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Summary of Findings

THE SHORT-TERM CREDIT NEEDS of an increasing number of businesses are now being satisfied through the sale or assignment of accounts receivable. This widening use of receivables financing is the more notable in that it has occurred without any organized encouragement from public or private agencies, while trade acceptance financing, which did have assistance and encouragement, has failed to assume important proportions. The procedure of accounts receivable financing is not a new one, but it has only recently begun to attract attention. The growing participation of commercial banks is one of the chief reasons for the increased interest in this method of financing. In addition, receivables financing represents a technique which, while frequently used by companies in a strong credit position, is particularly valuable in extending credits to concerns that might otherwise find it difficult or impossible to obtain adequate financing. Recent discussions of the availability of credit to small business have, therefore, called special attention to receivables financing.

Accounts receivable financing may be defined as a continuing arrangement through which a financing agency makes funds available to a business concern by purchasing its invoices or accounts receivable over a period of time, or by making advances or loans, taking one or a series of assignments of accounts as primary collateral security. These arrangements are of two general types. The first—known as "factoring"—is conducted by factoring companies and involves the purchase by the factor of a concern's accounts receivable, generally without recourse on the vendor for any credit loss on accounts and with notice given to trade customers that their accounts

have been purchased. The second—known as "non-notification financing"—is conducted mainly by commercial finance companies and commercial banks and involves the purchase of receivables or their assignment as collateral security for a loan, without notice to the trade customer and without the assumption by the financing agency of the risk of credit loss on receivables sold or assigned.

The present study deals with both of these arrangements, although two principal limitations must be noted. First, it deals with the financing of *open* as contrasted with *instalment* receivables and, second, it is concerned with receivables financing undertaken on its own merits as contrasted with assignments of receivables taken as additional security for an advance of funds in which primary reliance is placed on some other type of security device, or as an emergency measure adopted to "work out" a loan made previously on some other basis.

Factoring was the earliest form of accounts receivable financing, developing as early as the fourteenth century, when the factor was prominent in financing foreign trade. With the growth of commerce and industry the factor assumed greater importance and widened functions, purchasing accounts receivable mainly from textile manufacturing concerns (thus enabling clients to extend trade credit and at the same time to receive cash at time of sale), performing a credit selection and collection service, assuming credit risks on trade receivables, acting as selling agent and providing advice on styling and merchandising. In recent years, however, the merchandising functions have been dropped by most factoring companies.

In view of the fact that non-notification financing has not provided, on any systematic basis, for the merchandising and other management counseling functions formerly characteristic of factoring its growth must be explained mainly in terms of a need for funds. However, commercial finance companies now offer certain supplementary services, such as general management advice.

Demand for non-notification financing comes from two types of concerns, those unable to obtain sufficient funds on any other basis, and those that find the terms of receivables-borrowing most nearly suited to their needs. It is inaccurate to say that the demand for non-notification financing comes exclusively from concerns of relatively low credit standing, although the erosion of working capital caused by operating losses during the early thirties led an increasing number of such concerns to seek this method of obtaining funds.

Commercial banks have turned to non-notification financing under pressure of a situation in which their lending capacity has been only partially used and returns on bank assets have declined sharply. The successful operation of finance companies and factors has also stimulated interest in such financing on the part of commercial banks. On the other hand, the legal conditions under which accounts receivable financing must be conducted by commercial banks have served, in a number of states, to retard their activities. From the point of view of the banks, the primary legal problem is that of obtaining a valid assignment of the receivables without giving notice to trade customers. In some states this is impossible; in others it involves procedures that make the operation unattractive. There are many states, however, in which the legal conditions are favorable and, in these states particularly, commercial banks are showing a rapidly growing interest in receivables financing. Furthermore, there is a tendency for more states to pass legislation to simplify the financing procedure.

The relative quantitative importance of the principal receivables financing agencies is indicated by the following estimates. The volume of sales factored by factoring companies was close to $800 million in 1940, and $1,150 million in 1941; commercial finance companies, including both large local and regional companies as well as the more numerous small local companies, financed approximately $411 million in receivables in 1940, $536 million in 1941; commercial banks financed open accounts receivable of approximately

$826 million in 1940, $952 million in 1941. This places the total 1940 volume of accounts receivable financed at approximately $2 billion and the 1941 volume at about $2.6 billion.

Factoring is conducted almost exclusively in New York City, by companies many of which were founded in the first decade of the nineteenth century, or are derivatives of companies founded during that period. The business is concentrated in a small number of relatively large companies as the result of a widespread consolidation movement around 1930. The assets of these companies, several of which conduct an annual volume of about $125 million, are primarily accounts receivable acquired in factoring operations. A relatively small proportion of their assets is in advances made on merchandise held by their clients, an item that has tended to decrease since the early twenties. The asset structure of commercial finance companies is more diversified than that of factors, their receivables being acquired in various kinds of financing —notification and non-notification receivables financing, consumer instalment financing, commercial and industrial equipment financing, rediscounting for other finance companies and, to a limited extent, cash lending to consumers and business enterprises. Diversification is particularly characteristic of the larger finance companies.

Both factors and commercial finance companies obtain their funds mainly from invested capital and short-term bank borrowings. Net worth tends, in both types of companies, to be about 20 to 35 percent of total assets, and year-end notes payable amount to between 40 and 50 percent of total assets. Other liabilities are mainly reserve accounts. In general, the ratio of debt to equity tends to be higher for the larger than for the smaller companies.

The results of a questionnaire survey conducted in the summer of 1941 showed that about one out of every four commercial banks was active in accounts receivable financing. Participation in this type of financing is more characteristic of the larger banks, of those located in the larger centers of population and of those banks located in regions primarily

industrial and commercial in nature. But while accounts receivable financing is conducted by many commercial banks, it is of minor quantitative importance, amounting to only 1 percent of the total loans and discounts of the reporting banks. In general, these loans represent a smaller proportion of the loans of the larger banks than of the smaller institutions.

Very little factual information is available on the number and type of clients served by factoring companies. They are described as manufacturers, converters and selling agents; the receivables purchased from them are mostly obligations of manufacturers, wholesalers and retail outlets. While no statistical information is available on the kinds of commodities produced by manufacturers using a factor's services, it is known that, in general, this type of financing has been confined almost exclusively to the cotton, silk, rayon, and woolen and worsted trades of the textile industry. Recently, however, there has been a tendency for factors to serve manufacturers outside the textile field and this movement is steadily developing. The number of clients served by individual factors varies all the way from 100 to 500. The amount of receivables sold to the factor annually may range from $200 thousand to $2 million for individual clients, with some clients orginating even larger amounts.

Special schedules of information supplied by 24 commercial banks and 2 commercial finance companies reveal something of the market served by non-notification agencies. Of the loan balances reported, 70 percent were for manufacturing concerns, 14 percent for wholesalers and 11 percent for retailers. In the manufacturing group there was a very wide distribution of clients among the various types of manufacturers, indicating that currently non-notification financing is much more widely diversified throughout industry than is factoring.

Most of the clients of factoring companies are concerns with total assets of between $100 thousand and $3 million. The more complete information on non-notification financing agencies shows that smaller concerns constitute a large fraction

of all clients but are much less important, as regards volume of business originated, than the larger though less numerous clients. Thus, of 354 non-notification clients reported, 57 had total assets of less than $25,000 but originated less than 2 percent of all balances reported; concerns with total assets of less than $200,000 accounted for 63 percent of all clients but only 15 percent of all loan balances reported.

There is no direct statistical evidence concerning the financial position of the concerns obtaining funds on a non-notification financing basis. It is known, however, that the ratio of equity to total assets for these companies is somewhat lower than the ratio for all concerns in the United States of roughly the same size. Also, it is known that concerns borrowing on a non-notification basis do not generally continue to finance themselves in this manner for long periods; apparently many of them either strengthen themselves to the point where they are able to shift to some other borrowing arrangement, or else they go out of business. Finally, while non-notification clients may obtain additional funds on another borrowing basis, it is more frequently the case that these concerns depend exclusively on accounts receivable financing. Of 358 reported clients, 173 received funds on no other basis than through the sale or assignment of their receivables.

Commercial finance companies and commercial banks usually set a maximum limit to the accounts receivable that they are willing to hold for individual clients at any one time, because in non-notification financing the potential recourse against the client is related to the amount of his capital, the percentage advanced on receivables and the diversification and quality of the client's receivables. This limit, however, is a flexible one and is set for general control purposes. In factoring, since the factor generally has no recourse on the client for credit losses on unmatured sales, any limits that are set are of a different kind. In both of these fields the extent of the financing agency's investment in the business of the client can be measured by the amount of the client's unmatured sales held by the financing agency. In general, the amounts held

in non-notification financing are smaller than in factoring.

Both commercial finance companies and commercial banks reported that they held less than $10,000 of receivables for each of approximately half their borrowers. It should be added that balances of this size accounted for only 5 percent of the amount of all balances reported. The average size of such balances was largest in the larger banks, in those located in the larger centers of population and in those banks in the predominantly commercial and industrial regions of the country.

In factoring, the amount of unmatured sales held for the bulk of the clients ranges from $30,000 to $300,000 per client. Here also, most of the factor's total volume of business is done with those clients for whom the factor holds the largest balances of unmatured sales. It should be pointed out that, in addition to purchasing receivables, the factor may make advances on merchandise to certain clients although this is becoming a less frequent practice. In this case limits are set on the amount that will be loaned a given client; the upper limit may be the amount of one month's sales, an agreed percentage of the client's net quick assets or net worth, or an agreed percentage of orders in process of completion, depending on the financing agency's judgment.

Individual invoices or accounts purchased or taken on assignment are generally very small in amount. Of all balances reported by non-notification agencies 47 percent were secured by invoices averaging less than $250; over 25 percent of the clients produced invoices of less than $100 in average amount. In some cases, of course, the average invoice was very large; 26 percent of the balances represented clients' invoices of $5,000 and over. The average size of the clients' invoices or accounts is important in the sense that in most operating procedures each represents a separate bookkeeping and accounting problem for the financing agency. Thus, the average size of the individual transaction has a considerable effect on operating costs per dollar of outstandings.

There is only one sense in which it can be said that the fac-

toring arrangement has a term or contractual period; that is that the contract between factor and client stipulates a period during which the factor agrees to purchase and the client to sell his receivables. This period may be one year or longer; in some cases no period is set but the arrangement may be brought to a conclusion by ninety days' notice at any time. The contractual relationship between non-notification agencies and their clients generally stipulates no period but is terminable on thirty days' notice; there seems to be a current tendency, however, for non-notification contracts to be written on a term basis, for example, for a one-year period. The average maturity of the receivables purchased, which varies with the trade terms offered by the client, is of decided importance. In non-notification financing the period is generally about 50 days; in factoring it varies from 35 to 50 days. The average period of the client's receivables also affects the cost of financing but this is compensated for by the fact that charges are frequently based at least in part on volume of receivables handled.

In accounts receivable financing the collections on receivables supply the means whereby the financing agency's investment in the client's business is reduced. In factoring, since the accounts have been purchased outright, collections on all accounts are merged to reduce the factor's whole investment in receivables. Commercial finance companies apply the collections directly to the amount of their client's balance, each account being handled separately. When commercial banks take assignments of receivables as security for loans, the loan balance is paid down immediately as collections are made or at intervals, through withdrawals from a cash collateral account into which collections are paid as received. In non-notification financing the client usually contracts to take up receivables that are unpaid on their due date but an additional period—30 or 60 days after maturity, and possibly longer—is provided for in practice.

In both factoring and non-notification financing, funds are advanced only up to a certain percentage of the face amount of receivables acquired: from 70 to 90 percent in non-notifica-

tion financing and 90 to 95 percent in factoring. In factoring this margin protects mainly against returns of merchandise; in non-notification financing the percentage advance is determined by reference to past experience with returns, discounts and allowances, the cost of goods sold (on the ground that profits should not be advanced) and by the general credit risk presented by particular clients.

Two characteristics of accounts receivable financing exert important effects on the way this business is conducted. First, the average invoice purchased or taken on assignment and the average collections are so small that operations must be organized along relatively routine lines. This makes possible the most economical conduct of what is necessarily a mass or aggregate financing operation. Second, since receivables financing presupposes a *continuing* relationship with a frequent turnover of receivables it is usually the case that a formal contract is drawn up stating the rights and obligations of both parties.

Although operations are routinized in the interests of economy, the need for careful and thorough credit appraisal is of peculiarly great importance in receivables financing. The factoring company is particularly vigilant especially as regards the trade debtor, because it assumes the credit risk on the receivables purchased; the non-notification agency must be careful because its borrowers include many who are acquiring more funds on their receivables than they could get under any other financing arrangement. In order to limit the risks undertaken the different agencies have worked out very careful procedures and established definite standards in the light of their special credit problems.

A careful appraisal is made of each prospective client, involving a thorough audit of the applicant's business and, in particular, of the receivables, which are classified according to maturity, amount, collection and credit loss experience, credit rating and other important characteristics. Returns of merchandise are studied, as well as shrinkage in the face amount of receivables resulting from the discounts deductible

by customers. This appraisal enables the finance company or bank to set a limit to the amount of the client's receivables that it is willing to hold, to determine the amount of the payables of any individual trade customer that it is willing to accept, and to determine which, if any, of the client's receivables are unacceptable. As part of the original investigation of a client, the finance company or bank also verifies individual accounts to trade customers, taking a sample or investigating all the accounts outstanding. The factor's initial appraisal and investigation is similar to that of other agencies; when the factoring process actually begins there are certain important differences. For example, all sales must be submitted for the factor's credit approval before being made.

The initial appraisal does not complete the credit work of the financing agency; on the contrary, credit appraisal is a continuing process. Each invoice or receivable originated and offered by the client must be classified for approval or rejection unless there is a large number of very small invoices, in which case the average experience serves as a guide. This calls for a regular testing of accounts sold or assigned; certain standards may be applied in special cases, for example, no more than one invoice may be held for a particular trade customer or a maximum may be set on the amount of a given trade customer's invoices that will be accepted by the finance company or approved by the factor. In addition, supervision is maintained over all receivables held and collections received. The financing agency must keep a record of credit losses, returns of merchandise and deductions for discounts; frequent analyses are made of the composition of receivables purchased, lest the general credit standing of the customers of the agency's clients should weaken. In non-notification financing regular verifications are made of receivables acquired and surprise field audits are made at fairly frequent intervals to determine whether the client is making proper assignments of accounts on his books and whether remittances are being promptly redirected to the financing agency.

The objective of most of this credit appraisal work is to

set the percentage advance at a point that will provide the commercial finance company or bank with an appropriate margin of safety and to guide its policy with respect to loss reserves. In factoring it serves to determine the balance that individual clients may be expected to keep with the factor and also to govern the loss reserves that the factor keeps to absorb shrinkages in the face value of receivables purchased and general losses sustained in its business. These reserves are usually between 1 and 2 percent of the amount of receivables held. Since the commercial finance company usually consolidates different types of financing on its balance sheet it is not possible to state its reserve policy with respect to open accounts receivable financing. As additional measures, the non-notification client may, optionally or by requirement, take out credit insurance on receivables sold; it may be requested to supply fidelity bonds to protect the financing agency from fraud or asked to assume a partial or complete personal liability for the account.

Any analysis of charges levied in connection with receivables financing, and in particular a comparison of these charges with rates for financing services of other kinds, must take careful account of two conditions. First, the client may receive a number of non-credit services in addition to the advance of funds. Second, the risks presented by non-notification clients are relatively higher than those presented by borrowers on more conventional bases and the task of reducing these risks to manageable limits involves the use of specially designed procedures. Both of these conditions tend to make this type of financing more costly to conduct and, to that extent, lead to higher charges to the client.

Factoring companies quote their charges in two parts, as a commission on the amount of receivables purchased and as a per annum rate at which receivables are discounted prior to maturity. Commissions account for between 60 and 70 percent of the gross income of factors; they vary between .75 and 2 percent of sales cashed and have shown some tendency to decline in recent years; the interest charges levied by fac-

tors make up approximately 30 to 40 percent of their gross income and generally amount to 6 percent per annum. The charge levied by the commercial finance company in non-notification financing is generally quoted as a certain percent per day of the total gross amount of the customer's receivables held by the financing agency. Rates have been tending to decline and at present they vary between 1/50 of 1 percent and 1/25 of 1 percent per day, with a large proportion of the contracts calling for a rate of 1/40 of 1 percent per day. These rates are applied to daily balances of receivables or collateral held and, where the commercial finance company advances only a certain percentage of the total amount of receivables held, an adjustment has to be made in calculating the annual effective rate to the borrower. Assuming a 75 percent advance, a daily rate of 1/50 of 1 percent on collateral held amounts to an annual effective rate of 9.7 percent, a 1/40 rate to 12.2 percent and a 1/25 to 19.5 percent. Assuming a 90 percent advance, a daily rate of 1/50 of 1 percent equals an annual effective rate of 8.1 percent, a 1/40 rate equals 10.1 percent and a 1/25 rate equals 16.2 percent.

Rates charged by commercial banks on collateral loans secured by assigned accounts receivable are quoted in a number of ways. First, interest rates may be charged on outstanding loan balances, without any additional fee or charge of any kind. By and large, this seems to happen most frequently where banks make very few receivables loans. In general these rates are from 5 to 6 percent per annum, most frequently the latter; occasionally the rate has been as low as 4 percent. The effective rate to the customer on such an arrangement depends, of course, on the procedure followed by the bank in applying collections to the loan account. Where the bank uses a cash collateral fund and does not apply collections promptly, a borrower pays an effective rate higher than the quoted rate; however, since the term of the borrower's note is usually geared to the maturity of the receivables assigned, it seems

reasonable to conclude that the effective rate on money in use would generally be no more than one-third in excess of the quoted rates. Other commercial banks charge a given rate on customer balances *plus* a service charge which may be quoted in a great variety of ways. When both these charges are taken into consideration, it appears that the effective rate to customers is seldom above 9 percent per annum and generally less.

Total expenses of factoring companies amount to approximately 70 to 80 percent of their gross income. Of these expenses, salaries, write-offs and other provisions for losses and interest on borrowed funds are the most important items. It is notable that interest expense on funds borrowed by factors declined in relative importance from 1933 to 1940, reflecting the more economical basis upon which funds were acquired from commercial banks and the slower withdrawal of funds from factors by their clients, which serves to reduce the factors' demand for funds from their lending banks. In 1941 increased borrowings brought about an increase in the relative importance of interest expense. The ratios of net credit losses on receivables to total receivables purchased are very low in factoring; these losses varied, for the one company on which information is available, between .1 and .5 percent over the seven-year period, 1934-40. Nevertheless, while low as a percentage of receivables purchased, losses represent a substantial part of total operating expenses.

The expenses of commercial finance companies amount to about 60 percent of their gross income; the most important expense items are salaries, provision for losses, and interest on borrowings. It is true of commercial finance companies also that interest and discount on borrowed funds have declined in relative importance as an expense item in recent years, falling from 29 percent in 1932 to about 14 percent in 1940.

Studies of the relation between gross income and gross operating expenses of factors, commercial finance companies

and commercial banks reveal quite clearly that the relatively high ratio of income to total assets for the non-banking agencies is largely offset by high operating expense ratios. Net operating profits related to net worth appear to be both higher and more variable for the non-banking than for the banking agencies.