

Accounts Receivable Factoring

John's Bicycle Company

John owns a bicycle company and builds specialized lightweight racing frames. John maintains about \$20,000 in working capital which is normally enough to comfortably operate his business, carry inventory and make payroll each week.

John was surprised to receive a purchase order for one hundred new bicycles from a large corporation where they were to be used as production promotions for the sales force. In estimating his materials costs for the project, he immediately discovered he was in need of an additional \$10,000 to order raw materials for the purchase order.

John's business was small and he had no real collateral to secure a bank loan. A friend told John about the ability to raise the necessary capital by using a *factor*. John had never heard of *factoring* but called a Commercial Finance Consultant (CFC) to investigate the possibility.



The CFC looked at John's current outstanding invoices and work in progress and discovered that a \$15,000 order was about to be delivered to a large national sporting goods chain which would pay John's invoice within 45 days according to John's original terms of sale.

The CFC explained to John that by *factoring* that invoice, he would be advanced approximately 75% of its face amount immediately by the factor, thus providing enough capital for John to purchase the necessary parts to fill the new order. The CFC further explained that the factor would charge John a *factoring fee*, typically around 4% of the invoice face amount, for the first 30 days and an additional 1.5% of the invoice face amount for each additional 15 days until the amount was finally collected.

John agreed and after the factor's due diligence and contracting, the transaction was finalized. John ordered his parts and began to assemble bicycles for the new order, a job that would allow him a profit of over \$10,000.

Forty-five days later when the sporting goods chain paid the \$15,000 invoice, the factor settled the account with John. The factor kept his agreed upon fee of 5.5% of the invoice face amount, or \$825 and gave John a rebate check of \$2,925 for the balance due, computed as follows:

Invoice Amount	\$15,000.00
Less original advance by factor	11,250.00
Minus factor's fee for 45 days (5.5%)	825.00
Settlement balance due	\$2,925.00

Because of the factor's ability to provide John with the necessary financing, John now enters into contracts for production beyond his normal financial capabilities. One of the great, and too often unrecognized benefits of *factoring*, is that it allows small business owners to contract for jobs that would normally be out of reach. This benefit is known as the *multiplier effect* and is one of the strongest reasons for under-capitalized businesses to create factoring relationships.