M.Com. (Applied Economics)

Semester II

Accounting for financial decision II

Broad Topic

Working Capital Management

Sub-topic

Sources of Short-term Finance

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Topic – Sources of short-term finance

As we have discussed in the previous class that the sources of finance can be of two types –

(i) Short-term sources of finance

(ii) Long-term sources of finance

The long term sources of finance have already been discussed in detail during first semester course. Therefore, we will not devote much time upon long term sources, rather, we will be having detailed discussion on the short-term sources of finance which are more relevant from the perspective of working capital finance.

Following are the important sources of short –term finance:

1. Finance from the commercial banks
2. Trade Credit
3. Factoring
4. Commercial papers
5. Accrued expenses

Finance from the commercial banks: Commercial banks are one most important sources of working capital finance. Following are the major finance facility provided by the commercial banks:

i. Short-term loans
ii. Overdrafts
iii. Cash credits
iv. Purchase or discounting of bills and

Short-term loan is an advance – a sum given to the borrower against some security. The amount is deposited in the account of the applicant either in the form of cash or credit. On such loans, the interest is charged on the entire loan amount from the date the loan is sanctioned. Borrower can repay the loan either in lump sum or in installments depending upon conditions.

Bank overdraft is one of the most widely used facilities by the firms to finance their working capital. Under this facility, the borrower can issue cheques or withdraw amount more than the amount deposited in their account. The facility is available only on current accounts not on others. The limit and time duration of such over-drawl depends upon the firm's size of business and the agreement between the borrower and the bank. The interest is charged only on over-drawls for the duration for which it remains outstanding.

Cash credit is the also very popular source of working capital finance. Under cash credit facility, the bank allows the borrower to withdraw money up to a sanctioned credit limit against some tangible security or guarantees. The borrower can utilize the sanctioned amount whenever there is requirement. He needs not to withdraw the whole limit at once. Interest is also chargeable on actually used amount for the time period during in which it remains outstanding and there is no commitment charge. The borrower needs to clear up their dues within 3 to 6 months depending upon the agreement with the bank.

Purchase or discounting of bills: A bill arises out of a trade transaction. Bills receivable arises out of sales transaction, where the seller draws the bill on the buyer. The bill may be documentary or clean bill. A documentary bill is supported by a document of title to goods like a bill of lading. Once the bill is accepted by the purchaser, then the

drawer (seller) of the bill can get it discounted from his bank (the bank purchases the bill at less than the face value of the bill that is why it is known as discounting of the bill). At the end of the maturity period of the bill, bank presents the bill to drawer (acceptor) for payment.

Letter of Credit [L/C] and Bank Guarantee: These are also known as quasi-credit facilities as amount is not received immediately. A Letter of Credit (L/C) is issued by the buyer's bank (at the request of the buyer) in favour of the seller. Through this letter the buyer's bank gives an undertaking to the seller that the bank will pay the obligations of its customer up to a specified amount if the customer fails to pay the value of goods purchased. It helps the customer to obtain goods on credit from the seller. On the other hand, the bank guarantee is an assurance given by a bank on the behalf of a customer. By issuing this guarantee, a bank takes responsibility for payment of a sum of money in case, if it is not paid by the customer on whose behalf the guarantee has been issued. Of course, bank charges some commission for providing these services to the customers.

Trade Credit

Trade credit refers to the credit facility extended by the supplier of goods or services to his/her customer in the normal course of business. As we all know that credit selling is the norm these days and no business can afford to lose its customers. Similarly, almost all the suppliers also extend credit facility on their supplies to manufacturers to beat the tough completion. Therefore, trade credit has become one of the very commonly used practices in the business. Trade credit is a spontaneous source of finance that arises in the normal business transactions of the firm without specific negotiations. Under this facility the supplier sends goods to the buyer for the payment to be received in future as per terms of the sales invoice. As such trade

credit constitutes a very important source of finance; it represents 25 per cent to 50 per cent of the total short-term sources for financing working capital requirements.

Factoring

A “Factor” is a financial institution, often subsidiary of a commercial bank, which provides services relating to the management of trade receivables that arises from credit sales. Factoring is a popular mechanism of managing, financing and collecting receivables in developed countries. The factor takes the responsibility of managing receivables right from they arise out of any transaction. It collects, sends reminder and follows the payment of receivables. It also provides the credit facility to the client against these receivables. The factor assumes responsibility for collecting the debt of accounts handled by it. Generally, the amount advanced is 70 to 80 per cent of the face value of the receivable. Factoring may be on a recourse basis (this means that the credit risk is borne by the client) or on a non-recourse basis (this means that the credit risk is borne by the factor). For providing these services, the factor charges commission.

Commercial Papers

Commercial Papers are a source of short-term finance to mainly big corporate and large firms. Commercial paper is a short-term unsecured promissory note issued by firms. These are generally issued for a time period from 7 days up to one year from the date of issue. Commercial papers are issued in denominations of Rs. 5 lakh or multiples thereof. These are generally issued at discount but redeemed at par. The difference is the interest component. The following regulations guide the issue of commercial papers in India:

a. The company has a tangible net worth of at least Rs. 40 million.
b. It can be issued in denominations of Rs. 5 Lakh or multiples thereof.
c. Its equity is listed on any registered stock exchange.

d. Its commercial paper receives a minimum rating of P2 from CRISIL or equivalent thereof.
e. The minimum maturity period is 7 days and the maximum one year.

Accrued Expenses

The major accrual expenses are wages, labour charges and taxes. These are simply what the firm owes to its employees and to the government but has not been paid yet. Some of the expenses are usually paid on a weekly, fortnightly, or monthly basis - between payments, the amounts owed but not yet paid are shown as accrued expenses on the balance sheet. Income tax is payable quarterly and other taxes may be payable half yearly or annually. In the interim, taxes owed but not paid may be shown as accrued taxes on the balance sheet.

The material contained in this article has received help from the following books. These books can also be referred for additional reading:

1. *Financial Management – Ravi K Kishor (Taxman Publications)*
2. *Financial Management – Prasanna Chandra (Tata McGraw Hill Publication)*
3. *Financial Management – J V Vaishampayan (New Royal Book Publication)*