

## What Is the Cost of Factoring?

There are many factors to consider when calculating the cost of factoring. (Pardon the pun.) One of the many benefits of factoring invoices is the **value of turning your money more quickly**, thus increasing your profits. Here's an example:

Let's say you're in the custom golf cart business and it costs you \$7,000 to produce one golf cart in 15 days. Your customer agrees to pay \$10,000 for the cart, but needs 30 days to pay. That's a total of 45 days without any cash to cover the cost of producing another golf cart. Once you get paid for the first cart and cover the cost of building a second cart, you have \$3,000 profit.

It takes another \$7,000 and 15 days to produce the second golf cart and another 30 days to get paid. Now a total of 90 days have passed and only two golf carts have been built and sold. Your total profit so far is \$6,000; still not enough to build two carts at once to get ahead. At this rate, you're **turning your money** every 45 days and can only produce 9 golf carts per year, yielding \$27,000 in profits.

If you could be paid as soon as you deliver, you could build a golf cart every 15 days, for a total of 24 per year. Turning your money 24 times a year yields \$72,000 in profits, all the while using \$7,000 in working capital. The difference between \$27,000 and \$72,000 is what it costs you to **not** factor when your customers take 30 days to pay (\$45,000!!!).

But what about the actual cost of factoring, you ask. Let's continue with the example above, but we'll assume your business has grown, thanks to factoring. Now you're building 10 golf carts per month. Your customer is Ray's Golf World and he agrees to buy all \$100,000 of your carts every month with 30 day payment terms. You also have terms with your factor of 1.5% for 30 days and an advance rate of 85%.

You decide to factor Ray's invoices each month in order to grow your business even more. Each month, upon Ray's invoice verification, the factor wires \$85,000 into your account. Thirty days later, Ray pays the factor \$100,000. The factor deducts \$1,500 (1.5%) and pays you the balance of \$13,500.

Most people want to calculate the cost of factoring by multiplying 1.5% by 12 months (18% annual percentage rate). That's how the banks operate, but the factoring rate is calculated by multiplying \$1,500 (1.5% of \$100K) by 12 months. The factor's rate is \$18,000, 1.5% of the annual invoices, which are \$1.2 million.

It may seem like a lot of money, but how much do you pay your vendors by taking advantage of their 30 day terms? Many vendors offer 1% or 2% discounts if the invoice is paid within ten days rather than 30 days.

A 2% discount on a \$7,000 invoice is \$140! At 10 carts per month, you would owe the vendor \$70,000, so that discount adds up to \$1,400 per month and \$16,800 per year. Compare that to the annual cost of factoring, which is \$18,000. The money saved by paying your bills early can offset our rate, as well as build credibility with your vendors.