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Volume Author/Editor: Raymond J. Saulnier and Neil H. Jacoby

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Chapter Author: Raymond J. Saulnier, Neil H. Jacoby

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Credits and Associated Services

It is important to any description of accounts receivable financing to emphasize that the client, in many instances, seeks and obtains more than funds from the financing agency. The supplying of funds, *per se,* is frequently but one element in a combination of desired services. In this section, therefore, we shall deal, first, with the chief characteristics of the credit obtained and, second, with the associated services that are frequently extended to the client.

Size of Credits Extended

Factoring

While it is customary to describe borrowing arrangements in terms of the size of the loan extended and of other characteristics of loans, there are two senses in which it is misleading to think of factored accounts receivable in these terms. First, in the strict sense, the factoring transaction does not involve a *loan* at all; rather, the factor *purchases* those of the clients' receivables that conform to his established credit standards and assumes all credit risks involved in them. Second, this process of "cashing receivables" is a continuing relationship lasting for what may be a considerable period of time. The purchase of each individual receivable is, in a certain sense, a separate transaction, but in another sense it is part of a larger arrangement or relationship which involves the purchase of a great many receivables and which cannot be evaluated from a credit point of view without taking account of the continuing flow of *all* the receivables being purchased. The arrangement is a kind of revolving credit under which the client is supplied with funds in an amount determined by the rate at which

receivables are generated. We have, then, not a loan but an outstanding balance representing the amount of a client's receivables held by the factor at a given time. While the purchase of the receivables by the factor makes the factor's funds available immediately to the client, funds may be left with the factor, that is, the client may accumulate a credit balance. The factor, therefore, has an amount of funds in the client's business equal to the net amount[1] of the client's outstanding receivables minus the client's credit balance. It will not distort the facts to refer to this remainder as the client's outstanding *loan* balance, although it is understood that it is not really a loan to the client and does not appear on the latter's financial statement as a liability. The client is not responsible for paying this balance, except where receivables are purchased under a recourse agreement, but must make good for such merchandise claims and returns as arise.

Direct factual evidence concerning the size of these amounts, that is, the balances of client's unmatured sales held by the factor, is unavailable. As indicated above, most of these balances range from $30,000 to $300,000 with the great part of the factoring volume accounted for by the cases found at the upper limit of this range. However, no information is available on the credit balances that must be deducted from these to arrive at an estimate of the factor's net investment in the client's business. It is known that some clients are virtually non-borrowing, that is, their credit balances equal the amount of their unmatured sales. Others hold only the minimum amount agreed upon with the factor, say 5 or 10 percent of unmatured sales. The distribution is determined mainly by the client's need for funds and the terms upon which balances will be kept by the factor.

Another measure of the amount of the factor's business with an individual client is given by the volume of receivables purchased annually from individual clients. This may be inferred directly from the information already presented on outstanding balances of unmatured sales since it is not affected

[1] Net of reserves for discount.

by any credit balance that may be held by the client with the factor. On the assumption that receivables turn over 7 times a year, the range of amounts purchased would run from $210 thousand to $2.1 million. It should be indicated that a few accounts originate a volume considerably in excess of $2 million. One factoring company, for which information covers operations in recent years, reported that in 1940 it had purchased approximately $45 million in receivables, that no one client had provided more than 10 percent of this volume and, further, that the largest amount ever purchased from one client was $3 million in 1939.

When advances are made by the factor on a client's merchandise a loan transaction of conventional form has been entered into. Since not all of the factor's clients borrow on this basis, it is particularly misleading to compute *average* merchandise loan balances. It is known, however, that in 1940 one factor with about 300 clients had nearly $3.6 million in merchandise advances outstanding at year end and that another company with about 450 clients had only about $650,000 outstanding. Clearly, differences in management policy, as well as in the needs of clients, account for these widely different results.

Non-Notification Financing

Information on the size characteristics of the receivables balances owed by concerns using the facilities of non-notification financing agencies is summarized in Table 12 which gives the annual average loan balances of 361 clients classified according to the industry of the borrower.

These data show that the average of the balances of all non-notification clients was about $38,000 from which it would appear that non-notification balances are smaller, on the average, than factoring balances. Since the ratio of volume of receivables purchased to outstanding balances is about the same for these agencies as for factors it can be stated, further, that the volume of receivables purchased or assigned annually would also be smaller than the comparable measure of activity

Table 12—ACCOUNTS RECEIVABLE CLIENTS, 1940-41, BY AVERAGE LOAN BALANCE AND BY MAIN BUSINESS ACTIVITY [a] (*dollar figures in thousands*)

Average Loan Balance [b]	*Mining and Extraction*		*Construction*		*Manufacturing*		*Wholesaling*		*Retail Trade*		*Service*		*Total*		
	No.	Amt.	No.	Amt.	No.	Amt.	No.	Amt.	No.	Amt.	No.	Amt.	No.	Amt.	Percent
Under $1	..	..	1	$.5	8	$3.8	3	$1.9	4	$1.6	10	$5.9	26	$13.7	.1%
1–2 5	1	$2.3	2	3.1	29	48.6	10	16.2	2	2.1	4	5.4	48	77.7	.6
2.5--5	..	..	2	9.0	26	82.8	10	31.9	3	8.0	6	20.7	47	152.4	1.1
5–10	..	..	1	6.0	32	240.0	13	82.3	6	40.5	7	46.1	59	414.9	3.0
10–25	3	48.7	2	37.0	41	661.1	12	169.5	3	47.0	3	46.0	64	1,009.3	7.4
25–50	..	..	..	..	33	1,079.4	8	311.5	1	40.0	2	53.0	44	1,483.9	10.9
50–100	..	..	2	120.0	29	1,882.5	9	580.5	2	150.0	1	60.0	43	2,793.0	20.4
100–200	..	..	1	173.0	13	1,730.7	3	485.0	2	285.0	..	..	19	2,673.7	19.6
200–500	..	..	..	..	7	2,212.3	1	241.3	..	..	..	..	8	2,453.6	18.0
500 and over	..	..	..	..	2	1,640.0	..	..	1	950.0	..	..	3	2,590.0	18.9
TOTAL	4	$51.0	11	$348.6	220	$9,581.2	69	$1,920.1	24	$1,524.2	33	$237.1	361	$13,662.2	
Percent of total amount		.4%		2.6%		70.0%		14.1%		11.2%		1.7%			100.0%
Average balance	$12.8		$31.7		$43.6		$27.8		$63.5		$7.2			$37.8	

[a] Based on data submitted by 24 commercial banks and 2 commercial finance companies.
[b] Each size class is inclusive of the lower limit and exclusive of the upper.

for factors. Additional information on average balances of the clients of one regional commercial finance company, classified by industry, was given in Table 10.

In a preceding chapter, Table 9 showed that there is a direct relationship between the size of the borrower and the size of loan balance. Since non-notification accounts receivable financing is used most frequently by small concerns, it is not surprising that many of the average balances of receivables clients are small in amount. This is borne out by Table 12 which shows that approximately one-half of a sample of borrowers had balances, in mid-1941, of less than $10,000, although these borrowers accounted for only 5 percent of all balances reported. Whatever determines the average size of the non-notification loan balance, the fact that it is most frequently relatively small in amount has an obvious bearing on the cost of extending such credits, on the profitability of the business, and also on the costs to the borrower.

In an attempt to determine whether a definite relation exists between the size of non-notification loan balances and the financial strength of concerns borrowing on this basis, a comparison was made between borrower loan balances and individual ratios of the borrower's net worth to total assets. The latter was taken as the only available measure of financial strength. These data are not presented here, but they indicate that average size of loan varied from $60,000 for concerns whose net worth equaled 80 percent or more of total assets to $21,000 for corporations having a net worth deficit. However, there were no substantial differences in the average loan balances of the groups of non-deficit companies of differing ratios of net worth to total assets. This may indicate an inadequacy in the sample of companies studied. More likely it indicates that the ratio of net worth to debt reflects neither the borrower's financial strength, *as viewed by a receivables lending agency,* nor the borrower's need for financing. With regard to the former, it is clear that, barring default by the client's trade debtors, the amount of the client's debt and its relation to total assets are of secondary importance since the

loan is collateralized by receivables upon which the lender has a prior lien. It would appear, therefore, that the principal elements affecting the size of balance extended are the size of the borrowing concern, its need for funds and its ability to generate acceptable receivables.

Information was not assembled directly on the average annual volume of receivables purchased or taken on assignment by commercial finance companies and banks from individual clients. An estimate of this amount may be made, however, from information on average balances and the lender's estimate of the turnover of the balance. Using a turnover figure of seven times a year we can say that approximately 50 percent of the clients covered in the survey generated an annual volume of receivables of less than $70,000 each, although the receivables purchased from these clients represented only 5 percent of the total volume purchased. Again, it will be recalled that in many ways the volume of receivables financed per client is more important to the understanding of receivables financing than is the size of the client's loan balance. The charge for the service rendered is frequently based on the volume of accounts assigned as well as on outstanding balances; the costs to the lender of handling an accounts receivable balance are primarily determined by volume.

Differences in the average loan balances of non-notification borrowers of different industrial types were shown in Table 12. Further evidence on this point with special reference to the receivables borrowers of commercial banks was revealed also in a questionnaire survey, some of the results of which are presented in Table 13. Commercial banks were asked to classify their total open accounts receivable loans outstanding at the time of the survey (July and August 1941), according to whether they were acquired from retail or non-retail concerns, and to give the approximate number of their clients.

Table 13 shows that the retail accounts were smaller than the other, mainly manufacturing, accounts; the former averaged about $8,000 and the latter about $20,000. It also shows that the size of the average receivables loan balance is greater

Table 13—AVERAGE ACCOUNTS RECEIVABLE LOAN BALANCES OF RETAIL AND OTHER CLIENTS, JUNE 1941 BY DEPOSIT SIZE OF BANK, SIZE OF POPULATION CENTER AND REGION IN WHICH BANK IS LOCATED [a]

	Retail		*Other than Retail*	
	Number	Average Amount	Number	Average Amount
Deposit Size of Bank [b]				
$5,000 or less	38	$3,553	152	$5,639
5,000–10,000	13	8,736	82	10,852
10,000–50,000	57	7,181	354	21,525
Over 50,000	13	23,809	186	32,919
ALL BANKS	121	7,995	774	20,036
Size of Center of Population [c]				
Under 10,000	16	2,903	21	2,800
10,000–50,000	11	5,714	32	10,637
50,000–100,000	12	2,305	85	9,788
100,000–500,000	45	12,363	240	16,162
500,000 and over	41	7,164	409	25,935
ALL BANKS	125	7,896	787	19,771
Region				
New England	20	2,604	196	20,659
Middle Atlantic	26	17,670	216	29,258
East North Central	45	3,556	163	13,188
West North Central	11	18,712	34	12,269
South Atlantic	..	..	28	10,478
East South Central	..	..	74	11,227
West South Central	13	4,081	26	20,269
Mountain	2	4,000	..	..
Pacific	8	6,073	50	22,208
ALL BANKS	125	$7,896	787	$19,771

[a] Based on a questionnaire survey.

[b] Total deposits in thousands of dollars. Each size class is exclusive of the lower limit and inclusive of the upper.

[c] Each size class is inclusive of the lower limit and exclusive of the upper.

in the larger banks and in banks located in the larger centers of population than in the smaller banks and those located in smaller places. Perhaps the most important fact brought out in this table is the very small average size of loan balances in the smaller banks (with deposits of under $5 million) and in banks in smaller centers (of less than 100,000 population). In most instances the average balance reported for banks in these groups was less than the $10,000 minimum balance considered necessary by experienced commercial finance companies

for profitable operation and far below the $25,000 balance considered by some as the minimum.

It will be noted that the average balance shown in the earlier table ($38,000), based on special reports from selected banks, is larger than the average balance shown in Table 13. This reveals a degree of non-representativeness in the reports from the selected banks, not unexpected in view of the fact that the banks submitting special schedules of information on their receivables loans were banks that had made a special effort to develop this line of financing.

Factoring

Average Size of Client's Receivables

In many respects the individual invoice is a more important item in the factoring process than is the total amount of the client's unmatured sales held by the factor. Since all the credit risks are assumed on sales cashed, the factor must approve each sale *before* it is made. Once a sale has been approved and the invoice purchased, the factor merges this account with the total of purchased sales outstanding; the only sense in which the client is further involved is that some adjustments may be required on account of merchandise returns or other offsets. The principal ledger of the factor is set up alphabetically by the customers whose payables are owned by the factor. Each customer has a separate ledger card and entries are made on this card as sales to the customer are approved or remittances received. The ledger card of a given trade customer may show sales to this customer by a number of the factor's clients; on the other hand, the customer may buy from only one of the factor's clients. It will be seen, therefore, that the factor's credit appraisal activity revolves about the individual sale and invoice. Unfortunately, there is no body of statistical information available as to the size of these individual sales. They may vary all the way from sales of a few dollars' worth of merchandise to sales by manufacturers to other manufacturers or large retail outlets, amounting to several thousands of dollars. The average size depends on the nature of the sales market and the kind of goods sold.

Non-Notification Financing

In non-notification financing, as in old-line factoring, individual accounts receivable assigned as security for a loan or purchased by the financing agency are of primary importance for the reason that the average size of the transaction has an important bearing on the cost of administering receivables credits and, even though taken with recourse on the vendor of the account, considerable effect on the risk involved in any given credit extension. Information was sought on the average size of the receivables financed, but a special problem complicates the interpretation of the reports. This problem arises out of the fact that although factors buy individual invoices, commercial banks *sometimes* take an assignment of the whole account owed by the client's trade debtor (even though this account represents a cumulation of a number of separate invoices bearing different dates) or they may take an assignment of *all* the client's outstanding receivables. For this reason, some banks did not know the average amount of the invoices originated by their clients.

The results of this survey of non-notification financing, as summarized below, reveal that clients whose average invoices were less than $250 had 47 percent of the total loan balances reported while clients with average invoices of under $100 had over 25 percent. A sizable proportion of the loan balances, 26 percent, represented clients whose invoices averaged $5,000 and over. Accounts receivable loan balances of 316 clients are classified, according to the average size of the receivables that secure them, as follows:

Average Amount of Clients' Invoices	*Number of Clients*	*Loan Balances Reported*	
		Amount (000)	Percent
Under $100	65	$2,826.7	27.3%
100–250	61	2,041.1	19.7
250–500	49	1,178.8	11.4
500–1,000	32	779.2	7.5
1,000–5,000	58	828.5	8.0
5,000 and over	51	2,698.5	26.1
TOTAL	316	$10,352.8	100.0%

Whether these averages refer to single invoices or groups of invoices is unimportant; what matters is that the unit transactions involve very small dollar amounts. It follows from this that the cost of administering receivables credit, per dollar of funds advanced, is high as contrasted with conventional commercial lending.[2]

The information on average size of client's invoice makes it possible to estimate, very roughly, the magnitude of the detail involved in many accounts receivable loans. We know that the average loan balance reported in the special schedules prepared for the National Bureau by financing agencies was about $38,000 (Table 12) and that an average balance of this amount would represent about $250,000 in receivables purchased over a year. Thus, if this average loan balance can be applied to the 40 percent of the clients and the 47 percent of the loan balances reported as having average invoices of less than $250, we may conclude that the financing agency is required to handle, on the average, 1,000 or more separate invoices or accounts per year for such clients. For clients with invoices of $100, an average loan balance of this size would involve the handling of 2,500 separate accounts or invoices. It is this requirement that has given considerable stimulus to the development, among commercial banks, of operating plans that reduce to a minimum the handling of individual invoices.

Term and Repayment Provisions of Credits

Factoring

In old-line factoring the contract between client and factor, under which the factoring process is carried on, may stipulate no contract period at all or may set a definite period of one year or more during which it is to remain in force. If no period is stipulated the contract is usually prepared so that it can be terminated on 90-day notice by either party; otherwise the contract generally provides that the arrangement can be

[2] This point cannot be fully demonstrated except by a careful statement of the steps taken in handling each individual invoice. Such a statement is given in Chapter 6, where the conventional methods are described along with other operating plans that attempt to minimize the handling costs of receivables loan balances.

terminated at the end of any given contract period, on 60-day notice by either party. This is the only sense in which it can be said that the factoring arrangement has a "term" or contractual period. No information is available on the actual length of time over which a financing arrangement is continued between the client and any particular factoring company although it is frequently stated that these relations continue over a long period of time.

Some information is available, however, on the rate of turnover of receivables sold to factoring companies. This is indicated by what is called the collection period and is expressed in days; it can be estimated by dividing the volume of receivables purchased annually by the average amount of outstanding receivables held by the factor through the year and by then dividing the result into 365, or, more easily, by dividing the annual average of receivables held by the daily volume of receivables acquired. The data available on this point, which are not presented here in tabular form, cover a varying number of companies over the 24-year period, 1917-40. These data show that since 1929 the collection period has not averaged more than 55 days in any year and has been as low as 39. For 1940 the average collection period was 51 days; that is, receivables turned over, on the average, seven times a year, although one large company stated in an interview that its average collection period during 1941 was about 35 days.

If a tendency for the collection period to increase reflects a deterioration in the account it may be necessary to take certain protective measures but these vary, depending upon whether the arrangement is of the factoring type or is non-notification financing with recourse on the client. In factoring, a severe deterioration in a special group of accounts can be dealt with by refusing to buy such accounts. A less serious situation might be adjusted by a higher factoring charge which would enable the factor to accumulate a larger reserve to absorb losses that might accrue on the account. Other situations such as greater than usual returns of merchandise can be taken care of by requiring that the client hold a larger percentage

of unmatured sales in a credit balance with the factor but this can provide no protection for the credit risk since this is definitely assumed by the factor when the account is purchased.

Non-Notification Financing

In non-notification financing, as in factoring, the period of time over which the relation between financing agency and client continues is the only significant measure of the term of the loan. As was stated above, information on the length of this period was available only for clients that were still being financed by the reporting agencies; for these clients the period averaged about two years. There is a tendency for non-notification financing to be carried on under term contracts, as in factoring, although this has no necessary relation to the period of time that a client will use the financing services of a given agency. Such contracts are usually of one-year term; other contracts do not specify a definite period over which they are to remain in force and are terminable by either party on 30-day notice.

Information on the average period or turnover of client's receivables was assembled in special reports from 24 commercial banks and 2 commercial finance companies. These data are summarized below.

Average Turnover of Clients' Receivables	*Loan Balances Reported*		
	Number	Amount (000)	Percent
Under 30 days	55	$1,348.9	10.3%
30–44 days	98	4,246.1	32.3
45–59 days	83	3,274.5	24.9
60 days and over	108	4,287.0	32.5
TOTAL	344	$13,156.5	100.0%

These data are estimates, made by the reporting lending agencies, of the average turnover period of the receivables of each of their clients as of the middle of 1941.[3] They indicate

[3] A large number of balances were reported as turning over in exactly 60 days; only a few exceeded 75. Agencies were advised specifically to limit their reports to *open* accounts receivable loans. If loans secured by instalment receivables had been included, the average period would, of course, have been much longer.

that non-notification receivables turn over at about the same rate as the receivables purchased by factoring companies, a statement that is borne out by the fact that the collection period of combined open account and factoring receivables of Commercial Credit Company varied between 44 and 55 days over the period 1936-40, inclusive.[4]

While the actual turnover of accounts receivable is determined for commercial banks by the same considerations that affect the liquidity of these assets when acquired by other agencies, the problem for banks is somewhat different since they usually take the receivables as collateral for a loan rather than purchase them. The bank formulates the collateral loan so that it has a specified maturity date or it makes the loan on a demand basis, the customer being required, usually, to sign an ordinary collateral note at the time of each assignment. Many banks were found to use the demand note basis but most banks interviewed set up a definite maturity to conform, as far as possible, to the expected collection period of the receivables which secure the loan. While the notes generally have terms not longer than 60 days, this maturity can be extended if circumstances warrant.

The fact that the borrower often signs a new note with each assignment of receivables means that a given borrower may have several notes of different original and maturity dates outstanding at the same time. In this case the bank may attempt to match the collection on a particular account with the note arising out of its assignment, a difficult and perhaps impossible task except when individual accounts are unusually large. More frequently, the bank applies all collections as received to the *oldest* note outstanding. Some institutions simplify the procedure by allowing only one assignment and one note to be extant at a time. That is, a given note must be wholly paid out from the remittances on the accounts that secure it before a new note is drawn up. This has the advantage of simplicity but the possible objection of not providing continuous financing of

[4] Based on data in the *29 Annual Report* of Commercial Credit Company for the year ending December 31, 1940, p. 15.

accounts as generated. Another technique of commercial bank operation is to require a new note, covering new advances *and* the unpaid balances of previous advances, when each assignment of accounts is taken. This has the advantages both of simplicity and continuous financing but it is avoided by some banks because, in some states, to take an assignment of accounts for a *previous* debt would invalidate the assignment.

Just as in factoring, any notable increase in the average period of time for which its receivables are outstanding is watched with great care by the non-notification agency and certain measures may be taken to provide necessary additional protection. These may be in the form of increased service charges to the client (providing for larger reserves), or a refusal to take certain accounts that are longer than usual. More likely, the protection will be sought by a reduction in the percentage that the financing agency advances on any given group of receivables. It will also be clear that a shortening of the average collection period tends to increase the costs of operation per dollar of average outstandings. This can be compensated for by a charge levied on volume rather than on outstandings or by some combination of the two types of charges.

Before concluding this section on maturity provisions in accounts receivable financing, one additional point should be made with respect to the repayment plan for such loans. Clearly, a given lot of receivables, taken as collateral for a bank loan, provides the *means* of repayment, as individual accounts are collected. In general, therefore, if collections are applied directly to the note the rate of repayment is determined by collection experience. But some banks do not reduce notes directly as collections are made. Rather, collections are paid into a cash collateral account and sums are drawn from this periodically for application to the loan, the remainder, which represents the client's equity in the collections, being paid to the client. This has the effect of increasing the dollar cost of the service to the borrower if the cost is computed as a certain percent of the outstanding loan balance. On the other

hand, it has the advantage of simplifying the task of applying collections to outstanding loan balances.[5]

The technique of repayment used by commercial finance companies is somewhat different. Since this type of company usually operates under a purchase and sale agreement, there is no problem of one or a series of notes. A schedule of accounts is purchased at, say, 80 percent of the face amount of the accounts and as collections are made the finance company retains 80 percent of the receipts plus an amount equal to allowances for returns, etc., and less any credits for overpayments and the like. In this way there is a continuing sale of accounts and regaining of equity in collections as received. This is also the procedure followed by factoring companies.

Finally, it should be pointed out that both banks and commercial finance companies may have their notes paid or receivables liquidated by requiring the borrower, under their recourse arrangement, to repurchase them, or "take them up" at their maturity date. Generally speaking, 30 or 60 days after due date is the maximum delinquency allowance that lenders permit although certain exceptions may be made. The bank may require the borrower to take up the delinquent accounts by cash payment or exercise the right to charge these against the borrower's commercial deposit account. Since the finance company does not hold deposit balances for its clients, it can deduct delinquent accounts only from the customer's equity in collections. Such arrangements set real limits on the period a given receivable can be outstanding, although they do not affect the period of the "financing" arrangement between borrower and lender unless delinquency becomes serious.[6]

[5] The strategic legal condition of preventing the borrower from obtaining dominion over collections is accomplished by the establishment of a cash collateral account, but this legal protection is not affected by the frequency with which funds are applied to the note.

[6] Again, the procedure usually followed by banks of requiring that delinquent notes be taken up by a cash payment and their unwillingness to accept a substitution of new for old accounts is determined by legal conditions. Substitution might establish a preference on the ground that the assignment is for an antecedent debt.

Percentage Advance on Accounts Receivable

In receivables financing the percentage advanced on accounts receivable purchased, or taken on assignment, by the financing agency is, perhaps, the most important single risk-limiting device. It is necessary, however, to distinguish between the use of this device in factoring as contrasted with non-notification financing.

Factoring

The arrangement between factor and client usually provides that a certain amount of the proceeds arising from the purchase of a given amount of receivables will be left with the factor by the client as a "credit balance." The purpose of this balance is to provide a fund out of which provision can be made for any adjustments resulting from returns of merchandise, allowances or other offsets that are claimed by and granted to the client's trade customers. There seems to be no general rule regarding the amount of the credit balance that must be held but it is stated that 5 percent of unmatured sales is the usual requirement. This is smaller than in non-notification financing, because the client's balance does not have to absorb credit losses; these losses must be charged to the factor's own loss reserves. Actually, the credit balance of the client may be much greater than this minimum requirement since the client's need for funds may be much less than the need for credit approval and collection services and thus considerable balances may be accumulated. As a rule the balances carry interest for the client at 6 percent per annum, but where they assume much larger than necessary proportions the rate may be revised downward. In some cases the balances carry no interest return for the client. Clearly, while these funds are available to the factor, they are held as a demand liability and, except for very small factoring companies, would be expensive funds at 6 percent per annum. While there is no formal arrangement stipulating the percentage of cash proceeds to be left with the factor, that is, the amount of the credit balance to be maintained, the factoring company keeps a close watch

over the amount of the balance and if it seems insufficient the client is asked to leave a larger amount.

Non-Notification Financing

Since the non-notification financing agency does not assume the credit risk on purchased receivables, or on those taken as collateral, it is necessary to maintain a continuing margin over the amount advanced or loaned to the client. This balance must be large enough to absorb not only the returns and allowances for which the factor seeks protection but also the outright losses sustained on receivables held. Further, it is generally set so as to advance no more than the client's costs of goods sold. Some evidence as to the percentage advances made by non-notification agencies was assembled by the National Bureau in a mid-1941 survey and is given in Table 14. This shows that the advance is seldom under 70 percent of the face value of the receivables. Only 42 out of 357 clients received less than 70 percent of the face value of their receivables as an advance of funds. Furthermore, balances involving this relatively low percentage advance were, on the whole, smaller than those on which larger percentages of the face value of receivables had been advanced. From 70 to 90 percent is the range within which the percentage advance is most likely to fall.

This variation in the percentage advanced shows that lending agencies adjust the percentage, over fairly wide ranges, according to what they believe to be the degree of risk in any given client's receivables. Of course, the percentage advance is likely to become the focus of competition among lenders and may be in part a reflection of this condition as well as of the lender's judgment of the most appropriate margin of safety on the account. Nonetheless, competitive conditions cannot increase the percentage advance, or alter any other aspect of the credit bargain to the advantage of the borrower, without affecting the margin of safety that the lending agency maintains for its protection. In determining this margin the lender has to take account of a number of elements:

Table 14—ACCOUNTS RECEIVABLE LOAN BALANCES, 1940-41, BY PERCENTAGE ADVANCED AND BY SIZE OF ANNUAL AVERAGE LOAN BALANCE [a] (*dollar figures in thousands*)

Percentage Advanced	ANNUAL AVERAGE LOAN BALANCE [b]												
	Under $2.5		*$2.5–10*		*$10–50*		*$50–200*		*$200 and Over*		*Total*		
	No.	Amt.	No.	Amt.	No.	Amt.	No.	Amt.	No.	Amt.	No.	Amt.	Percent
Under 50%	7	$4.6	1	$8.0	..	..	..	..	..	..	8	$12.6	.1%
50–59	5	6.5	5	28.1	3	$48.9	1	$95.0	..	..	14	178.5	1.3
60–69	6	5.1	8	51.4	3	84.4	3	293.0	..	..	20	433.9	3.3
70–79	31	41.8	44	227.4	31	677.7	17	1,410.9	2	$1,241.3	125	3,599.1	27.0
80–89	21	28.7	41	223.6	55	1,284.5	18	1,572.2	5	1,527.4	140	4,636.4	34.7
90 and over	4	4.9	7	28.9	16	397.6	19	1,779.1	4	2,275.0	50	4,485.5	33.6
TOTAL	74	$91.6	106	$567.4	108	$2,493.1	58	$5,150.2	11	$5,043.7	357	$13,346.0	
Percent of loan balance	.7%		4.3%		18.7%		38.6%		37.7%				100.0%

[a] Data supplied by 24 commercial banks and 2 commercial finance companies.
[b] Each size class is inclusive of the lower limit, and exclusive of the upper.

(a) the general financial responsibility of the borrower and the moral hazard involved
(b) the client's line of business and the kind and quality of customers served
(c) the size of the accounts purchased or taken as security
(d) the expected ratio of returned merchandise to total sales
(e) the cash discounts that will be taken by the trade debtor
(f) the expected ratio of losses on bad debts to total receivables acquired
(g) the difference between the sales price of the goods sold and their cost of production.

The ratio of bad debt losses to total receivables includes clear charge-offs as well as the accounts that may become delinquent and so have to be charged back to the client. Beyond the ratios given in (d), (e), (f) and (g), all of which can be determined by studies of past experience, the lender maintains an additional margin to take account of undeterminable risks and to shorten the period during which collections on a given batch of receivables should equal the amount advanced on them or should pay out the loan balance which they secure.

It might be added that in non-notification financing, the withholding of a certain portion of the borrower's equity until the account has been paid has the special advantage of encouraging prompt collection by the borrower. Assuming a 70 percent advance, then, for every dollar collected the borrower can claim a 30 cent equity. By increasing the amount of the client's equity the lender limits his risk both by having a larger margin of safety and by giving the borrower a greater stimulus to press collection efforts.

Services Associated with Receivables Financing

Factoring

The most important services of the old-line factor are credit checking, absorption of credit losses on approved accounts

and collection of accounts. It is clear that if the factoring company is to assume the credit losses on purchased receivables, it must have absolute control over the extension and collection of the credits. Thus each factor maintains a credit department to approve or disapprove credit sales by clients and to supervise collections. In some instances this means that the mill dispenses with credit and associated departments, including accounts receivable bookkeeping, passing these functions, with the expense of performing them, over to the factor and paying in return a factoring commission.

In addition to these services, the old-line factor did in the past perform some selling or merchandising functions for the textile mill client. In general, these were of three, necessarily related, kinds: providing advice on the styling of merchandise and other marketing problems; selling the mill's output on a commission or other basis; providing the client with space on the factor's premises for use as display quarters. While the factoring companies have tended to drop the selling function, they may still offer guidance on such matters as the selection of a selling agent or other related problems. Because of the long experience of the factor's personnel in the textile industry, they are in a peculiarly advantageous position to offer this service to textile clients. Furthermore, the factor's interest is best served, as is the client's, by promoting the mill's sales; the factor has good reason to stimulate the client's sales along profitable lines.

Non-Notification Financing

Where accounts receivable financing is conducted on a non-notification basis, the pattern of associated non-financial services obtained by the borrower is quite different. This fact derives largely from a difference in the nature, and thus in the financial and other needs, of the commercial finance company's clientele.

First, the non-notification client obtains no guarantee against credit losses; therefore the client must assume the responsibility for selecting credit risks through his own established

credit department. It is possible, of course, for the client to obtain credit insurance but this procedure appears to be less frequently utilized than might be expected. Second, since the commercial finance company does not guarantee the credit risks on the receivables it acquires, its interest in the *quality* of the paper is somewhat less intense than is the factor's. The commercial finance company and the bank are interested in the quality of the receivables in order to determine the percentage advance to be made. However, even very poor paper may be accepted on a low percentage advance basis. All that is important is that the lending agency should be able to *estimate* the prospective quality of the receivables with reasonable accuracy and to require the borrower to absorb the losses arising therefrom. Finally, since customers are not notified of the sale or assignment of their accounts, the borrower must make all collections and handle the receivables bookkeeping.

On the positive side, it is of considerable value to the borrower to have the commercial finance company report regularly on the general quality of the receivables offered for sale or as loan security. Through these reports the borrowing company gets an objective opinion on the quality of the risks accepted by its own credit department and the effectiveness of its collection procedure. The supervision of current loans often provides for the preparation of reports to borrowers that give a clear statement of changes in the quality of receivables generated and in merchandise returns and allowances.

In further contrast to the client of the old-line factor, the non-notification borrower never contracts for merchandising and selling services in addition to the funds advanced. But while it is generally true that the concerns obtaining non-notification financing are primarily seeking working capital funds, it is stated by experienced officers of lending agencies operating in this field that many of the clients of the commercial finance company are as much in need of management advice as of funds. The need for the latter may, in fact, be merely the reflection of defective management. Consequently all commercial finance companies emphasize the importance of

this management counseling phase of their functioning, indicating that it ranges over financial, merchandising, production, personnel and all other aspects of business operations. In some instances commercial finance companies have a special department to handle this part of their work; some provide the service at a stipulated fee or retainer, although this is the exception rather than the rule. In most cases where the counsel is offered it is supplied in a more informal way and the cost of providing it is absorbed in the regular financing charge.

It is obvious that every lending agency is interested in the management and general efficiency of the client's business but, conventionally, this interest is based mainly on the importance of management as a determinant of credit standing. The loan is made if the management is considered adequate and rejected if the opposite prevails. On the other hand, many of the non-notification finance company's clients would be rejected if such standards were applied. As a result, this type of agency necessarily adopts a more positive interest in management. The borrowing concern's personnel is appraised as regards efficiency but, beyond that, steps must be initiated to *correct* defects in its policy and general administration. If this requires an overhauling of the borrower's business, then this can be, and often is, undertaken. If the commercial finance company could not approach the financing problem from this point of view, and if it were not willing to make this effort, its field of action would be restricted to a considerable extent.