Factoring 101: A White Paper from Fast A/R Funding

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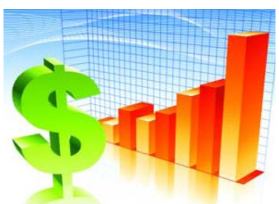
INTRODUCTION

Small business financing can be complicated. Struggling to get a small business loan, constantly managing accounts receivable and accounts payable, never knowing exactly what your working capital will be due to inconsistent cash flow from customers paying on widely varying terms – it can all really put a strain on the operations of your business and ultimately mean you spend less time doing what you enjoy and more time chasing money. Fortunately, there are better ways to manage your cash flow and your business by utilizing your accounts receivable (A/R). One of the best ways to simplify your small business financing and A/R management efforts is by choosing to factor your invoices. Often called accounts receivable financing or invoice factoring ("Factoring") is a method of small business financing whereby small business owners turn their outstanding receivables into cash, quickly and securely.



Did you know that your business accounts receivable are actually assets you can sell? Most U.S. small business owners don't realize this, even though Factoring is big business in America, even for small companies. In this Factoring 101 guide, we'll explain exactly what Factoring is and how it works, what the benefits are to small and mid-sized business, and discuss the ways in which Factoring is mutually beneficial for all parties involved.

A BRIEF HISTORY OF FACTORING

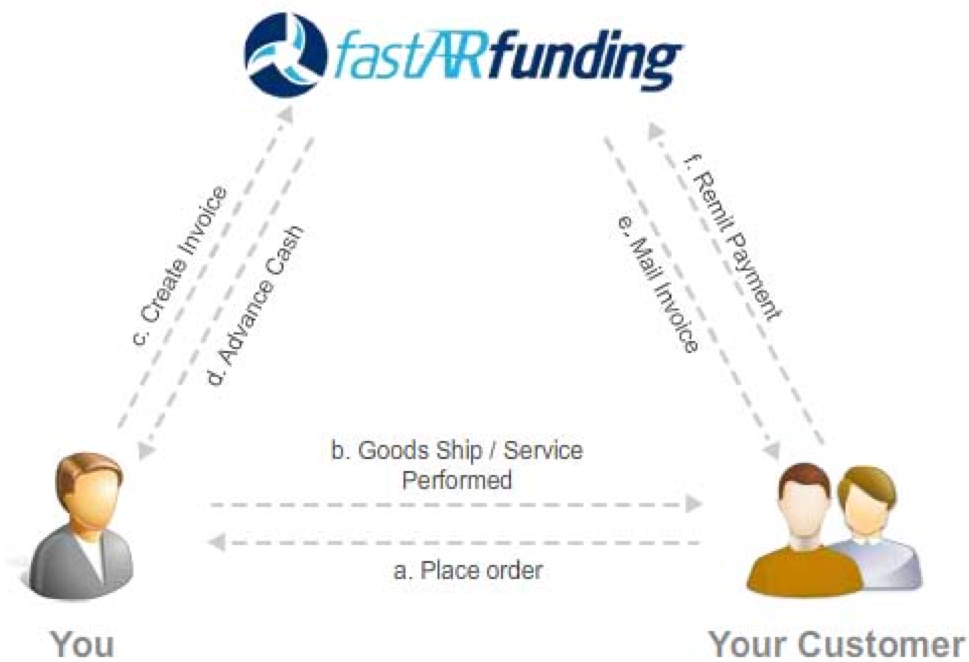
THE HISTORY

While Factoring is a new concept to many small business owners, the idea of selling receivables as assets has actually been around for many hundreds of years going back to the pilgrims and even ancient Romans. For examples of Factoring in modern times, you need look no further than your own closet. In the early 1900s, the U.S. garment industry began using Factoring, a practice still in heavy use by the industry today. In fact, Factoring is largely responsible for the rapid growth of the garment industry in 20th century New York.[i]

While many American small business owners are unfamiliar with Factoring, selling receivables is a common practice elsewhere, and it's extremely common among large corporations here in the U.S. and throughout the world. The reason for this popularity is simple: Factoring makes sense, and people stick with what works.

THE BASICS

The premise is fairly basic. The business provides a product or service, then bills its customer. The customer then has (on average) 30 days to pay that outstanding invoice, which creates a receivable for the business that provided the product or service. The challenge for the business here is that it has no way of knowing exactly when that money from its customer will come in. Will the customer pay early? On time? Late? Some business owners incentivize early payments by customers by offering a 2% discount when customers pay outstanding invoices within 10 days instead of toward the end of their net 30 agreement. For customers who have the working capital to take advantage of this savings, this is an excellent option because saving money is always a good thing. But most customers don’t take advantage of these discounts, and that’s where Factoring comes in.



As mentioned above, the business’ accounts receivable, created by the sale of goods/services, is actually an asset that can be leveraged for cash, much like a house can be financed as an asset. The Factor typically purchases the business’ accounts receivable at a slight discount, providing a rapid influx of working capital to the business, and then when the related invoices are due, the customer makes payments directly to the Factor instead of the original business (since the Factor now owns the invoice/accounts receivable).

The Benefits

This system of small business financing has several benefits to both the Factor and the business owner:

- The Factor has the ability to evaluate the credit worthiness of the business owner's customers. That means the Factor can determine which invoices to purchase by making an informed prediction of which customers are most likely to pay on time. The Factor then buys those invoices at less than face value and ideally receives full face value from the customer within the time frame agreed.

- The small business owner receives an influx of cash, and this increase in working capital enables the business to take advantage of opportunities such as receiving early payment discounts from its own vendors, investing in marketing, or covering critical near-term expenses such as employee payroll. Over time and with enough volume, the business owner is able to have a more reliable idea of how much money the company will have and when, which makes planning, budgeting, and growing easier and faster.

The Modern Twist

Up until the first decade of the 21st century, Factoring in America was, by and large, limited to larger companies with high volumes and large receivables. Factoring was an involved process that simply didn't make smaller volume Factoring cost-effective for large finance companies. That left small business owners out of the loop, which is particularly unfortunate considering how large a portion of the American economy these small businesses represent.

The Internet has changed the way Factoring can be delivered to small businesses and "Online Factoring" is now a reality with Fast A/R Funding. With Online Factoring, the administrative and operational costs to the Factoring Company are greatly reduced, and the ability to provide Factoring to small businesses is greatly increased: a "win-win" all around. In addition, Online Factoring makes it possible for small business owners to deal with a finance company that may be located across the country, as there's no inherent need to be geographically close to the Factoring firm.

Further, Online Factoring provides other benefits to small businesses:

- With Online Factoring, approvals take hours and days, not weeks and months.
- Online Factoring typically allows business owners to manage their own accounts receivable online, keeping them in the loop at all times.
- Online Factors offer electronic invoicing. This means small business owners spend less time and money on A/R because the Factor actually handles much of the business' invoicing, mailing, and payment collections electronically. It's a bit like outsourcing a significant portion of your A/R department, and it can be a major cost savings area for small businesses.

Sounds great, doesn't it? It's fairly amazing how under-utilized Factoring is among small business owners, considering how beneficial and easy it is. But before you're ready to get started with factoring, let's take a closer look at the nuts and bolts of the system.

THE NUTS AND BOLTS

Before embarking on any new business venture, whether it's carrying a new product or using a new form of financing, it's essential that you fully understand all the pieces and parts and how they come together. In this section, we'll discuss the many interconnected elements of small business financing through Factoring. *For a detailed listing of the most common Factoring terminology, please see the Glossary in Appendix A.*

WHO ARE THE PLAYERS?

First, let's talk about who's involved in Factoring. There's the *Factor*, of course. Sometimes the Factor is referred to as the *Factoring Company,* and what they do is called Factoring. This process is also referred to by a few other names, including accounts receivable factoring, accounts receivable financing, invoice factoring, invoice financing, and invoice discounting. Next up, there's the *small business owner*. This person or entity is the Factor's client, and s/he is usually referred to as "*the client*" in these transactions. Finally, we have the "*debtor*," which is the term used for the client's customer(s). The debtor is the entity that is ultimately responsible for paying the invoice (or "debt") to the Factor (once the Factor purchases the invoice).

WHO DOES WHAT?

So, it works like this: The client provides a product or service to the debtor, which results in the generation of an invoice or receivable. This receivable is deemed an asset by the Factor, who purchases the invoice at a discount. The Factor provides cash to the client for the invoice and then the Factor owns the receivable. Finally, the Factor accepts payment from the debtor when the invoice is ultimately paid.

HOW DOES IT ALL WORK?

Online Factoring is much simpler than people tend to think. Once you've chosen an Online Factoring firm to work with, you apply online by providing basic business, finance, background, and contact information. But before you apply, make sure you're doing business with a reputable company. Fast A/R Funding designed a very simple and secure online application process which is totally free to prospective clients. A link to Fast A/R Funding's free application can be found HERE.

As with any industry, in Factoring there are firms with outstanding reputations for great service, security, and reliability, and those you're best off avoiding. Take your time in selecting a Factor. Do your homework, and research the company's reputation. Look for Factors who are members of the *International Factoring Association, Better Business Bureau*, and other professional associations. Check out the Factor's website to ensure that they use secure browsing methods and data protections. You should see icons for things like "*VeriSign*," and security approval seals from hosting providers.

Once you've selected a Factoring company, follow their online application system. Typically these systems are self-explanatory and involve some security checkpoints for extra protection. If you have questions at any point in the process, there should be an online help function or a toll-free number you can access for additional assistance. Most importantly, a successful Online Factoring company should provide quick email response times, as this may be the preferred method of communication.

After the initial application phase, a reputable Factoring firm will be able to quickly acknowledge receipt of your application via email and give you an idea of when you'll hear back. Ideally, you should hear from the Factor again within 48 hours. If your information has all checked out and passed their screening system, you'll be asked to provide further information and proceed through a secondary application system, again online with easy-to-follow prompts.

At this point, the Factor will be asking for very detailed information about your business, sales volumes, customers, and the like. The more honest and complete your answers are, the better. Give the Factor a full and complete idea of who you are as a business, how your finances look at the moment, and how your cash flow varies over the course of a month and a year. Many Factoring firms will look beyond the credit worthiness of the client and look more closely at the credit worthiness of the client's customers. *To that end, a business owner should not hesitate to apply for a Factoring facility if s/he has poor personal credit or even a previous bankruptcy.*

Finally, the Factoring firm will do one of three things. You'll be approved, denied, or you'll be asked for further information before a determination is made. Once you've been approved, you may have cash wired to your bank account in as little as 24 or 48 hours (with a good Online Factoring firm).

When and Why is Factoring a Good Option?

At its simplest level, Factoring is a good option for companies who have creditworthy customers and need a reliable flow of working capital for anything from payroll to equipment upgrades, marketing to insurance payments. It's also a good option for businesses that want to utilize electronic invoicing while decreasing their in-house A/R costs.

A Few Fast A/R Funding Success Stories:

Factoring For Scalability and Growth

A growing software development firm was doing business with hospitals and other healthcare providers. They needed to pay their employees every two weeks, but their customers only paid them every 45 days. In this period of tremendous growth, the company was actually strapped for cash given that they had increased overhead and payroll expenses. Fast A/R Funding provided the cash this software firm needed in order to make payroll and invest in needed IT infrastructure.

FACTORING FOR DELAYED-PAYMENT, SHORT-TERM PROJECTS

A consulting firm won a large contract with a U.S. federal government agency. The firm needed to staff up significantly, in order to fulfill the government contract. However, the agency wouldn't be making its first payment for a full 60 days, leaving the consulting firm short on operating capital. Fast A/R Funding was able to fund this firm with cash in just 48 hours, enabling them to continue delivering against the lucrative contract.

FACTORING FOR SEASONAL BUSINESS FLUCTUATIONS

A seasonal consumer goods company needed to pay its suppliers on 60-day terms. However, in their industry, the online retailers to whom they provided goods were accustomed to making payments on 90-day terms. Fast A/R Funding was able to bridge this working capital gap and enable the consumer goods company to extend necessary credit while still making their own payments on time, all without a small business loan.

IN CLOSING, A NOTE FROM FAST A/R FUNDING

Choosing Online Factoring is a big decision, and it's one that takes serious consideration. In particular, opting for Online Factoring over more traditional "paper" or "in-person" Factoring (or even small business bank loans) is a choice each business owner must make for him or herself. In addition to the general background provided above, we've included some resource information in the following Appendices to help you make your choice.

Keep in mind that the rapid response, approval, and funding times mentioned throughout this document are specific to Online Factoring and, in particular, inherent to the proprietary software and service system we've developed at Fast A/R Funding. If you utilize a traditional Factoring company or another Online Factor for your small business financing needs, your experience will most likely vary tremendously.

We encourage you to shop around and ask questions, and we hope this overview has been helpful in your efforts to find the right fit for your business' working capital needs. We welcome you to contact us for further information any time, and we wish you every success in your business ventures.

APPENDIX A, GLOSSARY:

The following is an excerpt from Fast A/R Funding's Accounts Receivable Factoring glossary. You can view the entire glossary at http://www.fastarfunding.com/glossary/.

Accounts receivable: Accounts receivable refers to the listing of monies owed to a creditor for goods or services s/he has provided. In accounts receivable factoring services, "accounts receivable" are the monies owed to small businesses by their customers. The factor purchases the invoices for these accounts receivable, providing payment to the small business and receiving payment from the small business' customer(s).

Accounts receivable aging report: An accounts receivable aging report details how long customers' invoices have been outstanding.

Accounts receivable factoring: Accounts receivable factoring is a small business financing method involving three parties: the small business (sometimes called the "seller"), the factoring company (also called a "factor"), and the small business' customer (referred to as the "debtor"). The factor (Fast A/R Funding is a "factor") purchases the seller's accounts receivable (invoices), providing immediate funding on those invoices. The small business' customer (or debtor) then remits payment directly to the factoring company.

Accounts receivable financing: "Accounts receivable financing" is a term often used interchangeably with "accounts receivable factoring." It refers to the use of accounts receivable factoring services as a form of small business financing.

Advance rate: The advance rate is the amount of money a factoring company advances to a small business against any invoice.

Asset: In financial terms, an asset is any collateral of financial value. Assets are used as collateral in asset-based lending.

Asset-based lending: Asset-based lending is any form of lending involving an asset as security. For instance, home mortgages are examples of asset-based loans.

Asset-based loan: Asset-based loans are loans involving assets as security for the lender. In this scenario, if the borrower fails to pay the lender, the assets are relinquished to the lender.

Balance sheet: A balance sheet is one of the most basic elements in financial reporting. It demonstrates the financial state of a business at a set point in time and encompasses aspects of the company's finances such as assets, equity, and liabilities in great detail.

Cash flow: Cash flow is a measurement of an entity's (business or project) influx and output of money, generally measured over a set time period.

Charge back: When small business use accounts receivable factoring services, occasionally those factored invoices become uncollectible. If a factored invoice is deemed uncollectible, the client who factored the invoices is "charged back" a set amount of money based on an agreed-upon debtor non-payment clause in the original invoice factoring contract.

Collateral: Collateral is the asset used as security in asset-based lending. The borrower forfeits the collateral to the lender, should s/he default on the loan.

Collectability: Collectability is the ability of a factoring company to collect on purchased accounts receivable.

Credit: Credit is the agreement that payment for goods or services will be received at a later date. For example, a small business provides goods to a customer on 30-, 60- or 90-day terms, which is a form of credit. Credit is also the amount available to a given person, business, or other entity to borrow at a given time. Credit is the educated evaluation of an individual or business' ability to pay monies owed.

Credit analysis: Credit analysis is a process through which a business' financial records and history are analyzed to determine its creditworthiness.

Customer concentration: Customer concentration is an amount, measured in percentage value, demonstrating the portion of a company's outstanding receivables due from a given customer.

Dilution: Dilution is the quantity of risk related to collection of accounts receivable. It includes but is not limited to returns, trade allowances, bad debts, slow pays, concentrations, charge-backs, and other detected risks.

Due diligence: Due diligence is the research undertaken by the factoring company to determine whether to extend accounts receivable factoring services to an applicant company.

Equity: Equity is defined as the interest or value, above and beyond any debt owed, held by an owner in relation to a property.

Face value: For the purposes of accounts receivable factoring, "face value" refers to the actual amount of money owed on a given invoice. That is, if a service costs $400, and the invoice lists that amount, the face value of the invoice is $400.

Factor: A factor is a company offering accounts receivable factoring services for small business financing.

Factoring: Factoring is a method of small business financing involving three parties: the small business (sometimes called the "seller"), the factoring company (also called a "factor"), and the small business' customer (referred to as the "debtor"). The factor (Fast A/R Funding is a "factor") purchases the seller's accounts receivable (invoices), providing immediate funding on those invoices. The small business' customer (or debtor) then remits payment directly to the factoring company.

Factoring company: A factoring company offers accounts receivable factoring services for small business financing. Fast A/R Funding is a factoring company.

Factor's advance: When funding a client through accounts receivable factoring services, the amount of money the factor issues to its client upon verification of the invoices is known as the factor's advance. It is measured in dollars and is determined by multiplying the invoice's face value by the advance rate.

Factors verification: Prior to sending an advance to the client, the factoring company must confirm that the client did provide the specified goods or services to his/her customer and that the customer received those goods or services and intends to remit payment for the amount of the invoice. This process is called factors verification.

Fictitious name: When companies or other entities operate under names other than their official corporate name, they must file a fictitious name document with the state.

Holdback: In invoice factoring, a holdback is also known as a reserve. This is the amount that the factoring company literally holds back withholds from its client until an invoice has been paid. It is typically listed as a percentage of the invoice's face value.

Income statement: Income statements are financial documents demonstrating the income and expenses of a given company during a set time period.

Invoice: Also called a contract of sale or bill of sale, an invoice is a non- negotiable commercial instrument generated by a seller, provided to a buyer. This document identifies both parties and details the items sold or services provided. If applicable, it denotes the shipment date and method. Also listed are the price(s), any applicable discounts, and the terms of delivery and payment. For instances, particularly when the invoice is signed by the seller (or an agent thereof), it may serve as a demand for payment and, when paid in full, serve as a title document. There are many types of invoices, some of which are listed here: commercial, consular, customs, and pro forma.

As regards invoice factoring services, the factor purchases a company's invoices, providing immediate funding to that company. Then, the company's customers (debtors) remit payment on those invoices to the factor.

Invoice factoring: Invoice factoring is a method of small business financing whereby a factoring company (or "factor") purchases a business' invoices, providing immediate funding to that company. Subsequently, the small business' customers remit payment for those invoices directly to the factoring company.

Invoice financing: "Invoice financing" is a term often used interchangeably with "invoice factoring." It refers to the use of invoice factoring services as a form of small business financing.

Leverage: Leverage is a term used to describe the ratio of debt to total assets.

Loan-to-value ratio: A loan-to-value ratio measures how heavily a property is mortgaged and estimates the likelihood of owner default.

Notification letter: When companies choose accounts receivable factoring for small business financing, their customers receive notification letters explaining that the small business has sold its accounts receivable to the factor.

Payee: In business transactions, the payee (also called the client or seller) is the entity holding the right to receive payment(s).

Payor: The entity responsible for making payment to a payee is called the payor.

Personal guarantee: A personal guarantee is a contract between a seller and a funding provider (such as an accounts receivable factoring company) through which the seller accepts liability and personal responsibility for financial obligations.

Reserve: A reserve is an amount of money, held by the factor and not immediately paid to the factor's client when the client's invoices are submitted for factoring. The reserve is transferred to the factor's client (less the discount fee) once the factor receives payment for the invoices. Simply put: Advance rate + Reserve = 100% of invoice's face value.

Small business: A small business is a sole proprietorship, corporation, or partnership that is owned and operated privately, has few employees, and has comparatively low sales volume. In the U.S., industry standards for the definition of "small business" are set by the Small Business Administration (SBA) and vary by industry. SBA's website, www.sba.gov, offers the following as the general rule for defining "small business": "500 employees for most manufacturing and mining industries, and $7 million in average annual receipts for most nonmanufacturing industries. While there are many exceptions, these are the primary size standards by industry."

APPENDIX B, RESOURCE LISTING:

Visit us at http://www.fastarfunding.com to access useful tools and learn more about the processes and benefits of Factoring your invoices. In particular, check out our blog and resource sections, which are packed with great information and answers to common Factoring questions.

For more information or assistance, call us at 888.833.2286 or email our experienced representatives at info@fastarfunding.com to set up a free consultation.

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[i] Factoring Fundamentals: How You Can Make Large Returns in Small Receivables by Jeff Callender; Dash Point Publishing, Federal Way, Washington, Chapter 2.

