of lien, and, of course, the client is bound not to dispose of merchandise on which the factor has a lien without permission from the latter. The factor maintains a continuing interest in the merchandise, including a lien on any accounts receivable or other proceeds arising out of their sale.

Other provisions of the factor's contract cover interest rates chargeable on merchandise advances, commissions to be levied on sales, the client's obligation to meet expenses incurred in disposing of merchandise taken as collateral for advances, insurance to be taken out by the client on pledged merchandise and, finally, the conditions upon which the contract is to be terminated.

Commercial Finance Company Non-Notification Contract
The contractual agreement between the non-notification financing company and its clients sets forth, first, that the finance company agrees to purchase accounts acceptable to it, to make a payment up to a certain percentage of the face value of the accounts, and to pay the remaining percentage upon the full collection of the account less any deduction and plus any overpayment by debtors. In turn, the client agrees to execute an assignment whereby the finance company acquires full and absolute title to the accounts, and all the rights of the client as regards the merchandise from the sale of which the account originated.

Second, the fee or charge to be levied for this service is stated and the conditions of its payment are indicated. The commercial finance companies usually quote their charge as a fraction of 1 percent, frequently 1/30 or 1/40 of 1 percent,

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6 In New York State the validity of the factor's lien depends on the completion of all these steps, as set forth in the Factor's Lien Law.

7 Accounts may be defined in the contract to include open accounts receivable, book debts, notes, acceptances, drafts, contracts or other choses in action. The discussion relates to a purchase and sale type of agreement, since this is used generally by commercial finance companies.
of the face value of accounts purchased for each day the account is held by the company.

Third, the agreement provides that no payment need be made by the financing agency on accounts purchased if the client violates any one of the provisions of the contract with regard to any outstanding account.

Fourth, since the commercial finance company does not assume the credit risk on purchased accounts, as does the factor, the contract states fully the terms of recourse on the client if acquired accounts go into default. This is effected by having the client agree to notify the finance company of any act indicating or amounting to business failure or suspension on the part of any customer indebted on accounts it has sold to the finance company and promptly to pay the finance company the amount of the relevant account. Further, the client agrees to pay to the finance company the amount of any account held by the latter which is not paid on or before its due date. Like the factor, the commercial finance company attempts to protect itself from losses on accounts purchased by requiring that the client pay the full amount of any account if the merchandise which it represents is returned or if any dispute arises concerning the sales transaction. Also, the commercial finance company requires that returned merchandise on its accounts be held by the client in trust for the finance company and be purchased by the client at original invoice value. The client is also required to guarantee that the accounts represent bona fide sales, that they are not subject to any set-off or counterclaim and to agree that the payment of the account is not contingent upon the fulfillment of any other contract or condition.

Fifth, commercial finance company contracts generally provide for the maintenance of a number of other conditions calculated to give protection to the finance company. Specifically, the client agrees (a) not to sell or assign any of its accounts to any party other than the finance company named without giving 30-day written notice of intention to do so, (b) to indicate on his sales ledger the accounts sold or assigned, (c) if requested, to open mail only in the presence of a repre-
sentative of the finance company, (d) to give the finance company the right to endorse the name of the client on any remittance received by it on the account of purchased receivables, where necessary to effect collection, (e) to give the finance company access to its books, records and customer correspondence at all reasonable times, and (f) to give the finance company the right to retain, as security against loss on accounts purchased, any account, property or moneys of the client assigned to or coming into the possession of the finance company, and to apply these assets or their proceeds to the liquidation of any outstanding overdue or disputed accounts.

Sixth, separate provisions of the contract authorize the client to make collections on accounts purchased by the finance company although this authority may be revoked by the latter at any time; the client is obligated to deliver immediately to the finance company all remittances received on accounts sold to the latter.

Seventh, the contract provides that if the client defaults in the performance of any provision of the contract, if he suspends business, if he files a petition for reorganization, or has such petition filed against him, if a receiver for his property is appointed, or if any act occurs amounting to a business failure by him, he is obligated to repurchase from the finance company all accounts held by the latter at the aggregate principal amount of these accounts plus any charges having accrued upon them. Should the client fail to repurchase the accounts in question, the finance company reserves the right to sell them and to reimburse itself out of the net proceeds of the sale. Finally, it is customary to provide that the contract shall terminate at the discretion of the finance company, if the client is in default, and at any other time at the discretion of either party, on 30-day notice.

*Commercial Bank Non-Notification Agreement*\(^7\)

Where the open accounts financing of the commercial bank is

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\(^7\)This section is devoted exclusively to non-notification agreements because it is very exceptional for a bank to engage in factoring on a non-recourse and notification basis. Also the discussion relates to the taking of assignments of
conducted along lines broadly similar to those followed by the commercial finance company, the loan agreements utilized by banks are necessarily similar to those of the finance companies. This section deals only with this customary type of loan agreement. It should be noted, however, that some banks have made efforts to simplify procedure and these use a different form of agreement.

While there are differences in the bank loan agreements in use, due mainly to the law of the state in which the bank operates, certain common features are clearly observable. Like the finance company arrangement the usual bank contract does not require that all of the client’s accounts be assigned, but rather that the client provide a listing of accounts to be assigned and transfer to the bank full title to these accounts and all rights in the merchandise out of the sale of which they were created.\(^8\)

The client must also guarantee that the assigned accounts represent \textit{bona fide} sales, that they are not subject to counter-claims, etc., and that the assignor has full right to effect their assignment. The bank generally requires a statement in the contract giving it power of attorney for the client to provide for receipt of funds from trade debtors, endorsement of receipts, settlement of claims, collection of accounts, etc.

The bank usually retains the right in its loan agreement to notify trade customers and to make direct collections, but in practice the borrower’s customers are not notified unless default seems imminent. The client is necessarily permitted under the loan agreement to make collections on accounts assigned.\(^8\)

The contract sometimes used in an attempt to reduce the steps of the receivables financing operation to a minimum requires that all the borrower’s receivables be assigned or a certain block of receivables. This fact eliminates many of the provisions of the usual contract that have to do with the handling of individual invoices. Of course, the shorter contract form still provides for the exercise by the lender of dominion over remittances, protects against the commingling of funds and contains the usual conditions relating to the terms upon which advances will be made on receivables. Even these conditions are not always incorporated in the contract, which is a simple agreement to assign, but may be left for supplementary agreements.

\(^8\)The contract sometimes used in an attempt to reduce the steps of the receivables financing operation to a minimum requires that all the borrower’s receivables be assigned or a certain block of receivables. This fact eliminates many of the provisions of the usual contract that have to do with the handling of individual invoices. Of course, the shorter contract form still provides for the exercise by the lender of dominion over remittances, protects against the commingling of funds and contains the usual conditions relating to the terms upon which advances will be made on receivables. Even these conditions are not always incorporated in the contract, which is a simple agreement to assign, but may be left for supplementary agreements.
This fact, namely, that under any non-notification arrangement the borrower must make collections, raises two important problems for the bank. There is the practical matter of assuring itself that collections are wholly and promptly turned over to the bank. Then there is the legal consideration that, in order to establish and maintain its lien on the assigned receivables, it must be clear that the borrower exercises no dominion over the funds collected and that they are not commingled with the borrower's own funds. The bank may attempt to take account of these conditions: (1) by providing in its contract or in supplementary agreements for the appointment of an agent or custodian in the office of the borrower, who, as a bonded employee of the lender, is responsible for the receipt and custody of funds paid on assigned accounts, or (2) by requiring that it receive, or at least have presented for inspection, the payments on assigned accounts in the identical form in which they are received from trade debtors, and that the receipts be deposited as general security in a special cash collateral account from which the bank alone is able to order disbursements.

In addition to the above elements of the loan agreement, it is generally the case that the borrower is required by contract to mark on his ledger the assigned account, perhaps to maintain a separate ledger of assigned accounts, to agree to a percentage to be advanced on receivables assigned and to the charges to be levied on funds advanced, and, finally, to agree to substitute new accounts acceptable to the bank for any accounts proving to be unacceptable as collateral security, or to make payments to the bank sufficient to cover their net face amount. The agreement must state, of course, the grounds upon which an assigned account may be judged as unacceptable security. These grounds usually include delinquency on the part of the trade debtor, a dispute over merchandise or its delivery, or acts indicating or amounting to business failure or suspen-

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6The exercise of dominion and the commingling of funds would occur, respectively, if they were diverted by the borrower to his own uses or deposited in his bank account.
sion by the trade debtor. If the borrower does not make the payment or substitution, the bank frequently can exercise its right, reserved in the loan agreement, to apply all or part of any deposit account of the borrower to the liquidation of the indebtedness.

Other provisions of the loan agreements generally characteristic of contracts, and of collateral loan agreements, include an acceleration clause concerning the bank's right to dispose of collateral in order to liquidate the borrower's obligation, a clause stating the lender's rights with respect to returned merchandise, and a statement of the conditions under which the agreement may be terminated. Clauses having to do with the borrower's obligation to take out credit insurance on accounts are sometimes included, but this is by no means a frequent loan agreement feature. Finally, the borrower is specifically obligated to furnish certain financial statements and to give the bank access to records and premises on reasonable conditions.

Credit Analysis and Standards of Commercial Finance Companies

In accounts receivable financing the credit problem consists of three main parts: making careful appraisals of initial applications, setting credit standards that provide adequate margins of safety on current advances and loans, and following carefully the client's operations while the financing arrangement is in force. Each of these aspects of the credit problem is present in both factoring and non-notification financing, although they may receive different emphasis in the two types of financing. Since the factor buys the accounts of clients without recourse, the quality of the open account is the primary concern, although the client's financial condition is also always a matter of interest to the factor. In non-notification financing the general moral and financial risk presented by the borrower is naturally important because the accounts are bought with recourse but, even so, it cannot be said that the primary interest is in the client's statement as contrasted with the
quality of the receivables assigned. The client's financial condition may be of primary concern to those commercial banks taking accounts on assignment as secondary rather than as primary security. In finance company operations the emphasis is on the quality of the receivables acquired and the moral risk involved. This is purely a matter of emphasis, however, for each financing agency necessarily takes account of all aspects of the credit risk.

A review of the more important credit appraisal techniques and standards of receivables financing will show that they are very different, in many ways, from those characteristic of other types of business financing. Furthermore, the methods followed vary considerably among the different agencies. Since a detailed statement of these differences would be extremely lengthy it has been decided to devote most attention to the methods broadly characteristic of commercial finance companies and to follow this with a shorter statement of the operating methods of commercial banks. In order that as many as possible of the steps in the credit appraisal process may be brought into the discussion, the following statement of commercial finance company practice is prepared on the assumptions that the investigation relates to an application involving a high degree of risk, that it is to be as thorough as the most experienced agency can make it, that the financing agency has had no previous experience with the applicant and that accounts are to be taken on assignment without notification and with recourse on the client.

Appraising the Client

A complete investigation of an application for receivables financing is a costly procedure and it is therefore customary to make a preliminary sifting of requests. To this end the applicant is requested to submit financial statements covering a period of three or more years. Although credit officers were questioned carefully on this matter, there seem to be no generally accepted minimum standards that these statements must meet as regards financial ratios. On the contrary, there is rela-
tively little emphasis placed on financial ratios per se. Risks may be accepted where financial statements show unfavorable ratios, if there are underlying circumstances suggesting improvement. It is by no means unusual for accepted clients to show current ratios of 1 to 1 or 1½ to 1, or even net worth deficits. In some instances applications are accepted from concerns in receivership although such cases are not frequent and carry special conditions such as subordination of other creditor claims, and possibly the assignment of inventory as well as receivables. All of this suggests that financial ratios are considered of secondary importance, as might be expected since specific collateral is pledged against the loan. In this respect, although not in others, receivables lending is closely analogous to mortgage financing, for in both fields the credit analysis is focused more on the collateral than on the financial position of the client. The considerations that seem to weigh heavily in receivables financing are (1) the moral risk involved, (2) the quality of the concerns to which the applicant sells goods, (3) the general competitive position of the applicant, (4) the amount of funds that can be kept at work in the account and (5) the general financial position of the applicant. If this preliminary analysis shows that the applicant has acceptable receivables to be pledged, that a valid lien on the receivables can be obtained, that there is a reasonable amount of net worth in the business, that the advances will enable the client to take discounts on purchases to an extent that will make the financing beneficial and that the applicant will utilize sufficient funds to make the arrangement profitable for the lender,¹⁰ the more comprehensive credit analysis is initiated.

The detailed examination of the applicant is generally conducted by the financing agency’s own field auditing staff. It is customary, first, to submit the receivables to careful analysis. The investigator’s report shows the volume of sales made

¹⁰There are differences of opinion on this point, but it is unlikely that an account would be taken that could not employ $5,000 or more as an average loan balance; some companies feel that they must have at least $25,000 in use continuously in order to make the loan profitable to them.
on open account and provides a classification or "aging" of outstanding accounts receivable into those not yet due ("current") and those overdue. Overdue accounts are classified by the degree of their delinquency, for example, 1–30 days, 31–60 days, and over 60 days past due. Similarly, the report provides an aging of notes receivable, including separate study of any instalment receivables or lien instruments held by the applicant against which advances may be sought or which may be assigned as additional security. An effort is made to learn the reason for the creation of notes receivable and to determine whether they have been renewed; in many cases these notes grow out of long overdue open accounts, a condition that affects considerably their acceptability as collateral.

Another phase of the investigation has to do with the applicant's sales record. The audit shows annual gross sales for two or three years at least, the amounts collected in each of these years, the amounts allowed customers for trade and cash discounts, the total allowances for returns of merchandise and other credits and, finally, the amounts charged off as losses. These are frequently difficult analyses to make but they are essential for the determination of the appropriate percentage of the face value of receivables to be advanced. If the sum of the items deductible from gross sales should represent, on the average, 5 percent of the gross amount of sales, then the lender might decide to place the advance at 75 percent, allowing the additional 20 percent as a margin to cover the difference between the client's costs and the price of goods sold and to absorb losses not otherwise allowed for.

The examination usually includes a determination of the amount and condition of the inventory, the physical conditions under which it is being held, the propriety of the valuation methods used by the applicant, and a complete verification and valuation of the inventory. These steps are taken even if it is not anticipated that advances are to be made on inventory, and are especially important if such advances are to be made. Further, the analysis states the cash position of the firm and provides a reconciliation of cash with bank deposit
Policies and Procedures

statements; a careful study of cash receipts and disbursements is made in order to uncover any unusual entrepreneurial withdrawals or other payments.

The general audit also evaluates fixed assets and states the applicant's practice with respect to reserves for depreciation, but these facts are not reported in detail because they are not of immediate relevance to the credit problems presented by accounts receivable financing. A reasonably accurate appraisal of the fixed assets and of their general physical condition is required, mainly for the light it throws on the technical adequacy of the concern as a productive enterprise.

Among the liabilities, particular attention is given to the condition of accounts and notes payable and to the maturity schedules of the applicant's debts. A detailed analysis of the applicant's outstanding payables gives a breakdown according to creditor, date of origination, maturity date, amount and interest rate. Notes payable to trade creditors are analyzed separately since these may have arisen out of the applicant's inability to meet open accounts at maturity. Trade accounts payable are "aged" in an analysis comparable to that prepared for accounts receivable, and a special listing made of any particularly large or otherwise unusual items. The company must also state the terms on which it makes purchases on open account, for this can be used to determine whether the applicant can profitably borrow against its accounts receivable; that is, it may be that the cost of receivables financing is covered or even exceeded by the savings effected by the concern's availing itself of cash discounts on purchases. The audit also gives a schedule of other liabilities, including bonds and mortgages, taxes and other expenses payable, and any contingent liabilities to which the applicant is exposed. Finally, the report shows the capital and surplus of the applicant and the principal adjustments in the surplus account made in recent years.

The applicant concern is customarily requested to provide a detailed profit and loss statement covering a period of at least the last three years, and special note is taken of any
aspects of the concern’s record that seem unusual in the way of expenditures or receipts, taking account of the amount of business done. Credit officials of commercial finance companies emphasize the importance of the income statement for this enables them to make a judgment concerning the general efficiency of the concern, the probable causes of any loss, the amount of financing probably required, and the general prospects for the applicant as a business enterprise. In this connection it is well to note that the financial statements are particularly meaningful, and their analysis relatively easy, if the applicant is engaged in a line of business that is well known to the credit analyst and one to which empirically established standards can be applied.

Aside from this analysis of the prospective borrower’s financial position, it is sometimes necessary to examine carefully the more important non-financial aspects of the company’s operations. Thus cost studies may be made as well as analyses of the products sold and the distribution methods and policies followed. Often the applicant is required to engage the services of an outside agency to make the required study; some commercial finance companies, as pointed out above, have special personnel for such purposes.

Finally, it is important to emphasize the nearly universal agreement that the main risk taken in non-notification receivables financing is the risk of fraud. In the first place, the applicant is usually much in need of funds. In the second place, the non-notification scheme, since it necessitates borrower collections on collateral, provides opportunities for taking advantage of the lending institutions. The principal varieties of fraud are: assignment of fictitious accounts (perhaps accompanied by forged shipping documents); duplicate or triplicate assignment of the same accounts; diversion of collections to the client’s own uses (perhaps accompanied by large and unusual officer withdrawals); failure to report regularly and accurately the amounts credited to customers for returned merchandise, trade and cash allowances and discounts, offset or contra items (these making for overstatements of the value
Policies and Procedures

of receivables); finally, submitting false financial statements. This is by no means an exhaustive list of ways in which fraud is perpetrated in this business but it serves to illustrate why the financing agencies make careful investigations of the honesty of the principals involved.

Appraising the Collateral Security

The next step in the accounts receivable credit analysis focuses on the quality of the applicant's receivables. For analysis of the customers of the applicant (that is, of the collateral security available), the investigator obtains a credit rating from some one or more of the credit-rating agencies. If the average size of the receivables is very small it may be feasible to examine only into the group experience but usually individual ratings are assigned. The customers can then be classified into categories of acceptable ("rated") and non-acceptable ("off-rated") accounts according to the credit standards established by the financing agency. Not every agency sets up the same standards in determining the acceptability of a given group of accounts receivable, but the basis of the standard, namely, the mercantile credit rating, is usually the same.11 Frequently, there will be some concerns among the applicant's clients that are not listed in the credit agency rating books and some that are listed but for which ratings are not available. Both of these groups may be classed as off-rated but, since they are likely to be small in individual amount, they may also be classified as acceptable. In general, the financing

11 One division of credit ratings that is used frequently includes all concerns with a Dun & Bradstreet "limited" general credit rating (regardless of estimated pecuniary strength), and all with a "fair" general credit rating (excluding concerns whose estimated pecuniary strength is placed at G, H or J) in the off-rated classification. All other concerns would be considered as rated and acceptable. This represents, it would seem, a fairly conservative classification of mercantile credit risks. Other agencies classify only those concerns with a limited general credit rating as off-rated accounts. A still more liberal credit standard would be to include as rated accounts even those concerns with the lowest (limited) general credit rating provided they have an estimated pecuniary strength of $2,000 or less; this standard would be justified on the ground that such accounts would necessarily be very small and that the loss on them would be both moderate and forecastable provided a sufficient volume of them can be obtained.
agency takes all the rated accounts and accepts only a certain percentage of the off-rated accounts, although the percentage of off-rated to rated accounts is kept flexible and is altered to meet the special circumstances of various applicants.\textsuperscript{12}

In addition to determining the acceptability of receivables, the average size of accounts is calculated in order to determine the amount of detailed record keeping that will be required. The geographical distribution of sales is determined and any tendency for sales to be concentrated with a few buyers is noted. Where some accounts are particularly large the preliminary examination may call for a special mercantile credit report on the buyer.

Another measure of the quality of receivables is their collection period. This can be computed by relating outstanding accounts and notes receivable, over a period of time, to data on sales and collections. The collection period is used in setting a maturity for loans secured by receivables; data on sales are used to calculate the volume of financing that the borrower will require. Finally, in examining receivables the investigator determines the practice of the concern regarding shipments on consignment or approval and attempts to discover any offset or contra accounts that may affect the collectible face of the assigned receivables. While these may not be important in most situations, occasionally a borrower sells merchandise to a company that supplies it with materials on a contra account basis.

The preliminary examination of an application also requires that receivables be verified to trade debtors. This is ordinarily accomplished through a subsidiary audit company, operated by the financing agency under a name and address that will not disclose the fact of assignment. A brief note is mailed to the debtor stating that an audit of the books of the creditor is being conducted and asking whether the account is a valid one, pointing out that the verification is not a request for

\textsuperscript{12} Even though no funds are advanced against them, the lender may require that “unacceptable” accounts be assigned. Aside from adding some collateral value to the loan this has the important merit of simplifying the accounting procedures of both borrower and lender.
payment. The investigation may verify only the relatively large accounts and a random selection of others, but it is not unusual for every account to be verified at the time of the first examination.

Controlling an Active Loan

Once an application has been examined and approved and the client submits the first group of accounts for sale or assignment, there begins a continuous credit appraisal that does not cease until the arrangement is finally ended. This continuing credit appraisal has to do with two features of the client's affairs: first, the quality of the accounts assigned or sold and, second, the general status of the client's operations.

Each batch of submitted accounts is listed on a prepared "schedule of accounts." The schedule gives the date each invoice was created, its maturity date, its amount (gross and net) and the name and address or coding of the debtor. Finally, a column is provided for entering credit ratings for each individual debtor. At the same time that the schedule is being rated, the lending agency may initiate verifications of a sample of the invoices or accounts. Some financing agencies prefer to make sample verifications at frequent intervals rather than at the time a schedule of accounts is received (for example, a verification every 30 days of a certain percentage of the accounts held as collateral on outstanding loan balances).

Some financing agencies require that evidences of shipment be presented along with the assigned invoices. The financing agency examines the shipping documents and may actually verify them for a new client. Evidences of shipment are not required when the lender takes an assignment of a debtor's total account rather than of individual invoices, as is frequently the case in commercial bank practice.

Individual accounts are posted on ledger cards prepared for each trade debtor and grouped under the name of the client assigning them. These cards give the name and address of the debtor, his credit rating, and list all invoices purchased
and remittances received, together with all credits and allowances. Also, the card provides a record of verifications and shows delinquency, if any. Posting to the trade debtor's card reveals the present status of that account as regards the net value of collateral held and shows any special controls that have been established for the account. For example, as a credit standard the financing agency may set a maximum credit on certain accounts or may require that the account have no more than one invoice outstanding at a time. If there is a delinquency condition this will be disclosed in the posting, providing information that would not be revealed in even the most recent mercantile credit report. On the basis of this careful checking, which must be repeated every time the client submits a schedule of accounts, the financing agency decides what accounts are to be purchased from any particular schedule.

Periodic checks are made of all assigned accounts in order to keep current the classification of accounts by delinquencies. The principal means for checking this aspect of a client's account is the field audit. Every thirty days, or at some other interval determined by the financing agency's judgment as to the status of the account, an auditor makes a surprise examination of the client's records. This means, primarily, that the examiner must compare his ledger account for each trade customer with the ledger maintained by the client. This comparison may reveal credit allowances, contra items or unreported receipts. Where discrepancies do arise the auditor notes them in his report and tries to obtain not only an adequate explanation, but some correction of the situation. At this time the auditor also examines the cash book and journal entries to determine whether remittances have been diverted, or credits allowed, that do not appear on the ledger sheets. At these 30-day intervals all receivables and accounts and notes payable may be aged and compared with those shown in previous audits.

An essential function of the regular audit is to see that the receivables are properly stamped or designated in the client's office records as having been sold or assigned, and that all
recordations of assignments have been made where necessary. Frequently, all or part of the client's accounts are verified at the time of the audit rather than at the time accounts are purchased or taken under assignment. If the client is obtaining funds on inventory, as well as on receivables, the periodic audit affords an opportunity for an examination of the value and condition of this collateral. Finally, the audit may include an examination of the principal current assets and liabilities of the client, of returns and allowances related to sales, and a listing of accounts that seem large—for example, those that constitute more than 10 percent of the total credit line established for the client or are otherwise deserving of special mention.

The examination of the schedules of accounts as received and the surprise audits provide a running or continuing control over collateral security. In addition, these controls keep the financing agency continuously informed as to the client's business habits and financial condition. In order to systematize and simplify the use of such information, some companies maintain rather elaborate records on each client. First, there is a credit file on each client containing all financial statements, copies of auditor's reports, and all memoranda and correspondence dealing with the account. Second, a control sheet is maintained on which daily entries are made showing (a) amount of collateral held, (b) client's debit balance, (c) client's reserve, (d) daily totals of assignments accepted, (e) daily totals of cash advances, (f) daily totals of remittances received, (g) daily totals of returns, credits, and contra or offset items, (h) cash payments to the client out of equity, (i) totals of delinquent accounts repurchased or taken up by the client. These daily totals are then cumulated and a monthly report prepared.

Third, a special record may be prepared for each client showing the monthly reports. From this it is possible to compute ratios of returns to sales, ratios of cash and trade discounts taken by customers to sales, ratios of delinquent accounts repurchased to total accounts assigned, etc. On the
basis of these records the credit officer can detect trends that may require a decrease or permit an increase in the percentage advanced on accounts, and may discover other changes in the client's financial position that are important to an understanding of the underlying credit situation.

**Credit Analysis and Standards of Commercial Banks**

The operating methods and practices of commercial banks in accounts receivable financing are sometimes patterned closely after those of commercial finance companies. Some banks have employed credit officers with finance company experience to organize and operate their receivables loan departments. It will not be necessary to describe the operating policies of such banks beyond saying that the foregoing description of finance company practice is also broadly applicable to them. However, not many banks have a volume of receivables financing which they consider sufficiently large to warrant their adopting methods similar to those of the commercial finance company; other banks feel that a shorter method of appraisal is sufficient on the ground that the quality of their borrowers justifies the exercise of somewhat less in the way of precautionary measures. Still another group of banks is composed of those that have made a more determined effort to obtain a substantial volume of this type of business and, while they have developed more formalized and routine methods of operation, have attempted to cut the operating details to a minimum in the interests of simplicity and economy. In the following discussion we shall limit ourselves to a description of the latter and to the main points of difference between their operating procedures and those of commercial finance companies.

With regard to the appraisal of the general financial risk in receivables financing, there is little difference between the practices of commercial finance companies and commercial banks. Commercial banks are somewhat more inclined, perhaps, to lay principal emphasis on the general financial position of the applicant rather than on the collateral security
offered. With the bank credit officer, as with others, the moral hazard presented by the applicant is of primary importance and considerable care is taken to investigate this aspect of the applicant's record.

It is in the appraisal of the collateral security and in the continuing supervision of the loan account that we find the most marked differences between agencies. Some banks appraise their accounts and supervise individual assignments of accounts in just the same manner as that described above for commercial finance companies; at the other extreme, some banks simply study the general paying record of the applicant's customers and select the better accounts for assignment; loans continue to be made on these accounts so long as subsequent developments are reasonably favorable. Between these two extremes are other methods that are of interest because they incorporate many of the features of the more complete method but eliminate certain of its detailed operations.

A general feature of these shorter operating techniques is that the bank takes an assignment of all or a certain block of the borrower's accounts receivable rather than of a list of selected accounts. Where all of the receivables are assigned, a technique may be used which eliminates appraisals of accounts every time an assignment is made. This is done by determining, at intervals generally not greater than two months, what proportion of the borrower's total accounts are acceptable as loan security and what percentage is to be advanced on acceptable collateral. Once these proportions have been set, they can be applied to the borrower's accounts when assigned, until another appraisal is made. One such method is to express the amount of the unacceptable accounts of the borrower as a dollar amount, say $10,000 out of a total of $60,000. If the bank decides, on the basis of its investigation, that it will make an 80 percent advance on acceptable receivables, the borrower's receivables will have a maximum loan value of $40,000. This loan value is established at the time of the initial appraisal of the client and revised subsequently, at bi-monthly intervals or more frequently, if the facts warrant
it. In the interval, the established ratios are applied to each assignment as made.

Another method takes special account of the size of the accounts receivable in deciding which are acceptable. While this method can be used where all receivables are assigned it is especially suitable for the assignment of blocks of accounts. Obviously, in these cases the block of receivables assigned is not composed of selected accounts but is a certain section of the borrower's ledger, for example, all accounts numbered 1 to 100. All accounts below a certain amount, depending on the character of the client's business, are considered acceptable at their full face amount (unless seriously delinquent) regardless of the general credit rating of the trade customer. Accounts of larger amount, particularly those over $1,000, are given special attention. Each of these accounts is listed and the maximum trade credit extended to the trade customer determined by an examination of records going back over several years. This maximum is referred to as a "high credit" and is compared with the trade debtor's net worth; the amount of the credit considered acceptable is limited to the high credit or to 10 percent of the trade debtor's net worth, whichever is smaller. This comparison of acceptable to high credits may be made for all accounts over a certain size having a "high" or "good" mercantile credit rating; the full amount of accounts of this size representing sales to concerns with only "fair" or "limited" credit rating may be considered unacceptable. After these calculations have been made, summations of acceptable credits and high credits are made and the proportion of one to the other determined. The ratio so derived, say 80 percent, can then be applied to each subsequent assignment of a block of receivables to determine their gross loan value. The net loan value is set by deducting an additional percentage determined on the basis of studies of returns, allowances, trade and cash discounts, normal bad debt losses and profit margins. This same method is sometimes followed with the difference that in determining the ratio of acceptable to total receivables principal emphasis is placed on the paying record of trade debtors.
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That is, all current accounts may be considered acceptable and varying proportions of past due accounts, depending primarily on the extent of their delinquency. In any case these ratios can be adjusted when further general appraisals are made of the client’s business.

There are other ways in which detail is reduced in taking an assignment of all, or of a certain block, of the client’s accounts rather than of a specific listing of accounts. The effect of this procedure is to reduce considerably the amount of record keeping performed in the banking office. Where all accounts are taken, there is no question about which remittances are to be sent to the bank and the bank does not keep separate ledger cards for each of the trade debtors whose accounts payable it has acquired as collateral for the loan balance. The full amount of the flow of collections is applied directly to the loan balance or placed in a collateral deposit account. Obviously, if the loan equals only a small part of the total receivables outstanding (because the borrower had use for only this amount but gave an assignment of the full amount of his receivables) then the loan is paid out in a period much shorter than the average maturity of accounts. However, it is usually the case that the borrower is receiving the full loan value of all his accounts under this plan. The bank may keep credit cards for the principal trade debtors of its borrower, but this is for credit references and not for a continuous posting of assignments, remittances, etc. During the period between audits, any remittances from the client that seem large in relation to what the bank considers a reasonable amount of trade credit for the debtor in question are checked against these cards. Another method of reducing the amount of record keeping done in the bank is to use a custodian in the office of the client to see that remittances on assigned accounts are turned over to the bank as received and to perform other duties in supervising the client’s account.

A third feature of some of these shorter methods is that they generally provide that the borrower have only one note
outstanding at a time. When the client wishes to make a new assignment to acquire additional funds, another assignment is taken of all, or of a certain block, of the client’s accounts. The loan value of the assigned accounts is determined and a new note is prepared for the unpaid balance on the old note and the amount of new funds advanced. This reduces greatly the amount of detail involved where the bank holds more than one note and has to match remittances with the particular note secured by the account on which the remittance has been received.

Other Risk-Limiting Procedures

Aside from appraisals of the client and the collateral security, there are other procedures that are adopted by the financing agency to limit its risk exposure and to assure itself of some stability even in the face of losses. First, the financing agency may strive for a diversification of risks, second, it may establish special reserves against losses on its receivables financing. With regard to diversification there are wide differences among the different types of financing agencies. Commercial banks seem to have paid little attention to diversification of receivables loans, doubtless because they represent only a very small part of the total loan portfolio. This is not the case with the commercial finance companies; their diversification consists partly in a wide range of types of clients and in a combination of accounts receivable financing with the extension of credit on the security of instalment contracts arising out of sales of consumer and income-producing equipment and other types of assets.

Some evidence is available to show the amount and kind of reserves held by factors against assets acquired in the course of business. However, the practices of factoring companies in preparing financial statements vary so widely that it is not possible to consolidate enough separate statements to cover any appreciable share of the total business. In general, the factoring companies hold separate reserves designated as "reserves for losses and contingencies" and "reserves for discounts"
and, in some cases, a special reserve against losses on merchandise advances. In addition, the factoring company carries a liability item called "balances due to clients," although this is not properly viewed as a reserve account. These credit balances represent the proceeds of purchased receivables that have not been withdrawn by the clients. As has been indicated above, the factor customarily requires that the client maintain a credit balance to take account of merchandise returns, customer allowances, etc., that arise on purchased receivables but usually the amount held in the credit balance is much more than would be necessary to meet this requirement, the excess representing funds that the client has not wished to withdraw.

Data on the two factoring companies reporting these items in detail are given in Table 15 showing that reserves for losses and contingencies were at a low of .9 percent of notes and accounts receivable held at the end of 1937 and at a high of 1.4 percent at the end of 1938 and 1939. It is understood that 2 percent of outstandings, or less, is considered the general practice with respect to reserves. Separate reserves, of course, are held against merchandise advances and these may vary quite widely. In 1938 the reserve for discount was the same as the reserve for losses, in the other years slightly greater. However, this is not a loss reserve but rather an account set up to absorb the reduction in the gross face value of receivables for discounts allowable to customers according to terms of sale. Other data not presented here show that the relation of reserves for losses and contingencies and reserves for discounts to accounts receivable held by factoring companies have remained substantially stable since 1930 and that all concerns for which data are available followed approximately the same practice with respect to these reserves.

It will be noted that the credit balances of clients were quite substantial over the period studied. From 1937 to 1941, inclusive, these varied from 24 to 31 percent of outstanding receivables for the two factoring companies covered, indicating the considerable extent to which factors' clients fail to
<table>
<thead>
<tr>
<th>Year</th>
<th>Accounts and Notes Receivable</th>
<th>Reserve for Losses and Contingencies</th>
<th>Due to Manufacturers and Other Clients&lt;sup&gt;b&lt;/sup&gt;</th>
<th>Reserve for Discount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Amount</td>
<td>In Percent of Receivables</td>
<td>Amount</td>
<td>In Percent of Receivables</td>
</tr>
<tr>
<td>1941</td>
<td>$22,025,760</td>
<td>1.0%</td>
<td>$6,843,778</td>
<td>31.1%</td>
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<tr>
<td>1940</td>
<td>$16,499,338</td>
<td>1.2</td>
<td>4,584,012</td>
<td>27.5</td>
</tr>
<tr>
<td>1939</td>
<td>17,212,455</td>
<td>1.4</td>
<td>4,413,443</td>
<td>25.6</td>
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<tr>
<td>1938</td>
<td>18,273,218</td>
<td>1.4</td>
<td>5,354,195</td>
<td>29.3</td>
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<tr>
<td>1937</td>
<td>16,480,160</td>
<td>.9</td>
<td>4,000,695</td>
<td>24.3</td>
</tr>
</tbody>
</table>

<sup>a</sup> Data obtained from 10K statements submitted to the Securities and Exchange Commission, and from the National Credit Office, Inc.

<sup>b</sup> Includes credit balances of clients.
withdraw the full amount of their proceeds from sales of accounts.

The loss reserve practice of commercial finance companies is more difficult to state because of the diversified financing in which they engage. The fact that they, like commercial banks, advance only a certain percentage of the estimated collectible face value of the accounts purchased, usually 70 to 80 percent, provides a margin of collateral but this is not a reserve in the strict sense. It has been shown in Chapter 3 that the "reserve for losses" set up by these companies, plus clients' equities, varied at the end of 1941, for six different companies, from 9 percent to 25 percent of total assets. Commercial banks, on the other hand, make such small amounts of these loans that they depend on their general reserves for losses and contingencies to absorb losses arising from their accounts receivable loans.