REVOLVING LOAN CAN REVOLUTIONIZE CASH FLOW

By putting up its accounts receivable as collateral, a business with a revolving loan can turn sales into immediate cash for growth

By Bryan E. Milling

The accounts receivable revolving loan (A/R/R/L) can help a small business grow into a large business, providing cash flow financing that expands and contracts according to a borrower's needs.

A firm's accounts receivable provide the collateral, but not merely to justify a single loan with a predetermined repayment date. Instead, the lender agrees to advance funds-subject to a realistic upper limit-in proportion to a borrower's total accounts receivable at any particular time.

For example, a lender might approve an 80 percent advance rate so that a business with $100,000 in total accounts receivable enjoys $80,000 in potential credit consideration. Should the firm's total receivables rise to $150,000, the maximum available credit consideration rises up $120,000 (80 percent x $150,000). Alternatively, a drop in those receivables to $50,000 reduces the maximum available credit

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consideration to $40,000. In any instance, the maximum loan at any time cannot exceed the limit set by the relationship between the firm's total accounts receivable and the designated advance rate.

Borrowers must use cash from the on-going collection of receivables to repay prior advances. Thus the accounts receivable loan becomes a fluid, revolving relationship between borrower and lender. Borrowers enjoy discretionary use of the lender's funds up to the allowable limit, so that the loan expands and contracts in direct response to cash requirements.

How does an accounts receivable revolving loan actually operate? Consider the example of a company whose lender agreed to advance cash in amounts up to 80 percent of the firm's total accounts receivable (see Table 1).

On Day 1, when the revolving loan begins, the company's accounts receivable total $150,000. The 80 percent advance rate thus provides $120,000 in borrowing power. Initially, the firm obtains the full amount of cash available to retire an existing single payment loan and pay some past due trade credit obligations.

On Day 2, the company generates $25,000 in sales, but receives no collections from accounts receivable previously outstanding. This raises receivables to $175,000 and so boosts borrowing power to $140,000. The firm decides to take another $20,000 cash advance from the lender.

On Day 3, the company generates no sales, but receives $20,000 in payments on account from its customers. Since the receivables stand as collateral for the credit consideration, the company remits the collections to the lender. Because the lender advances cash up to 80 percent of each sales dollar, but the company collects 100 percent, the $20,000 remitted "over pays" the original advance-thus increasing borrowing power $4,000 (i.e., $20,000 x 20 percent).

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On Day 4, the company needs no additional cash. Consequently, the $4,000 in incremental borrowing power remains unutilized. Subsequently, the $15,000 in new sales on Day 4 raises Action's unutilized borrowing power to $16,000. However, the firm does not use all its available borrowing power, since the A/R/R/L is only an elastic loan that responds directly to real cash requirements.

Of course, different advance rates change the cash flow equation. For example, with various advance rates, a borrower's cash flow becomes:

Advance Rate	Cash Flow
70%	70% of sales plus 30% of collections
75%	75% of sales plus 25% of collections
80%	80% of sales plus 20% of collections
85%	85% of sales plus 15% of collections
90%	90% of sales plus 10% of collections

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Finally on Day 5, the company generates no new sales and receives no payments from customers, but uses a portion of its available borrowing power and obtains a $2,500 advance from the lender.

Of course, actual administration of the accounts receivable revolving loan is more complex than the illustration suggests. But this example shows how the A/R/R/L changes the cash flow so that a business no longer relies on the cash from collections. Instead, the firm's cash flow becomes primarily dependent upon sales. Indeed, presuming a business had an 80 percent advance rate, its cash flow becomes 80 percent of sales plus 20 percent of collections.

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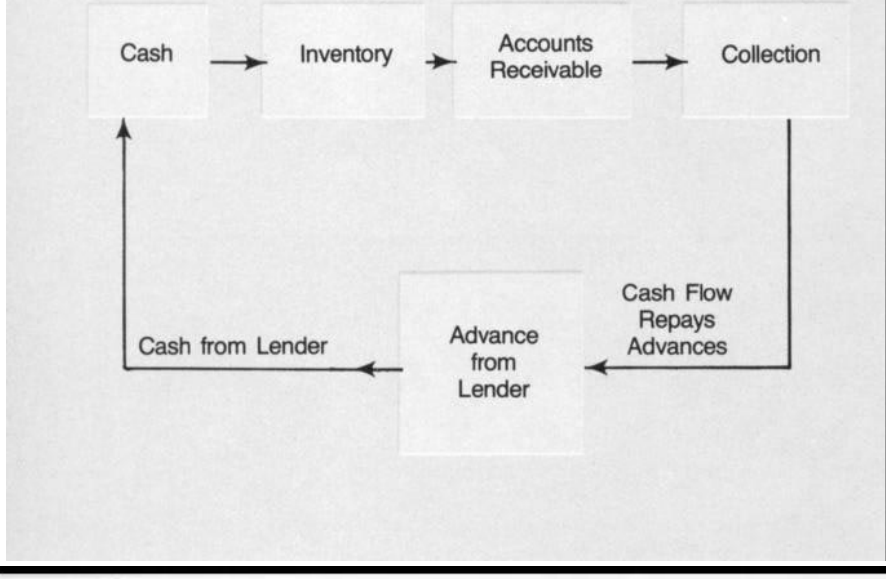
Table No. 1
The Accounts Receivable Revolving Loan

Day	Sales	Collections	A/R Balance	Borrowing Power	Daily Cash Advance	Loan Outstanding	Unused Borrowing Power
1	—	—	$150,000	$120,000	$120,000	$120,000	—
2	$25,000	—	175,000	140,000	20,000	140,000	—
3	—	$20,000	155,000	124,000	—	120,000	4,000
4	15,000	—	170,000	136,000	—	120,000	16,000
5	—	—	170,000	136,000	2,500	122,500	13,500

Figure No. 1
A Conceptual View of the ARRL



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Remember, the above perspective of the cash flow from an A/R/R/L assumes a business constantly utilizes every available dollar of borrowing. Businesses with excess borrowing power gain complete control over their cash flow, obtaining cash advances only when necessary for actual expenditures.

Not every business can benefit from the accounts receivable revolving loan. Indeed, the A/R/R/L is most suited for growing businesses that constantly strain traditional cash flow limits. At the same time, business managers who understand the accounts receivable revolving loan can often use it in a profitable manner suited to a firm's unique circumstances.

About the Author: Bryan E. Milling is the author of three books on financial management. He is an instructor of accounting at the college level and is employed as a banker.