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IN THIS PAPER I shall discuss three types of financing which are relatively little known. Two of these may be described as the financing of current assets, namely, inventory financing and accounts receivable financing. The third is the financing of machinery and equipment on instalment terms. It would, therefore, technically be classified as the financing of fixed assets, but actually it is closely related in operation to accounts receivable financing. Legal problems and legal uncertainties still becloud these relatively new fields of business and law, but in this short paper I shall not enter into these legal questions. I intend instead to try to appraise the function of these forms of financing in the economy and in the general field of supplying business, and particularly small business, with the capital with which to operate.

These three forms of financing were not traditionally areas in which the commercial bank operated. The classical commercial banking function was conceived as the financing of current transactions in production or distribution. This concept included the provision of funds to meet a temporary peak in inventory, followed by a temporary peak in the resulting accounts receivable. But the financing was short-term, and unsecured. When the need for money was steady, it was considered to be a need for credit other than bank credit. And when a pledge of the inventory or the accounts as security was involved, the borrower was conceived to be in desperate straits and unworthy of bank credit.

Likewise, equipment financing was not included in the traditional view of the banking function because of a once prevailing economic theory that the financing of fixed assets through bank credit increased the money supply without a corresponding increase in the flow of goods, and thereby led to inflation.

It is, therefore, fair to say that in large measure these three types of financing hereunder discussion reached their development through the pioneering of non-banking financing institutions—the types of companies which are now commonly called sales finance

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companies, factoring companies, and accounts receivable or commercial financing companies. It is not suggested that these areas remain the exclusive preserve of non-banking financial institutions. To greater or lesser degree, depending upon the bank and the area, banks are now active in all of these fields, particularly with larger accounts. Some banks now handle these types of financing very effectively.[1] Nevertheless, it is still fair to say that these types of financing are relatively new for banks and require supervision and control going beyond that exercised by bank lending officers in typical commercial bank lending. Hereafter in this paper the forms of financing under discussion will be considered solely in relation to their economic function and without reference to the type of financial institution by which they are made available.

These forms of financing are used largely by smaller types of business. Without troubling to reach a definition of small business,[2] it can be said that the smaller the business, the more prevalent are these forms of financing. That is so because the smaller the business, the less available are the conventional forms of obtaining capital.

The problems of small business in obtaining capital have long attracted public attention. Innumerable hearings have been held on the subject before congressional committees, the most recent being in 1950.[3] Innumerable proposals for government aid to small business have been suggested. I recall, as a government lawyer before World War II, participating in the drafting of such proposals. Extensive hearings on the question were held in 1940[4] before the Temporary National Economic Committee of the pre-war days, and studies were made by its staff.[5] Legislation along similar lines was proposed in Congress in 1950.[6] Without reviewing the history of the many public and private attempts, it is sufficient to say categorically that no general method of interesting equity capital in really small business has ever been devised. The public securities markets are not, as a rule, open to the sale of stocks of small companies except

1. See the chapters on these forms of financing in Prochnow and Foulke, Practical Bank Credit (2d ed. 1951).

2. See the suggested definitions and statistics in Temporary Nat. Economic Comm., Final Report of the Executive Secretary 297 (1941); Nat. Ass'n of Manufacturers, Financing Small Business 3-4 (1946).

3. Hearings on S. 3625 and S. 2975, 81st Cong., 2d Sess. (1950). See McCabe, Statement on Proposed Small Business Legislation, 36 Fed. Res. Bull. 810 (1950).

4. Hearings before the Temporary Nat. Economic Comm., pt. 9, 3871 *et seq.* (1940). The Temporary National Economic Committee is hereinafter cited as TNEC.

5. TNEC, Monograph No. 17, Problems of Small Business, pt. 3 (1941).

6. See note 3 *Supra*.

at an exorbitant underwriting cost and seldom with a firm commitment.[7] The insurance company market is not available for such equity securities. The most frequent resort used to be to friends and neighbors, but the growth of urban civilization and the tax laws are shrinking this source.[8] Apart from this source the only outlets for equity securities of really small enterprises are a few institutions organized in a few areas by chambers of commerce and similar agencies to try to attract new industry locally,[9] or such groups as the American Research and Development Corporation,[10] and a few other corporations which are genuinely looking for equity investment, but on a very highly selective scale in outstanding growth industries, leading to expected capital gain.

It can also be said that standard long-term lending procedures have not proven conspicuously successful with really small business. Valiant efforts in this direction were made in 1934 by amendments to the Federal Reserve Act and to the RFC Act, both intended to put the Federal Reserve Bank and the Reconstruction Finance Corporation into the field of lending to small business.[11] On the Federal Reserve side, the number of loans actually made was very small in relation to the cost and the effort.[12] Something more was done with the RFC, but it is still fair to say that neither program really solved the problem.[13] One of the principal difficulties is that these smaller companies frequently need advice in management, budgeting and accounting as much as they need money. Another difficulty is that the cost of investigation and operation is much higher per dollar for small loans.

The most important actual source of credit for the small busi-

7. TNEC, Final Report of the Executive Secretary 308 (1941); McCabe, Statement on Proposed Small Business Legislation, 36 Fed Res. Bull. 810, 814 (1950).

8. U. S. Dep't of Commerce, The Small Businessman and Sources of Loans 2 (1948); TNEC, Final Report of the Executive Secretary 308 (1941).

9. U. S. Dep't of Commerce, The Small Businessman and Sources of Loans 24 (1948).

10. See Wiesenberger, Investment Companies 313 (1951).

11. Federal Reserve Act, § 13B; Reconstruction Finance Corporation Act, § 5(d).

12. Rosa, The Industrial Loans of the Federal Reserve Bank of New York, Proc. of the Sixth Annual Convention of the Commercial Finance Industry 57 (1950); U. S. Dep't of Commerce, Government Financial Aids to Small Business 5-11 (1945); TNEC, Final Report of the Executive Secretary 312 (1941).

13. So it was concluded in TNEC, Final Report of the Executive Secretary 313 (1941): "Whatever the reasons, the facts indicate that the role played by both organizations (R.F.C. and Federal Reserve Banks) in solving the financial problems of small business has been relatively slight."

nessman is the trade credit which he gets from his suppliers.[14] Trade credit is frequently very expensive, for it means the loss of cash discounts. The staff of the TNEC concluded that, apart from the trade credit, some of the most significant techniques involved in financing small business had been worked out by the nonbanking financial institutions.[15] These techniques are the forms of financing which are the subject of this article, and are now to be considered separately.

Instalment Financing of Machinery and Equipment

The economic significance of the instalment purchase of machinery and equipment is rather easy to analyze. From the purchaser's point of view, the instalment purchase of fixed assets is a way of borrowing on medium term, two to five years being a common range of credit. It is interesting to note that the label which is given to the form of financing frequently influences the thinking of the lending officer. The banks which, immediately after the Second World War made a great number of term loans to large business, but have subsequently rather generally withdrawn from that field, are still ready and anxious to extend what is economically the same type of credit, to large and small business, through the device of taking over the seller's position on a two to five year instalment sale. The small businessman who might have trouble getting two to five year credit directly from his banker, whether or not secured with a chattel lien, can get the same number of dollars and the same terms through the medium of an instalment purchase of his machinery and equipment.

One other point is worth noticing about instalment purchasing of machinery. When the Temporary National Economic Committee wrote its reports some ten years ago, and bemoaned the unavailability of credit to the small businessman, it commented repeatedly that larger businesses were becoming increasingly self-sufficient as to capital, and were financing themselves largely out of depreciation and retained earnings. A corollary was that their capital investment programs did not have to submit to the competition of the capital markets.[16] In passing, it might be questioned whether similar conclusions could now be reached. The expansion

14. TNEC, Monograph No. 17, Problems of Small Business, 272-276 (1941); U. S. Dep't of Commerce, The Small Businessman and Sources of Loans 18 (1948).
15. TNEC, Monograph No. 17, Problems of Small Business 277 (1941).
16. Hearings before TNEC, pt. 9, 3670 *et seq.* (1940); TNEC, Monograph No. 37, Savings and Investment 58 (1941).

of our economy and the rise in the price level have resulted in a tremendous quantity of long-term debt financing by industrial corporations, in the public capital markets, from insurance companies and other institutional investors, and by bank term loans.

But even to the extent that the ten-year old conclusions for the large corporations are still sound, the TNEC staff was in error in its emphasis on the uniqueness of the internal financing of the large corporation. The instalment purchase is the small businessman's way of achieving the same result. How does the large corporation pay for the replenishment and modernization of its equipment, which is said to be internally financed? It does so out of the cash thrown off by the depreciation of the equipment being replaced, and out of retained earnings. How does the small businessman pay for his instalment purchase? He does so out of cash thrown off by depreciation on the equipment being purchased and out of the retained earnings subsequent to the purchase. The only difference is the timing, and the instalment purchase is the small businessman's way of getting a two or three year jump on his cash budget.

The Permanent Nature of Current Assets

The other two types of financing to be dealt with are inventory and accounts receivable. Both of these types of assets are classified by accountants as current assets. They show "above the line," in an accountant's financial statement, and they enter into his computations of "current assets," "net current assets," and "net quick worth." Because of this accountant's classification and because each item of inventory and each account receivable is itself of short duration, these types of assets are sometimes thought of as ephemeral. The price level changes since the end of World War II, however, and the heightened pace of industrial activity have served to impress the lesson that even though the individual item of inventory or the individual account receivable is of short duration, the aggregate investment in accounts receivable and the aggregate investment in inventory are permanent. It has been learned, sometimes painfully, that it requires more dollars of permanent investment to maintain a given physical quantity of inventory at a higher price level. Persons who have lengthened their trade credit terms after World War II, including such devices as the 4-pay, 6-pay, or 12-pay revolving credits of the department stores, have discovered that the change requires a vastly increased amount of permanent capital. The conclusion is that the accountant's classification, when we take it too literally, leads us astray and conceals from us the permanent long-term fixed character of the investment of a business enterprise in its normal inventory and in its normal amount of accounts receivable. The enterprise needs long-term capital for these purposes just as much as it needs long-term capital for its plant and machinery, which the accountant recognizes as fixed assets.

To the extent that the conventional forms of equity financing and long-term capital financing are available, there is, of course, no problem, except for devices to take up the slack during periods of maximum need for funds. But for the small businessman who is chronically undercapitalized,[17] and to whom the conventional long-term sources of funds are not available, credit devices by which he is enabled to obtain the capital with which to carry his inventory or his accounts receivable, may, in fact, be credit devices for extending long-term credit even though the arrangements are nominally for the short term and are quickly terminable.

Inventory Financing

Let us take the inventory situation, for instance, of an automobile dealer. Situations are of daily occurrence in which an automobile dealer borrows 100% of the cost of the automobiles on his floor, for which the factory has been paid, the money being provided by a finance company or bank. These 100% loans against his inventory may in the aggregate be considerably more than 100% of the proprietor's, partners', or stockholders' investment in the business. Nominally, each extension of credit on a "floor-planned" automobile must be paid off when the automobile is sold; thus the credit looks superficially like exceptionally short-term credit. But when the automobile is sold, it is replaced by another, and another extension of credit takes place. A capital investment sufficient to maintain a suitable inventory of cars for sale and display is as permanent a part of the automobile dealer's capital requirements as is the capital with which he buys and maintains his showroom and service department. The finance company or bank which supplies his inventory credit is, in a very practical sense, supplying him with long-term capital.

The same point could be equally well illustrated with a dealer in appliances or machinery, and also with a manufacturer who finances his inventory of raw materials and work in process.

17. Nat. Ass'n of Manufacturers, Financing Small Business 11-12 (1946); McCabe, Statement on Proposed Small Business Legislation, 36 Fed. Res. Bull. 810, 813 (1950).

Receivables Financing

The same basic principle also comes to light when we study the third form of financing to be discussed—accounts receivable financing. An account receivable is the creditor's side of what was referred to above from the debtor's side as the small businessman's most important source of credit, namely, trade credit. If a debtor is enabled to buy on thirty or sixty-day terms or on two to five year instalment terms, his ability to do so exists because the creditor in some manner is able to wait thirty or sixty days, or two to five years, for his money. Between the creditor and any given debtor the extension of credit may be casual and of relatively little significance; but from the viewpoint of the creditor's operations as a whole, his outstanding accounts receivable or charge accounts or instalment accounts run to very considerable amounts. Some of them are always present and being newly created. The investment in accounts receivable or the longer term instalment accounts is just as permanent as the creditor's investment in his machinery or his fixtures, even though the individual components of the accounts receivable may change faster than the components of his list of equipment. We may be sure that in every industry where purchasers customarily use short term trade credit or long term instalment purchase credit—somewhere, someone is supplying long-term capital which enables the seller to carry the resulting accounts receivable or instalment accounts. Where the creditor is a large well-financed corporation, the capital invested in accounts receivable or even instalment sales may be undifferentiated from the capital invested in its fixed assets, for in a real sense they are all fixed assets.

In the smaller seller corporation, however, the problem of financing trade credit by finding permanent capital with which to carry accounts receivable and instalment paper is not as simple. Accounts receivable financing frequently provides this capital. In a larger sense, accounts receivable financing includes every device by which a seller extending credit is enabled to get his cash immediately while someone else takes over the function of providing the capital necessary to extend the credit. If a furniture store or department store has outstanding some hundreds of thousands or million of dollars of instalment or charge accounts and pledges those receivables to a bank or finance company, it is apparent that the credit to carry the receivables is provided by the financial institution, and frequently the arrangement is renewed so regularly that the credit is clearly long-term in economic effect. Sometimes, however, variation in legal form will conceal the fundamental identity of business fact. Thus, an automobile dealer sells the automobile on 18-month instalment terms and then gets his cash immediately by selling the purchaser's instalment contract to a bank or finance company. When he does this day after day, and year after year, the bank or finance company is providing the long-term capital with which that dealer is extending credit, although the transaction may not be reflected on his balance sheet. When we get down to accounts receivable financing, as that term is more narrowly used, meaning the sale or pledge of short term, thirty or sixty-day trade receivables by a manufacturer or merchant to a finance company or a factoring company, we again have an arrangement by which, under the technical form of the financing of short term current assets, an arrangement which becomes in practice a long term method of supplying permanent capital can be made.[18]

Therefore, I have entitled this paper "Current Assets Financing as o Source of Long-Term Capital." It is interesting to note that because the permanent financing takes the form of a rapidly revolving arrangement secured by assets which are individually of short duration, the arrangements are self-liquidating and can be quickly terminated by the supplier of capital if the debtor's financial condition changes, or by the debtor if he reaches the point where other methods of getting capital are available and advantageous. These forms of financing under discussion are, therefore, ideal devices by which financing institutions can extend credit with relative safety to small businesses which do not have either the experienced management or the internal controls or other essentials of a credit picture which would measure up to the standards for more conventional types of financing. Nevertheless, this type of credit extension requires close supervision and advice and close watching by a specialized and highly trained staff.

18. It is interesting to note the differences in financing arrangements which result from differences in trade practices. In the automobile and other "hard goods" industries, manufacturers and distributors successfully demand cash for their products at shipping point, extending no trade credit. They, therefore, have smaller accounts receivable, proportionately, than other types of industrial businesses. The dealers, however, have to finance their purchases, and the inventory or "wholesale" or "floor plan" financing of automobiles, appliances and machinery runs into many billions of dollars annually.

In the textile and related "soft goods" lines, however, trade credit is regularly extended at every step of the manufacturing and distributing process. The sellers, therefore, have large accounts receivable, and a problem in financing them. This has led to the growth of "factoring companies" as financing devices by which textile sellers finance their receivables. See Steffen and Danziger, *The Rebirth of the Commercial Factor*, 36 Col. L. Rev. 745 (1936).

The legal position of the security in these types of financing was until recently, and is still, a matter of great complexity and some uncertainty. This legal position has steadily improved with the adoption of some of the uniform laws like the Uniform Conditional Sales Act,[19] the Uniform Trust Receipts Act,[20] Factors Liens Acts[21] and the 1951 amendment to Section 60a of the Bankruptcy Act.[22] Finally, the proposed Uniform Commercial Code will, in its Article 9,[23] if it is widely adopted, solve a great number of the legal and operating problems of these types of financing.[24] It may confidently be predicted that increased provision of long-term capital will occur in the form of revolving financing of current inventory and receivables. These types of financing, participated in increasingly by specialized financial institutions and by banks, will continue to be among the most fruitful methods by which small business can provide itself with capital.

19. 2 U. L. A. Ten states have adopted this law.

20. 9A U. L. A. 284. Twenty-nine states have adopted this law.

21. *E.g.,* N. Y. Pers. Prop. Laws, § 45. About twenty other states have similar laws.

22. Pub. L. No. 461, 81st Cong., 2d Sess. (March 18, 1950). See Kupfer, *The Recent Amendment to the Preference Section of the Bankruptcy Act*, 22 N. Y. St. Bar Ass'n Bull. 329 (1950).

23. Uniform Commercial Code, Final Text Edition 229 *et seq.* (1951). The most complete discussions of the Code appear in a two issue symposium in 16 Law and Contemporary Problems (Winter and Spring 1951).

24. For a general discussion of these problems, see Seidman, Finance Companies and Factors (1949) *passim.*