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Asset-Based Financing Basics

What CPAs need to know about using asset-based lending and factoring as alternatives to traditional bank financing

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Once considered financing of last resort, asset-based lending and factoring have become popular choices for companies that do not have the credit rating or track record to qualify for more traditional types of financing.

In general terms, asset-based lending is any kind of borrowing secured by an asset of the company. This article will consider asset-based lending to mean loans to businesses that are secured by trade accounts receivable or inventory.

Asset-based lenders focus on the quality of collateral rather than on credit ratings. Borrowers pledge receivables, inventory and equipment as collateral. Traditional bank lenders may have significant problems with asset-based loans. Banks are constrained by both internal credit granting philosophies as well as federal regulations. Banks typically do not accept transactions with debt-to-worth ratios higher than four to five to one. Asset-based lenders that are either nonbanks or separate subsidiaries of banks are not subject to such constraints. This gives asset-based lenders the freedom to finance thinly capitalized companies.

Editor’s note: After reading this article, click here (news/20113992sidebars.html) for step-by-step examples, including footnote disclosures, for GAAP treatment of factoring agreements, lockboxes and acceleration clauses.

REVOLVING LINES OF CREDIT (REVOLVERS)

A revolver is a line of credit established by the lender for a maximum amount. Revolvers are used by retailers, wholesalers, distributors and manufacturers. The line of credit typically is secured by the company’s receivables and inventory. It is designed to maximize the availability of working capital from the company’s current asset base. A typical term for a revolver is one to three years or longer. The borrower grants a security interest in its receivables and inventory to the lender as collateral to secure the loan. In most cases, lenders require personal guarantees from the company’s owners.

The security interest creates a borrowing base for the loan. As receivables are collected, the money is used to pay down the loan balance. When the borrower needs additional financing, another advance is requested.

The borrowing base consists of the assets that are available to collateralize a revolver. It generally consists of eligible receivables (defined below) and eligible inventory. The size of the borrowing base varies with changes in the amounts of the borrower’s current assets limited to the overall revolving line of credit. As the borrower manufactures or acquires new inventory, and as it generates receivables from sales, these new assets become available for inclusion in the borrowing base.

The borrowing base certificate is a form prepared by the borrower and submitted to the lender periodically (usually monthly). It reflects the current status of the lender’s collateral. This certificate should be compared to the balance sheet for consistency.

Within the overall line of credit, there can be a sublimit for letters of credit. For example, an asset-based lender may grant a company an overall line of $16 million, which includes $2 million for letters of credit and $14 million for loans collateralized by the receivables and inventory. Letters of credit are usually necessary when a company is making purchases from a foreign vendor who requires a guarantee of payment.

USE OF A LOCKBOX

A typical agreement gives the asset-based lender control of the company's incoming cash receipts from customers. A "lockbox" or a "blocked account" is established by the lender for the receipt of collections of the accounts receivable. The lockbox account usually is created at the bank where the borrower does business. The company's customers are instructed to pay their accounts by mailing remittances to the lockbox. These payments are deposited in a special account set up by the lender. The lender credits these funds against the loan balance. The lender then makes new advances against the "revolver" as requested.

A revolver differs significantly from a term loan. As discussed, the loan balance in a revolver typically is secured by receivables and inventory, which can fluctuate daily. With a term loan, the outstanding balance is fixed for a period ranging from a month to several years. A term loan has an agreed-upon repayment schedule. Generally, once an amount has been repaid in a term loan, it cannot be reborrowed. In a revolver, however, the company can borrow, repay and reborrow as needed over the life of the loan facility.

**ELIGIBLE ASSETS**
Not all receivables qualify for inclusion in the borrowing base. Examples of receivables that would be ineligible are receivables that are more than 90 days old and related-party receivables.

Borrowing against or factoring U.S. Federal Government receivables is subject to the requirements of the Assignment of Claims Act of 1940 (see "Other Resources"). There may also be restrictions on receivables generated from foreign sales and receivables to companies that both buy from and sell to the borrower.

In general, eligible inventory includes finished goods and marketable raw materials and excludes work-in-process and slow-moving goods. There also could be limits on the advance rate for specially manufactured goods that can only be sold to a specific customer.

**Advance rate.** The amount that can be borrowed is based on the advance rate set by the lender. The advance rate is the maximum percentage of the current borrowing base that the lender can make available to the borrower as a loan (see Exhibit 1 for an example).

**Dilution of receivables.** Dilution of receivables represents the difference between the gross amount of invoices and the cash actually collected for such invoices. Factors such as bad debt write-offs, warranty returns, invoicing errors, trade discounts and returned goods all are involved in computing dilution. Dilution is expressed as a percentage. Dilution is important because, as mentioned, the lender uses it to establish the advance rate (see Exhibit 2 for an example).

**Credit insurance.** An insurance company provides an asset-based borrower with an insurance policy covering the receivables. It is common for asset-based lenders who are financing companies in certain industries, for example, the retail industry, to require credit insurance. The cost of credit insurance is relatively modest. Credit insurers may decline to insure certain customers.

**PURCHASE ORDER FINANCING**
Purchase order financing can be used by companies with limited working capital availability who receive an unusually large order from a customer and, as a result, need additional funds to provide materials and labor to manufacture or supply its product.

In this type of financing, the lender accepts the purchase order from the company's customer as collateral for the loan. These lenders are willing to accept the added risk that the order will be completed, delivered and accepted by the company's customer. While the cost is also higher than traditional asset-based borrowing, in some circumstances—based on the profit margin for the company and maintaining or establishing its relationship with the customer—purchase order financing may be cost-effective.

**FACTORYING**
Factoring is a financial transaction whereby a company sells its accounts receivable to a third party, the factor, at a discount to obtain cash. Factoring differs from a bank loan in three ways:
• The emphasis is on the value of the receivables, not the company’s creditworthiness.

• Factoring is not a loan—it is a sale of receivables.

• A bank loan involves two parties; factoring involves three parties. The three parties are the company, the factor and the company’s customer (debtor).

The sale of the receivables transfers ownership of the receivables to the factor. This means that the factor obtains all of the rights and risks associated with owning the receivables. The factor also obtains the right to receive the payments made by the company’s customer for the invoice amount. As previously discussed, this also occurs in asset-based borrowing. In nonrecourse factoring, the factor bears the risk of loss if the debtor does not pay the invoice.

There are three principal components to the factoring transaction: the advance, the reserve and the fee. The advance is a percentage of the invoice face value that the factor pays to the selling company upon submission. This is similar to the advance in asset-based borrowing. The reserve is the remainder of the total invoice amount held by the factor until the payment by the selling company’s customer (debtor) is made. The fee is the cost associated with the transaction that is deducted from the reserve prior to its being paid back to the seller (credit guarantee). The interest charge fee is calculated based on the advanced amount outstanding, multiplied by the agreed-upon interest rate. The factor will often add a surcharge for debtors who are not considered creditworthy. The factor’s overall profit is the factoring fees and interest charges less bad debts (if the factoring is nonrecourse).

It is a fairly common belief that factoring is too expensive, but this is not necessarily true. It is well known that factoring is more expensive than a bank loan. Factoring is a method used by a company to obtain cash when the company’s cash liquidity is insufficient to meet its obligations and accommodate its other cash needs. A company sells its invoices at a discount when it calculates that it would be better off using the proceeds to bolster its own growth than it would be by effectively functioning as its “customer’s bank.” Therefore, the trade-off between the return the firm earns on its investment in production and the cost of utilizing a factor is crucial in determining the extent that factoring is used and the amount of cash the company has on hand. In other words, whether to use factoring or traditional lending is an important business decision. Sometimes in cases where a bank will not extend credit, a factoring company will.

When initially contacted by the company, the factor first establishes whether a basic condition exists: Do the company’s customers have a history of paying their bills on time? That is, are they creditworthy? Note that a factor may obtain credit insurance against the debtor’s becoming bankrupt and therefore not being paid, similar to credit insurance in asset-based borrowing. In a full-service factoring arrangement, the debtor is notified to pay the factor, who also takes responsibility for collecting payments from the debtor and assumes the risk of the debtor’s not paying in the event the debtor becomes insolvent. This is called nonrecourse factoring. Recourse factoring is typically less costly for the company because the company retains the bad debt risk.

ACCOUNTING FOR FACTORING AGREEMENTS
When a receivable is sold to the factor without recourse, the balance sheet presentation is straightforward—account for the receivable as a sale. When the receivable is sold with recourse to the factor, whether or not the receivable is accounted for as a sale or as a secured borrowing will be determined by following the provisions of FASB Accounting Standards Codification (ASC) Section 860-10-40.

Typically, factors that are familiar with the provisions of U.S. GAAP will purposely structure the agreement so that the transaction is treated as a sale rather than a secured borrowing. This is crucial if a company is mandated by loan covenants or otherwise to meet certain ratios such as debt to equity and working capital.

For a step-by-step example that applies ASC Section 860-10-40 to factoring agreements with recourse, click here.

ACCOUNTING FOR LONG-TERM DEBT REVOLVERS
The classification of long-term debt revolvers is an important consideration when a classified balance sheet is presented because asset-based lenders generally attach great importance to working capital. Under certain circumstances, all the debt will be classified as short term or long term. Under certain conditions, a portion of the debt will be classified as short term with the balance classified as long term. The proper accounting presentation under U.S. GAAP depends on whether the agreement provides for a subjective acceleration clause or a lockbox arrangement.

A subjective acceleration clause is a provision in a debt agreement that states that the lender has the right to accelerate the payments of the obligation under conditions that are not objectively determinable. For example, the agreement may provide for acceleration if the debtor fails to maintain "satisfactory operations" or if a material "adverse change" occurs.

In effect, if the lender feels uncomfortable, the line can be pulled and repayment demanded. A lockbox arrangement can exist either in an asset-based loan or in factoring. It provides that the company’s customers must remit payments directly to the lender or factor and such amounts received are applied to reduce the outstanding debt or the amount advanced.

Where there is a subjective acceleration clause and the likelihood of the acceleration of the due date is remote (such as when the lender historically has not accelerated due dates of loans containing similar clauses and the financial condition of the borrower is strong and its prospects are bright), neither current classification nor disclosure is required. However, when an entity is in poor financial condition, has had recurring losses, or has liquidity problems, debt otherwise classifiable as long term
that is subject to such covenants shall be classified as a current liability, unless the lender has formally waived accelerated payment beyond one year. In other situations, disclosure of the existence of such clauses is sufficient (see ASC Subtopic 470-10, Debt—Overall).

Borrowings under a revolving credit agreement may be classified as noncurrent if the agreement extends for at least one year beyond the date of the financial statements, even when the borrower intends to reduce the amount outstanding. However, under certain circumstances, debt issued under revolving credit agreements shall be classified as current, even though the agreement runs for more than 12 months. This would be the case where there is a maximum borrowing base.

**MAXIMUM BORROWING BASE**

If the maximum borrowing is tied to a borrowing base, the entity shall make a reasonable estimate of the lowest borrowing base during the next year. Any borrowings in excess of the amount permitted at the estimated low point of the borrowing base shall be classified as current (see ASC Subtopic 470-10). Consider the following example:

A company has $10 million of debt under a revolving line of credit that matures more than one year from the balance sheet date. The company estimates that during the upcoming year, it will repay $2 million of the debt. Then $2 million of the debt will be classified as current on the company’s balance sheet, and $8 million will be classified as long term.

If, however, the company does not intend to repay the loan during the 12 months after the balance sheet date because it needs to reinvest in its business, for example, if the company’s business is growing, the company could estimate that there will be no repayments during the current year. In that case, all of the $10 million of outstanding debt would be classified as long term.

If the agreement requires that the outstanding balance be reduced to zero at least once each year (cleanup requirement), all of the borrowing shall be classified as current (see ASC Subtopic 470-10).

Borrowings under a revolving credit agreement that contain a subjective acceleration clause and also require a borrower to maintain a lockbox with the lender (whereby lockbox receipts may be applied to reduce the amount outstanding under the revolving credit agreement) are considered short-term obligations. As a result, the debt shall be classified as a current liability (see ASC Subtopic 470-10).

Note that some lockbox arrangements do not go into effect unless the lender exercises a subjective acceleration clause (a springing lockbox). Long-term borrowings under such arrangements should be classified as noncurrent, because the customers’ remittances do not automatically reduce the debt outstanding. This would be rare. The authors have never encountered a springing lockbox in practice.

Click here (/news/20113992sidebars.html) follow step-by-step examples, including footnote disclosures, for GAAP treatment of factoring agreements, lockboxes and acceleration clauses.

- **Example 1: GAAP Treatment of Acceleration Clauses and Lockboxes**
- **Example 2: GAAP Treatment for Factoring Agreement With Recourse**
- **Example 3: Footnote Disclosure Examples**

**Exhibit 1: Computation of the Advance Rate**

A company has a revolving line of credit with an asset-based lender for a maximum amount of $10 million. The agreement provides for an advance rate of 85% of eligible receivables and 60% of eligible inventory. The agreement provides that eligible receivables consist of balances that are not over 90 days old and that eligible inventory consists only of finished goods. The accounts receivable at the end of the period is $5.5 million with $500,000 over 90 days old. Inventory is $10 million of which $6 million is finished goods. The borrowing base would be computed as follows:

\[
\text{a. Accounts receivable } [(\$5,500,000 - \$500,000) \times 85\%] \quad \text{\$4,250,000} \\
\text{b. Inventory (\$6,000,000 \times 60\%)} \quad \text{3,600,000} \\
\text{c. Total available} \quad \text{\$7,850,000}
\]

Because the total available, $7,850,000, is less than the maximum line, $10 million, and assuming that the company has borrowed the total amount available, the loan is considered to be “in formula.”
If in the above example eligible receivables were $8 million, the loan would be “out of formula” as follows:

a. Accounts receivable ($8,000,000 x 85%)  $ 6,800,000
b. Inventory (same as above)  3,600,000
c. Total (and amount borrowed)  10,400,000
d. Maximum line  10,000,000
e. Excess capacity above line limit  $ 400,000

A typical agreement would require that the amount overborrowed be immediately repaid to the lender. That amount would generally be subject to a higher interest rate.

**Exhibit 2: Dilution**
A company bills $1 million to its customers for invoices. Of that, $930,000 is eventually collected. The difference is $70,000 ($20,000 represents returned goods; $5,000 is subtracted for prompt payment discounts; and $45,000 is written off as bad debts). The rate of dilution would be 7% ($70,000 ÷ $1,000,000).

**EXECUTIVE SUMMARY**

- **A revolver is a secured line of credit.** The granting of the security interest to the lender creates a borrowing base for the loan. As receivables are collected, the money is used to pay down the loan balance.

- **A “lockbox” or a “blocked account” is established by the lender for the receipt of collections of the accounts receivable.** The company’s customers are instructed to pay their accounts to the lockbox, and the lender pays down the loan with these funds.

- **Eligible inventory includes finished goods and marketable raw materials and excludes work-in-process and slow-moving goods.** There could be additional limits on the advance rate for specially manufactured goods that can only be sold to a specific customer.

- **Purchase order financing can be used by companies that receive an unusually large order.** The credit grantor accepts the purchase order from the company’s customer as collateral for the loan.

- **Factoring is a financial transaction whereby a business sells its accounts receivable to a third party, the factor, at a discount to obtain cash.** Factoring differs from a bank loan in three ways: (1) The emphasis is on the value of the receivables, not the borrower’s creditworthiness; (2) factoring is not a loan—it is the purchase of the receivable; and (3) a bank loan involves two parties whereas factoring involves three.

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