

**Factoring from a
Business Owner's
Perspective**

&

**Improving Collections
Today**

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Factoring from Business Owners Perspective

Factoring Basics

History

Factoring is the act of selling an asset at a discount for the advantage of immediate cash. As a business, it has been around for hundreds of years. In fact, if you want a Biblical reference to discounting invoices check out Luke16: 1-13.

Waiting for your ship to come in

In the United States, factoring most likely got its foothold at the docks on the east coast. When the growers brought their crops, mostly cotton, to places like Savannah they placed them in dockside warehouses and preceded to wait for the ship to arrive to buy their crops. Hence developed the saying "waiting for your ship to come in."

Today, if you go to Savannah, Georgia, along the docks you just might see an old street sign with the words, "Factors Row." All along that row of small offices sat Factors who would buy the title to the farmer's crop at a discounted price. The farmer could then go home and tend his farm while the factor waited for the ship to come in that would buy that crop.

Time was very valuable to the farmer. If you have ever spent any time on a farm, you know that farms don't do well when left unattended. The farmer knew the value of his time. Too much time spent waiting for that "ship to come in" could cost him dearly. The factor performed a very valuable service to the farmer. And the farmer got back to what he does best.

Well, from the docks of Savannah to the mills of the Carolinas, factoring followed the cotton. Each step along the way one business after another added value to the cotton and was faced with the long wait for the buyer to pay the bill. Eventually the cotton and the factoring arrived in the garment districts of New York.

Ford Required

The factoring business was very slow to make the transition to other industries in the US. Eventually, however, it did jump and this time it was to the emerging auto industry. In fact, it is rumored, that one of the largest and oldest car manufacturers in the US once required their suppliers to show proof they could "carry" the manufacturers invoices for 90 to 120 days. If the supplier could not show the financial strength required, the car manufacturer required that the supplier provide the name of his factor.

In the Southwestern US as recently as the 1980's, factoring was relatively unknown. Today, however, factoring is available to almost any known

industry. The basics are still fairly simple: a vendor, subcontractor, or supplier to a larger company needs to be paid sooner than the larger client company is able or willing to pay.

For the vendor, subcontractor or supplier, this delay can be distressing. Not only do they have the cost of producing and delivering their product or service, but they have the additional expense of lost opportunity - they cannot take on more business because their capital is tied up in receivables.

Again, this "ship" with the invoice payment on it is slow to arrive. Just as in Savannah, the factor cashes-out the vendor, subcontractor or supplier at a discount and the large client company pays the factor in due course. The vendor, subcontractor or supplier takes the relatively small trade discount off the face value of the invoice in exchange for immediate cash, which is then available to fund new business. Thus factoring funds business growth.

Benefits

The benefits of factoring depend on the stage and needs of a company.

Take for example a start-up company ; the benefits include:

1. The ability to make payroll while waiting for slow clients to pay
2. The ability to purchase materials and inventory at a discount by paying cash
3. The ability to "get started" without sacrificing equity
4. The ability to "get started" at all, without investor dollars
5. The ability to pay 940's and 941's without penalties
6. The ability to pay overhead in a timely fashion

Start-up companies inevitably are under-capitalized. It always takes more money and more time to get a business up and running than was budgeted. That is just a fact. So, the availability of working capital early on can mean the difference between being a success or merely being a statistic.

Benefits to an established company include:

1. The ability to fund new contracts and new orders
2. The ability to pay cash and take discounts from suppliers
3. The ability to grow through acquisition (using cash from accounts receivable to fund the acquisition)
4. The ability to fund internal growth SPIKES
5. The ability to expand into new territories or new lines
6. The ability to retain equity when others might have to sacrifice it
7. The ability to avoid tax penalties
8. The ability to work out of a tax liability
9. The ability to fund a buyout of a retiring partner or heirs
10. The ability to avoid long term debt

Mechanics of Factoring

Essentials

In order to factor, most businesses will need to provide some fundamental information to the Factor. With this information, the Factor will determine whether or not factoring will benefit the prospective client. This information usually consists of:

1. a short application
2. copies of the company's Articles of Incorporation or Assumed Name Certificate
3. an aging of the company's receivables and payables
4. recent tax return or financial statement on the company

If a business is a start-up, don't worry. The Factor can help the start-up, too. The start-up business may not have receivables or payables yet. But if there are invoices to good customers, the Factor may still buy them, even though the business is just starting up.

The Factor's review and approval process usually takes about a day. The next step is entering into an agreement with the Factor. This is usually an industry standard agreement whereby a business agrees to sell and the Factor agrees to buy invoices approved by the Factor at prearranged discounts for the time it takes the invoices to pay.

Reputable Factors do not charge application fees, handling fees, due diligence fees, interest, or processing fees. The upfront expenses incurred by the experienced Factor are considered a cost of doing business.

Once the contract is signed, the Factor must begin the process of confirming the invoices. Just as no one would not want to buy a car without knowing that it will run, the Factor does not want to buy invoices without knowing they will be paid. When handled by seasoned professionals, this process goes very smoothly. Most reputable Factors employ well trained personnel who know how to graciously engage accounts payable personnel and get the invoices paid. Seldom is it necessary ever to speak to anyone beyond the accounts payable office.

Upon confirmation of the receivables, an arrangement is made with the accounts payable personnel to direct the payment to the Factor's lock-box. This would be a lock-box arrangement just like a bank will use for a traditional line of credit. Accounts Payable personnel are very familiar with this process and are quickly able to make the necessary remittance changes. The confirmation process usually takes from a couple of days to a week depending on the number of accounts to be factored. Once completed, funding can occur immediately.

After the initial funding, most good factoring firms will be able to fund your additional requests within 24 hours of receipt of approved invoices. Funding usually occurs via wire transfer or ACH. Funds electronically deposited are immediately available to the business.

Process

So, the process is this simple:

1. Application and submission of the required documents
2. Approval by the Factor on agreed terms
3. Execution of the Factoring Agreement including UCC filing
4. Credit approval of individual accounts by the Factor
5. Submission of invoices to be discounted along with proof of performance
6. Verification and confirmation of invoices by the Factor
7. The Factor funds the approved, verified and confirmed invoices

Why does the Factor need a signed application? The application, which is usually a one page document, usually establishes the company name and address, the ownership of the company, the size of the accounts receivable outstanding, whether or not the business has filed bankruptcy, and a few other simple facts about the business. Perhaps most importantly, it contains an authorized signature giving permission to the Factor to verify the facts provided and to check personal and business credit.

Factors are in the risk management business. They need to take steps to ensure that they are dealing with legitimate companies who produce and deliver legal products and services. In today's world, they are required to take prudent steps to ensure they know with whom they are transacting business. Think of it this way, no business can acquire a credit card without credit being checked.

The next step is entering into the Factoring Agreement. This industry standard document is a contract that must contain a security agreement between the company and the Factor. This is the place where the business agrees to sell receivables and the Factor agrees to purchase those that meet the credit standards of the Factor. The discount price should be clearly stated in an understandable manner.

Additionally, the Factoring Agreement should explain what happens if the customers do not pay the receivables the business sold to the Factor. The Agreement will also state clearly what is the available maximum credit limit with the Factor.

After the Factoring Agreement is signed, the business will begin to submit credit requests and individual invoices for funding. It should be expected to have individual credit limits on the business' customers as well. Remember a Factor wants to buy good accounts. The Factor is not a collection agency that might buy some bad debt. The Factor wants to buy only those credit-worthy accounts that will pay in a reasonable amount of time.

The invoices should carry unique numeric identifiers and should have any Purchase Order number or client number or work Order number required by the specific customer. Invoices must contain the customer's name and the address being billed along with any separate delivery address used. These invoice specific details along with the Proof of Performance will not only satisfy the Factor

but they will facilitate the invoices being paid in a timely manner, thus costing less in fees. Remember, the more detailed the invoices, the faster they get paid.

Questions

What questions should I ask myself to determine if I am a candidate for factoring? That is easy. You know your business. Are you looking for capital? Are you hoping there is an Angel out there who will give you the money you need to grow your business? Ask yourself these questions:

1. If I had the money in cash from my receivables right now, would I take on new jobs?
2. If I had the money in cash from my receivables right now, could I get some suppliers off my back?
3. If I had the money in cash from my receivables right now, would I use it to meet payroll?
4. If I had the money in cash from my receivables right now, could I take care of the IRS?
5. If I had the money in cash from my receivables right now, would I be able to focus on something other than collections and juggling payables?
6. If I had the money in cash from my receivables right now, could I avoid giving up equity in order to grow the business?
7. If I had the money in cash from my receivables right now, would I buy that competitor of mine who is supposedly for sale?

If you answered yes and especially if you smiled and answered yes, you just might be a candidate for factoring. At least give it some thought. You may be concerned about what other people will think. Don't be.

If you are dealing with a well established, reputable factoring firm, their contact with those "other people" will usually be limited to the accounts payable personnel. Accounts payable personnel deal with factored accounts every day.

The payables personnel do not "judge" you if you factor your receivables. They don't want to pay for work that has not been done and they don't want to send the money to the wrong place. Other than that, it is business as usual for them.

In fact, you have just demonstrated to anyone who cares that you are a stronger company, you have cash in the bank (from factoring your receivables) with which you can keep your bills paid. Thus you are a stronger company than before you factored. You have avoided creating long term debt.

Zero Long-term Debt

Factoring never creates long term debt that would have to be repaid in bad times as well as good. Any business that survived 9/11 in the United States

knows that bad times can come suddenly and unexpectedly. Not having long term debt can mean you survive when others do not. Never create long-term debt to meet short-term needs in your business. Factoring allows your business to “pay as it grows” without losing equity and without long-term debt.

Improve Collections Today

Without changing your general business practices and without hiring new collections personnel, is there anything can you do to collect the money that is owed to you in less time than it takes you today?

In a word, NO. No growth occurs without change. You will have to change. If your current practices could get you paid sooner, they would be doing that already. So, the first thing you have to agree to do is...CHANGE.

Change is important indeed, but change for change's sake will not relieve your stress nor shorten the collection cycle. The changes that you implement must be based in truth. It is true that your customers are taking longer to pay you. It is probably true that your largest customers take the longest time to pay you. But why is this true?

The time value of money. It is true that your customers can do a lot with the money they owe you while you sit and wait to be paid. Paying you faster is not a value proposition to them. In truth, you are financing your customers, especially your large customers. The fortunes of the Fortune 500 are essentially built on the backs of small vendors, suppliers and subcontractors. That would be you.

Did you ever think you were financing some of the richest companies in the world? No, because you are an involuntary lender. Ten-to-one you did not set out to lend money to your large clients. Actually you set out to make money by getting that BIG contract and selling your products and services to "the big guys", whoever they are in your industry. But the truth is that waiting for those "big guys" to pay what they rightfully owe you is costing you dearly.

So, how do you change this pattern? Can you call up the "big guys" and demand that your invoices be paid in a timely manner? Such a demand will not likely be received well on the other end. Can you put in your contracts the stipulation that if the "big guy" doesn't pay you within 30 days you can repossess your product or charge thousands of dollars in penalties and fees? Not if you ever want another contract from the "big guy". So what is to be done?

Basically, this is a two-step process.

First Step, you must clean your own house. Granted, it is business brutality for the "big guy" to hold your money when you desperately need it to pay your workers and suppliers, not to mention your mortgage. But the cleaning must begin at home. Don't go to your customer and demand that they change the way they pay you until you have cleaned up what you give them.

It is probably true that you do what you do very well; that is why you got those big contracts in the first place. You pay attention to the design, execution and

delivery of your product or service. Your name is on it. You value your name and your reputation in your industry. So, where is that same attention to detail when it comes to creating the documents that will initiate the payment process? Usually, you turn this function over to someone less skilled and often less experienced than yourself.

Now, your accounts receivable person does not set out to do a poor job. But, because of work load and insufficient training, this person frequently fails to see the creation of the invoice and the accompanying proofs of performance for what they truly are: the most valuable assets you have. Many a company has failed, or entered into bankruptcy while perfectly good receivables languished unpaid.

So, change number one is with your accounts receivable personnel. You must convey to them the essential nature of their work and its critical importance to the survival of your business. Then stop and observe how the job gets done. Look at the systems you use: Are they effective and efficient? Do your people in receivables know why they do things the way they do? Or, are they doing what their predecessors did without considering a better alternative? Are you stuck in a loop of legacy practices that is neither efficient nor effective in getting your receivables paid?

Your most critical person in the invoice generating process may be charged with answering phones, making and filing copies and dealing with sales personnel in the field. Do you ever turn off the phones long enough for concentrated attention to the critical detail of creating the invoices? If this is your most valuable asset, your working capital, your cash profit, then begin by giving the person responsible for creating the invoices enough focused time to do an excellent job.

Then teach that person what an excellent invoice looks like. How do you know what an excellent invoice looks like?

Ask your customer.

Sit down in your customer's accounts payable department and ask the following five questions:

1. What are the essential elements that you need to see on the face of my invoices in order for you to be able to pay them? (Purchase Order numbers? Contract number? Ship to address? Detailed Product Description? Project Manager's Signature?...take notes, get it all)
2. What specific back-up documents do you need attached or accompanying my invoices in order for you to be able to pay them? (Purchase Order? Work Order? Drawings? Product Specifications? Signed Time Sheet?)
3. What is your internal approval process? Who has to approve my invoices before you can pay them? How long does that usually take? What can I do to facilitate that process for you?
4. How should I submit my invoices for you to easily pay them-mail, fax or email?
5. Is the information you need clearly presented on my invoices so that you can easily find it?
6. Is there anything else I need to change or improve that I have not asked you today?

Take what you learn from your customer and go back to that very valuable person who creates and sends out your invoices. Share what you have learned. Ask your accounts receivable person how you can make the changes your customer wants. Then DO IT. Be sure to FOLLOW-UP to make sure it gets done. (Performance that is not consistently inspected cannot be consistently expected.)

Now for the Second Step.

This step is everything else. What's everything else?

Well, there are manuals for running a good accounts receivable department but generally the best practices boil down to some very implementable procedures. There are no secrets here. Here are the typical recommended best practices:

1. DO STEP NUMBER ONE! If you jump to this part of the process without doing what is necessary in step number one, you will fail. It is just that simple. If you

don't make "pleasing the accounts payable clerk in your customer's office" step number one, you will fail. So don't short cut the process. Don't do the following steps unless you are willing to first change your invoicing procedures to comply with the needs of the people in charge of paying you.

2. Find problems sooner rather than later. Some companies send out their invoices like a chain letter, hoping for something to come back to them but with no planned system of follow-up. With this "mail, sit, and wait to be paid" approach, no action is taken until patience is exhausted and frustration is extreme. With the company desperate for working capital, somewhere around the 65th day past due, the word goes out from the top to "find out why that invoice has not paid!" Unfortunately, the answer is all too often, "We don't have that invoice. Would you please send a copy?"

So, establish a consistent procedure for follow-up on invoices and not on the 65th day. Thirty to thirty-five days after you deliver the invoice make contact with the person responsible for paying your invoices. Verify that the invoice was received and that there are no problems with it. You can make this contact via email, fax or phone. But make the contact and get acceptance of the invoice by someone at your client's office. This can be very low key, very friendly and not intrusive, just touching base with them, but in the process you get someone to say "all is well." Or, you find out what you did wrong and you can fix it immediately.

3. Follow-up on the follow-up. Simply stated, write a series of form letters to which you can add new recipients and new details when needed. Letter one should ask again if there is any problem, any reason why you have not been paid. You are asking for information in this letter. This letter should go out when your invoice has passed the agreed upon payment day. If your customer says he will pay in 40 days, don't send this letter out until the 41st day. But do send it.

4. Follow-up again. Follow-up letter two should follow letter one by one week and should give all the invoice information, list the contacts made prior and the promises given for payment. Then this letter should ask that payment be made by a certain date or that the customer notify you immediately as to why payment has been delayed. Around about now you should suspend any further shipments or service to this client until the payment is resolved. This sounds risky but this customer has essentially lied to you at this point. He has promised to pay and perhaps even promised again, but no payment has been received.

5. Follow-up letter three is a demand letter. Again, list everything you have done to collect the payment along with the promises made by your customer. Give the pertinent details of the invoice (invoice number, date, amount, etc.). Then - and this is the critical part - demand that payment be made immediately. Advise this recalcitrant customer that if payment is not received at your place of business within ten (10) days, you will take legal action to collect and you will report the customer to the commercial credit agencies. All legal expenses

incurred in your attempt to collect will be the responsibility of your customer (though, in reality, this is hard to enforce and they know it). At this point this customer will either pay or you will have to engage a lawyer and fight for your money.

REMEMBER, these letters assume you have faithfully completed STEP NUMBER ONE! Until you have done it right, you cannot expect your customer to pay you, ever.

If you consistently don't do it right you will eventually get so tangled up in their problem resolution process that you will lose your status as a valued vendor. So, don't point fingers at your customer until you have first taken the 2 x 4 out our your own eye.

In closing, remember that people do business with people. Get to know the payables departments of your customers. Know the people by first name. Show genuine care for them. Don't just tell them to "have a nice day", though that is better than nothing. But know what makes them smile, comment on their manner of dealing with you, thank them for their kindness, stop pushing and start pulling. Help them help you. Ask what you can do to help them. In short, bless them. They will bless you in return. You can still have favor with the payables personnel.

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