SOS POLITICAL SCIENCE AND PUBLIC ADMINISTRATION
MBA FA 202
SUBJECT NAME: FUNDAMENTALS OF FINANCIAL MANAGEMENT

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TOPIC NAME: FINANCING OF CURRENT ASSETS

INTRODUCTION

- A current asset is either cash or an asset (e.g. stock) that can be converted into cash within a year and is often used to pay off current liabilities.
- *Current assets* typically include categories such as cash, marketable securities, short-term investments, accounts receivable , prepaid expenses, and inventory.
- Current assets of enterprises may be financed either by short-term sources or long-term sources or by combination of both.
- The long term source of finance provides support for a small part of current assets requirements which is called the working capital margin.
- Short-term financing of current assets includes sources of short-term credit, which a firm is mostly required to arrange in advance. Short-term bank loans, commercial paper etc. are a few of its components.

Approaches to Financing Current Assets

- **1. Matching Approach**
- Under this approach a match is established between the expected lives of current asset to be financed with the source of fund raised to finance the current assets. Thus, a ten-year loan may be raised for financing machinery bearing expected life of ten years. Similarly, one-month stock can be financed by means of one-month bank loan. This is also termed as hedging approach.
- **2. Conservative Approach**
- Conservative approach takes an edge over and above matching approach, as it is practically not possible to plan an exact match in all cases. A firm is said to be following conservative approach when it depends more on long-term financial sources for meeting its financial needs.
- **3. Aggressive Approach**
- As against conservative approach, a firm is said to be following aggressive financing policy when depends relatively more on short-term sources than warranted by the matching plan. Under this approach the firm finance not only its temporary current assets but also a part of permanent current assets with short-term sources of finance.

Instruments in raising finance

1. Spontaneous liabilities
2. Trade credit
3. Short term bank finance
4. Public deposits
5. Inter-corporate deposits
6. Short term financial assistance from financial institutions
7. Commercial paper

Spontaneous Liabilities

- Spontaneous liabilities are types of funding that arise from the normal operations of the firm.

- Types of Spontaneous Liabilities

  Accounts Payable

  Accruals – **Wages Payable**

  -- **Taxes Payable**

Bank Finance:

The major source for financing current assets is bank finance. The various ways in which the banks finance current assets are:

(1)Loan arrangement
(2) Overdraft arrangement
(3) Cash credit arrangement
(4) Bills purchased and bills discounted
(5) Letter of credit

PUBLIC DEPOSIT

- Public deposits refer to the unsecured deposits invited by companies from the public mainly to finance working capital needs. A company wishing to invite public deposits makes an advertisement in the newspapers.
- Any member of the public can fill up the prescribed form and deposit the money with the company. The company in return issues a deposit receipt.
- The rate of interest on public deposits depends on the period of deposit and reputation of the company.
- A company can invite public deposits for a period of six months to three years. Therefore, public deposits are primarily a source of short-term finance.
- Public deposits of a company cannot exceed 25 per cent of its share capital and free reserves.

Merits and Demerits of Public Deposits:

Merits

- Simplicity
- Economy
- Flexibility

Demerits

- Uncertainty
- Limited Funds
- Temporary Finance

Trade credit

- Trade credit is an important external source of working capital financing.
- It is a short-term credit extended by suppliers of goods and services in the normal course of business, to a buyer in order to enhance sales.
- Trade credit arises when a supplier of goods or services allows customers to pay for goods and services at a later date.
- Cash is not immediately paid and deferral of payment represents a source of finance.

Advantages and disadvantages of trade credit

Advantages

- It is easy and automatic source of short-term finance.
- It reduces the capital requirement.
- It helps the business focus on core activities.
- It does not require any negotiation or formal agreement.

Disadvantages

- Trade credit is available only to those companies that have a good track record of repayment in the past.
- For a new business, it is very difficult to finance working capital through trade credit.
- It is very expensive, if payment is not made on the due date.

Commercial Paper

- WHAT: A Commercial paper is an unsecured short term debt instrument issued by corporation typically for meeting short term liabilities.
- WHY: It provides the organization a borrowing option other than a bank.
- WHEN: CP's are issued or sold when an organization needs to borrow money for its short term needs.
- Who can invest Invest in CP's:
  - Individuals
  - Banks
  - Corporates
  - Non Resident Indians
  - Foreign Institutional Investors
- Who can issue CP's:
  - Corporates
  - Non Banking Financial Company
  - Financial Institutions
- Prior Approval of RBI is required
- Entity has to go through with Credit rating process

Benefits & Example

- **Benefits:**
  - Low Interest Expenses
  - No collaterals required
  - It does not need to be registered with the SEBI
- **Example**:
  - Say Future Group, the owner of large retail store like Big Bazaar wishes to raise funds from the market to raise funds from the market to purchase its merchandise
  - If it were to go to a bank for a loan, then it would probably have to pay around 15% interest on the loan, but from the open market it could perhaps get the loan at only 10%.
  - Hence by resorting to an instrument like CP, the organization gain 5%.

Inter Corporate Deposits

- Inter Corporate Deposits indicates unsecured short term funding raised by one company from another company. They are dependent on personal contacts.
- 1) They are for a very short period of time i.e 3 months or 6 months.
- 2) They are unsecured source for raising funds.
- 3) They are not regulated by any law.
- 4) It is a relationship based borrowing made by the company.
- 5) They involve high risk and high returns
- 6) Useful in solving temporary capital crisis.

Such deposits are of three types:

1. **Call Deposit:**

Such a type of deposit is withdrawn by the lender by giving a notice of one day. However, in practice, a lender has to wait for at least 3 days.

2. **Three-month Deposit:**

As the name suggests, such type of a deposit provides funds for three months to meet up short-term cash inadequacy.

3. **Six-month Deposit:**

The lending company provides funds to another company for a period of six months.

Fund based Assistance of Commercial Banks:

Fund based assistance is in the form of credit and loans directly extended by the commercial banks to the exporters at different stages of export procedure. The fund based assistance of commercial banks includes:

(a) **Pre-shipment Finance**: Pre-shipment finance refers to the credit extended to exporters prior to the shipment of goods for the execution of export orders. It is also known as 'Packing Credit'.

(b) **Post-Shipment Finance**: Post-shipment finance (short-term) refers to the credit extended to exporters after the shipment of goods for meeting working capital requirement.

(c) **Finance against deferred Payment Export**: Export of goods or services against to be received partly or fully beyond the period statutorily prescribed for of export proceeds are treated as deferred payment' exports. Finance against payments is referred to as Deferred Credit. Commercial rate of interest with the EXIM Bank.

Thankyou