SOS POLITICAL SCIENCE AND PUBLIC ADMINISTRATION

MBA FA 403

SUBJECT NAME: WORKING CAPITAL MANAGEMENT

UNIT-V

TOPIC NAME: SHORT TERM SERVICES OF INTERNATIONAL FINANCIAL TRANSACTION

Financing is a very important part of every business. Firms often need financing to pay for their assets, equipment, and other important items. Financing can be either long-term or short-term. As is obvious, long-term financing is more expensive as compared to short-term financing.

There are different vehicles through which long-term and short-term financing is made available. This chapter deals with the major vehicles of both types of financing.

The common sources of financing are capital that is generated by the firm itself and sometimes, it is capital from external funders, which is usually obtained after issuance of new debt and equity.

A firm’s management is responsible for matching the long-term or short-term financing mix. This mix is applicable to the assets that are to be financed as closely as possible, regarding timing and cash flows.

SHORT-TERM FINANCING:

Short-term financing with a time duration of up to one year is used to help corporations increase inventory orders, payrolls, and daily supplies. Short-term financing can be done using the following financial instruments −

1. Commercial Paper:

Commercial Paper is an unsecured promissory note with a pre-noted maturity time of 1 to 364 days in the global money market. Originally, it is issued by large corporations to raise money to meet the short-term debt obligations.

It is backed by the bank that issues it or by the corporation that promises to pay the face value on maturity. Firms with excellent credit ratings can sell their commercial papers at a good price.

Asset-backed commercial paper (ABCP) is collateralized by other financial assets. ABCP is a very short-term instrument with 1 and 180 days' maturity from issuance. ACBCP is typically issued by a bank or other financial institution.

2. **Promissory Note:**

It is a negotiable instrument where the maker or issuer makes an issue-less promise in writing to pay back a pre-decided sum of money to the payee at a fixed maturity date or on demand of the payee, under specific terms.

3. **Asset-based Loan:**

It is a type of loan, which is often short term, and is secured by a company's assets. Real estate, accounts receivable (A/R), inventory and equipment are the most common assets used to back the loan. The given loan is either backed by a single category of assets or by a combination of assets.

4. **Repurchase Agreements:**

Repurchase agreements are extremely short-term loans. They usually have a maturity of less than two weeks and most frequently they have a maturity of just one day! Repurchase agreements are arranged by selling securities with an agreement to purchase them back at a fixed cost on a given date.

5. **Letter of Credit:**

A financial institution or a similar party issues this document to a seller of goods or services. The seller provides that the issuer will definitely pay the seller for goods or services delivered to a third-party buyer. The issuer then seeks reimbursement to be met by the buyer or by the buyer's bank. The document is in fact a guarantee offered to the seller that it will be paid on time by the issuer of the letter of credit, even if the buyer fails to pay.

INTERNATIONAL FINANCIAL SYSTEM - SHORT TERM FINANCING:

FINANCING:

Financing is defined as a means of obtaining the resources to purchase an item, then paying back the loan in a set time period for a set monthly, weekly, yearly.

SHORT TERM FINANCING:

Arranging of available external funds to meet the needs of a firm for a year or less time.

WHY DO FIRMS NEED SHORT TERM FINANCING?

- Cash flow from operations may not be sufficient to keep up with growth related financing needs.
- Firms may prefer to borrow now for their inventory or other short term assets needs rather than wait until they have saved enough.
- Firms may prefer short term financing instead of long term sources of financing.

SOURCES:

- Trade credit
- Accrued expenses
- Bank financing
- Factoring
- Commercial paper

1. TRADE CREDIT:

A trade credit is a business-to-business (B2B) agreement in which a customer can purchase goods on account without paying cash up front, paying the supplier at a later scheduled date. Usually businesses that operate with trade credits will give buyers 30, 60, or 90 days to pay, with the transaction recorded through an invoice. Trade credit can be thought of as a type of 0% financing, increasing a company's assets while deferring payment for a specified value of goods or services to sometime in the future and requiring no interest to be paid in relation to the repayment period.

A trade credit is an advantage for a buyer. In some cases, certain buyers may be able to negotiate longer trade credit repayment terms which provide an even greater advantage. Often, sellers will have specific criteria for qualifying for trade credit.

A B2B trade credit can help a business to obtain, manufacture, and sell goods before ever having to pay for them. This allows businesses to receive a revenue stream that can retroactively cover costs of goods sold. Wal-Mart is one of the biggest utilizes of trade credit, seeking to pay retroactively for inventory sold in their stores. International business deals also involve trade credit terms. In general, if trade credit is offered to a buyer it typically always provides an advantage for a company's cash flow.

The number of days for which a credit is given is determined by the company allowing the credit and is agreed upon by both the company allowing the credit and the company receiving it. Trade credit can also be an essential way for businesses to finance short-term growth. Because trade credit is a form of credit with no interest, it can often be used to encourage sales.

Since trade credit puts suppliers at somewhat of a disadvantage, many suppliers use discounts when trade credits are involved to encourage early payments. A supplier may give a discount if a customer pays within a certain number of days before the due date. For example, a 2% discount if payment is received within 10 days of issuing a 30-day credit. This discount would be referred to as 2%/10 net 30 or simply just 2/10 net 30.

Trade Credit Accounting:

Trade credits are accounted for by both sellers and buyers. Accounting with trade credits can differ based on whether a company uses cash accounting or accrual accounting. Accrual accounting is required for all public companies. With accrual accounting a company must recognize revenues and expenses at the time they are transacted.

Trade credit invoicing can make accrual accounting more complex. If a public company offers trade credits it must book the revenue and expenses associated with the sale at the time of the transaction. When trade credit invoicing is involved, companies do not immediately receive cash assets to cover expenses. Therefore, companies must account for the assets as accounts receivable on their balance sheet.

With trade credit there is the possibility of default. Companies offering trade credits also usually offer discounts which means they can receive less than the accounts receivable balance. Both defaults and discounts can require the need for accounts receivable write-offs from defaults or write-downs from discounts. These are considered liabilities a company must expense.

Alternatively, trade credit is a useful option for businesses on the buying side. A company can obtain assets but would not need to credit cash or recognize any expenses immediately.

In this way a trade credit can act like a 0% loan on the balance sheet. The company’s assets increase but cash does not need to be paid until sometime in the future and no interest is charged during the repayment period. A company only needs to recognize the expense when cash is paid using the cash method or when revenue is received using the accrual method. Overall, these activities greatly free up cash flow for the buyer.

2. ACCRUED EXPENSES:

An accrued expense is an accounting term that refers to an expense that is recognized on the books before it has been paid; the expense is recorded in the accounting period in which it is incurred.. Because accrued expenses represent a company's obligation to make future cash payments, they are shown on a company's balance sheet as current liabilities; accrued expenses are also known as accrued liabilities. An accrued expense is only an estimate, and will likely differ from the supplier's invoice that will arrive at a later date.

Following the accrual method of accounting, expenses are recognized when they are incurred, not necessarily when they are paid. Unless an expense is substantial, it is generally not accrued because accrual accounting requires the work of multiple journal entries.

Example of Accrued Expenses:

A company pays its employees' salaries on the first day of the following month for services received in the prior month. So, employees that worked all of November will be paid in December. If on December 31, the company's income statement recognizes only the salary payments that have been made, the accrued expenses from the employees' services for December will be omitted.

Because the company actually incurred 12 months' worth of salary expenses, an adjusting journal entry is recorded at the end of the accounting period for the last month's expense. The adjusting entry will be dated December 31 and will have a debit to the salary expenses account on the income statement and a credit to the salaries payable account on the balance sheet.

When the company's accounting department receives the bill for the total amount of salaries due, the accounts payable account is credited. Accounts payable is found in the current liabilities section of the balance sheet and represents the short-term liabilities of a company. After the debt has been paid off, the accounts payable account is debited and the cash account is credited.

3. BANK FINANCING:

Bank overdraft:

An overdraft occurs when money is withdrawn from a bank account and the available balance goes below zero. In this situation the account is said to be "overdrawn". If there is a prior agreement with the account provider for an overdraft, and the amount overdrawn is within the authorized overdraft limit, then interest is normally charged at the agreed rate. If the negative balance exceeds the agreed terms, then additional fees may be charged and higher interest rates may apply.

Cash credit:

Cash credit is a facility to withdraw money from a current bank account without having credit balance but limited to the extent of borrowing limit which is fixed by the commercial bank. This is a very common facility by banks. It is one of the important short term sources of finance for a business.

Purchase and discounting of bills:

Bill purchase and bill discounting facility. When a Sale and Purchase Transaction takes place, the seller issues an Invoice (Bill) to the Purchaser. If this Sale is a Credit Sales, then the seller will get the money from the purchaser only after the expiry of credit period.

Short term loan:

A short term loan is a type of loan that is obtained to support a temporary personal or business capital. As it is a type of credit, it involves a borrowed capital amount and interest that needs to be paid by a given due date, which is usually within a year from getting the loan.

Letter of credit:

A letter of credit (LC), also known as a documentary credit or bankers commercial credit, or letter of undertaking (LoU), is a payment mechanism used in international trade to provide an economic guarantee from a creditworthy bank to an exporter of goods. Letters of credit are used extensively in the financing of international trade, where the reliability of contracting parties cannot be readily and easily determined. Its economic effect is to introduce a bank as an underwriter, where it assumes the counterparty risk of the buyer paying the seller for goods

4. <u>FACTORING:</u>

Factoring is a financial transaction and a type of debtor finance in which a business sells its accounts receivable (i.e., invoices) to a third party (called a factor) at a discount. A business will sometimes factor its receivable assets to meet its present and immediate cash needs. Forfeiting is a factoring arrangement used in international trade finance by exporters who wish to sell their receivables to a forfeiter. Factoring is commonly referred to as accounts receivable factoring, invoice factoring, and sometimes accounts receivable financing. Accounts receivable financing is a term more accurately used to describe a form of asset based lending against accounts receivable. The Commercial Finance Association is the leading trade association of the asset-based lending and factoring industries.

In the United States, Factoring is not the same as invoice discounting (which is called an assignment of accounts receivable in American accounting – as propagated by FASB within GAAP). Factoring is the sale of receivables, whereas invoice discounting ("assignment of accounts receivable" in American accounting) is a borrowing that involves the use of the accounts receivable assets as collateral for the loan. However, in some other markets, such as the UK, invoice discounting is considered to be a form of factoring, involving the "assignment of receivables", that is included in official factoring statistics. It is therefore also not considered to be borrowing in the UK. In the UK the arrangement is usually confidential in that the debtor is not notified of the assignment of the receivable and the seller of the receivable collects the debt on behalf of the factor. In the UK, the main difference between factoring and invoice discounting is confidentiality. Scottish law differs from that of the rest of the UK, in that notification to the account debtor is required for the assignment to take place. The Scottish Law Commission is reviewing this position and seeks to propose reform by the end of 2017.

5. COMMERCIAL PAPER:

Commercial paper, in the global financial market, is an unsecured promissory note with a fixed maturity of rarely more than 270 days.

Commercial paper is a money-market security issued (sold) by large corporations to obtain funds to meet short-term debt obligations (for example, payroll) and is backed only by an issuing bank or company promise to pay the face amount on the maturity date specified on the note. Since it is not backed by collateral, only firms with excellent credit ratings from a recognized credit rating agency will be able to sell their commercial paper at a reasonable price. Commercial paper is usually sold at a discount from face value and generally carries lower interest repayment rates than bonds due to the shorter maturities of commercial paper. Typically, the longer the maturity on a note, the higher the interest rate the issuing institution pays. Interest rates fluctuate with market conditions but are typically lower than banks' rates.

Commercial paper – though a short-term obligation – is issued as part of a continuous rolling program, which is either a number of years long (as in Europe) or open-ended (as in the US).