SOS POLITICAL SCIENCE AND PUBLIC ADMINISTRATION
MBA FA 406(A)
SUBJECT NAME: INTERNATIONAL FINANCIAL MANAGEMNT

TOPIC NAME: SHORT TERM FINANCE

SHORT TERM FINANCE:

- Short term finance refers to financing needs for a small period normally less than a year. In businesses, it is also known as working capital financing. This type of financing is normally needed because of uneven flow of cash into the business, the seasonal pattern of business, etc. In most cases, it is used to finance all types of inventory, accounts receivables etc. At times, only specific one time orders of business are financed.
- It refers to financing needs for a small period normally less than a year. It is also known as working capital financing.

CHARACTERISTICS OF SHORT TERM FINANCE:

- Short term finance as the name itself is meant for short term financial need.
- It generally fulfills short term financial needs which varies between few days to one year.
- It is generally raised from various sources such a bank credit, trade credit, consumer credit etc.
- It helps in meeting day to day financial need of the firm such as purchase of raw material etc.

TYPES/SOURCES OF SHORT-TERM FINANCING:

- Trade credit
- Short term loans
- Business line of credit
- Invoicing discounting
- Factoring

TRADE CREDIT:

- The credit extended by the accounts payables. We would classify this credit into 2 types – free trade credit and paid trade credit. After a particular no. of days as per payment terms, the supplier charges interest on the delay of payment. So, the period before this is free trade credit and after that is paid trade credit.
- The free trade credit should be as much as possible because it is free of cost. It depends upon the creditworthiness of the buyer, discipline maintained in payment commitments, the bulk of the business, etc.
- Paid trade credit is definitely a type of short-term financing but on the priority list, it would be quite below.

SHORT-TERM / WORKING CAPITAL LOANS

- Short term loans can be availed from banks and other financial institutions. Banks extend these loans after careful study of the business, its working capital cycle, past track record etc. Once availed, these loans are repaid either in small installments or may be paid in full at the end of the period. This depends on the terms of the loan. It is advisable to use these loans for financing permanent working capital needs. There are other alternatives to fund the temporary working capital needs.

BUSINESS LINE OF CREDIT

- A business line of credit, a type of short term financing, is most appropriate for temporary working capital needs. In this type of financing, an amount is approved by the issuing bank or financial institution. Within the limit of this amount, the business can make payment and keep depositing once payment from customers is received. It works like a revolving credit and best part of this is the interest is charged on the utilized amount only and not on the approved amount. The business has the flexibility to deposit unused amount to save on interest cost. This way it becomes a very cost-effective financing option.

INVOICE DISCOUNTING

- Invoice discounting is another source of short-term finance where the receivable invoices can be discounted with the financial institutes or banks or any third party. Discounting invoices means the bank will pay you the money at the time of discounting and collects the money from your customer when the bill becomes due.

FACTORING

- Factoring is also a similar arrangement like invoice discounting where the accounts receivables of a business are sold to a third party at a price which is lower to the realizable value of the accounts receivable. This purchasing party is commonly known as a factor. These factoring services are provided by both banks and other financial institutions. There are many types of factoring like with recourse or without recourse etc.

ADVANTAGES SHORT-TERM FINANCING:

1. Interest paid back by value will be lower in short-term loans than long-term loans. For example, considering the rate of interest to be 10% for an amount of $1,000 for five years, the amount of interest paid will be $500, but when it is for 20 years, the interest will be $2,000.
2. The approval and disbursement process is faster. As the rate of return increases and yield per unit time is higher due to interest rate approval.
3. There are several options available. Considering a faster rate of return, many banks and other alternate lenders offer short-term loans. Hence, a customer has multiple opportunities to get short-term loans.
4. It is a measure to improve credit rating. In the short-term loans, the equated monthly amount would be higher. Hence, the borrower can pay quickly without payment issues to improve the credit rating. Also, there is a lesser risk of default due to shorter duration which also helps improve the credit score.

DISADVANTAGES OF SHORT-TERM FINANCING:

1. When capital is invested in long-term loans, the amount returned to the bank as interest is higher between the successive processing of the capital. But if the same capital is invested in short-term loans, then the amount returned as interest is lower. To avoid this situation, banks usually have a higher rate of interest on short-term loans which increases the cost of borrowing.
2. Easier accessibility can cause the borrower to fall into the borrowing cycle. As a credit to short-term loans is easily accessible, a borrower can fall prey to continuous borrowing cycles.
3. Timely repayment is helpful to increase credit score, but missing the payments in the short-term can have a severe impact on the credit score.