Introduction to Vendor Finance: How and Why to Start a Software Vendor Program

By William S. Veatch

As businesses continue to expend an increasing percentage of their overall technology budget on software, the question of financing the acquisition of software becomes increasingly important to both providers of software and their customers. This column is the first of a series that will explore Vendor Finance in some detail, including the issues of greatest concern to software vendors, their customers, and the funding sources providing the acquisition financing.

WHAT IS VENDOR FINANCE?

Vendor Finance is defined as a program in which the software company extends credit to its customers to facilitate the acquisition of software products by the customers. Usually, there is a bank or leasing company behind the scenes, working with the software vendor to actually provide the extension of credit. For example, when a customer makes the decision to license software, the price for the software is typically due net 30 days. The customer must pay for the license either with its own cash, with funds borrowed from a bank or leasing company, or through an extension of credit by the software vendor. Customers often prefer to choose the vendor finance option, if available, not because they do not have the cash, but because they would rather pay over time for budgeting reasons. For example, if the license has a three-year term, even Fortune 500 companies would often prefer to make payments over three years in order to match the payments with the use of the product, rather make the entire capital expenditure in year one.

WHY START A VENDOR FINANCE PROGRAM?

Once the customer has decided to finance the acquisition of products, financing through the vendor is often more desirable than going directly to a bank or leasing company for a variety of reasons:

- **To meet customer demand** One of the most common reasons that software vendors start vendor finance programs is because customers are asking for financing from the vendor. If the vendor program is structured properly, vendor financing can be put in place for the customer faster and more easily than financing directly from a third-party funding source.

- **To provide better pricing to the customer** Through the use of vendor incentives, it may be possible to achieve better pricing for the customer on the financing than the customer would get through its own bank.

- **To close the sale faster** For many software companies, most of the sales occur at the end of the quarter, and the ability to close quickly on financing is essential. Setting up the vendor program in advance speeds up the sales process.

- **To meet competition and increase sales** Another common reason to start a vendor program is because the competition has one. Sometimes whether or not the vendor has a finance program can be the deciding factor between your product and your competitor's.

- **To improve cash flow** As discussed below, part of setting up a vendor program involves working closely with one or more funding sources in order to shift the risks of financing to a bank or leasing company that is in the business of extending credit. As a result, the vendor receives cash up-front and can improve cash flow.

- **To improve DSO** Through careful structuring, it may be possible to improve "days sales outstanding" by selling customer receivables on a nonrecourse basis.

- **To shift credit risk to a bank or leasing company** Perhaps the most important benefit to the vendor of setting up a vendor program, however, is to shift customer credit risk to a bank or leasing company. This is discussed more in the next section.

MANAGING CREDIT RISK

Software vendors need to consider carefully whether they want to enter into the business of lending money, or whether they want to outsource this function to a bank or leasing company that is in the business of extending credit. In fact, many software companies inadvertently enter into the lending business. For example, suppose the software vendor normally requires cash up-front, but the customer wants to pay in 12 quarterly installments. If the software vendor agrees to accept quarterly payments, it has now arguably entered into the lending business.

Another example is the subscription license model. Suppose the software vendor switches from cash up-front to a subscription model in which the customer makes monthly subscription payments. While this may be a desirable way to account for the revenue, if the software vendor is not careful, it may inadvertently enter into the lending business.

As a lender, the software vendor should consider, among others, the following issues:

- **Evaluation of credit risk** The software vendor should establish a means of checking and ranking the customer credit risk.
- **Time value of money** Having established the cash up-front price and credit risk associated with the particular customer, the software vendor should set an appropriate interest rate to charge the customer to take into account the time value of money and risk of default.
- **Documentation issues** The documentation of the payment obligation should be reviewed carefully to make sure that it is noncancellable and not subject to defenses. This is reasonable, considering that the customer's only other options are to pay cash up-front or to obtain a loan from its own lender.
- **Credit enhancement** If the particular customer is not creditworthy, then the software vendor should consider obtaining collateral, a guaranty, a letter of credit, or some other form of credit enhancement.
- **Enforcement of the receivable** In the event of a customer payment default, the software vendor will need to take appropriate action to enforce payment of the customer receivable.
- **Assignability of the receivable** To effectively shift the credit risk and all of the other risks associated with being a lender, the software vendor should ensure that the receivable is assignable.

Partnership with a Funding Source. Rather than enter into the business of lending money, it may be preferable for the software vendor to enter into a program agreement with a bank or leasing company ("**Funding Source**"), whereby the Funding Source is the party extending credit and taking all of the risks associated with being a lender. There are two basic structures for software vendor finance programs:

- **Outsourced or referral program** In an outsourced or referral program, the software vendor, in essence, refers its customers to a particular Funding Source for financing (see fig. 1). The Funding Source and software vendor have typically entered into a program agreement in advance, so most of the issues that typically arise in a financing have been worked out in advance, and the financing can be completed quickly and efficiently. The referral program can be operated on a private label basis, so that the customer, to some degree, still feels that it is working with the software vendor. A referral program is a great way to start a customer finance program, especially in light of SOP 97-2, which limits the ability of a software vendor to recognize revenue up-front if the customer payment terms are longer than one year. The referral program also allows the software vendor to gain experience with software financing and to establish customer payment history, so that the vendor program can later be brought in-house.

- **In-house or assignment program** The alternative to a referral program is an in-house or assignment program (see fig. 2). In this structure, the software vendor extends credit to the customer, and then assigns the customer receivable to a Funding Source. The principal advantage of the assignment program is that the software vendor maintains control over the customer relationship. The software vendor can also reduce the overall cost of the program through the financing of diversified pools of receivables, as opposed to financing customer receivables one by one. The assignment program is, however, more complicated to document, and raises potential revenue recognition and true sale accounting issues that must be carefully addressed.

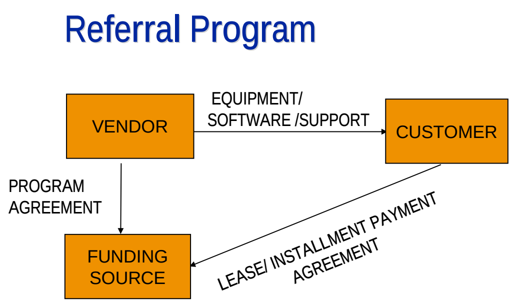

Fig. 1

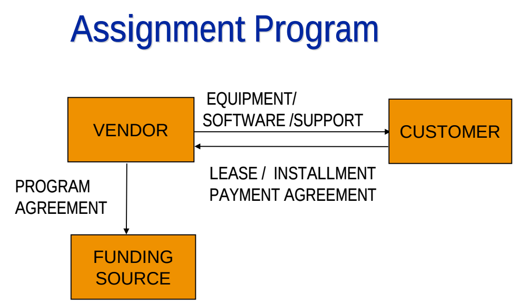

Fig. 2

CONCLUSION

As discussed above, there are many reasons for a software vendor to consider setting up a vendor finance program, perhaps the most important of which is to use the vendor finance program as a tool to increase sales. Unless the software vendor is committed to learning the business of lending money, it is preferable to separate the financing from the underlying license transaction, and outsource the financing part of the business to a bank or leasing company. Future columns will address in more detail the specific issues that must be worked out among the software vendor, its customer, and the Funding Source.

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