DEPARTMENT OF COMMERCE AND FINANCIAL STUDIES
BHARATHIDASAN UNIVERSITY, TIRUCHIRAPPALLI – 620024

MBA (Financial Management)

Course Name: -WORKING CAPITAL MANAGEMENT

Course Code :FMSC3/ 21

Course Teacher: Dr.S.Vanitha

Email ID: vanitha@bdu.ac.in

Unit – II/ Topic: FINANCING CURRENT ASSETS

Scheme of Presentation

- Different approaches to financing current assets:
- Conservative, aggressive and matching approach
- Sources of finance
- Spontaneous source
- Trade credits
- Short term bank finance
- Commercial papers and Public deposits Committees on working capital finance
- Factoring.

Short-Term Vs. Long-Term Financing

- Short-term financing tends to be riskier than long-term financing:
  - Uncertainty concerning future rates.
  - May not be able to renew.
- Use of short-term financing, however, may lead to higher returns:

  (i) Most frequently, short-term rates are lower than long-term rates (i.e., the term structure is normally upward sloping)

  (ii) Flexibility: When financing is not required, short-term debt can be paid off.

Source:www.csus.edu/indiv/s/schafferb/133chapter082002.pp

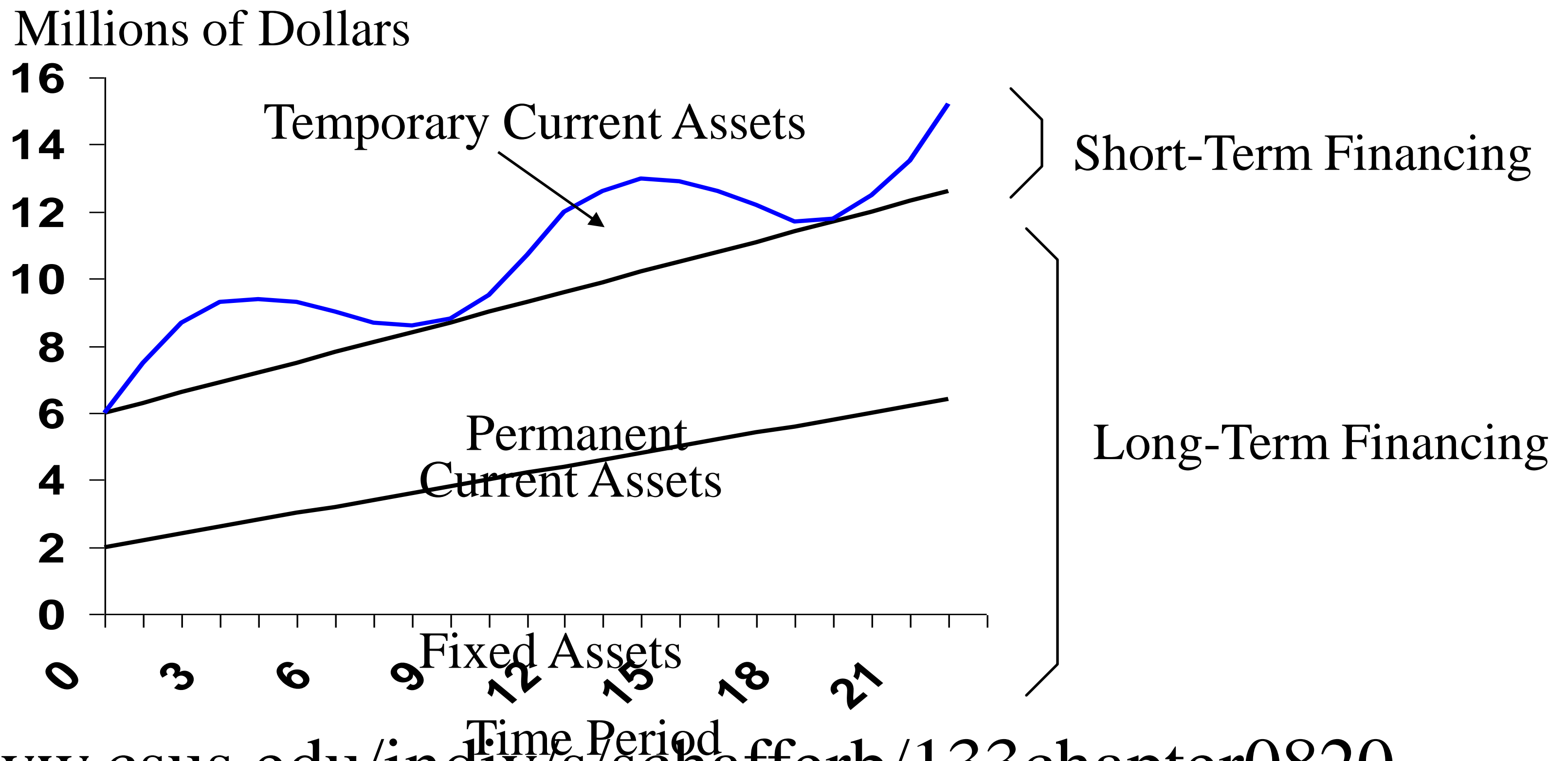
Approaches to Financing Policy

- Maturity Matching Approach
  - A general rule of thumb is to use short-term financing for temporary asset needs, and long-term financing for permanent asset requirements.
- Aggressive Approach
  - Use more short-term financing.
- Conservative Approach
  - Use less short-term financing

Source:www.csus.edu/indiv/s/schafferb/133chapter082002.pp

Maturity Matching

(A Moderate Financing Approach)



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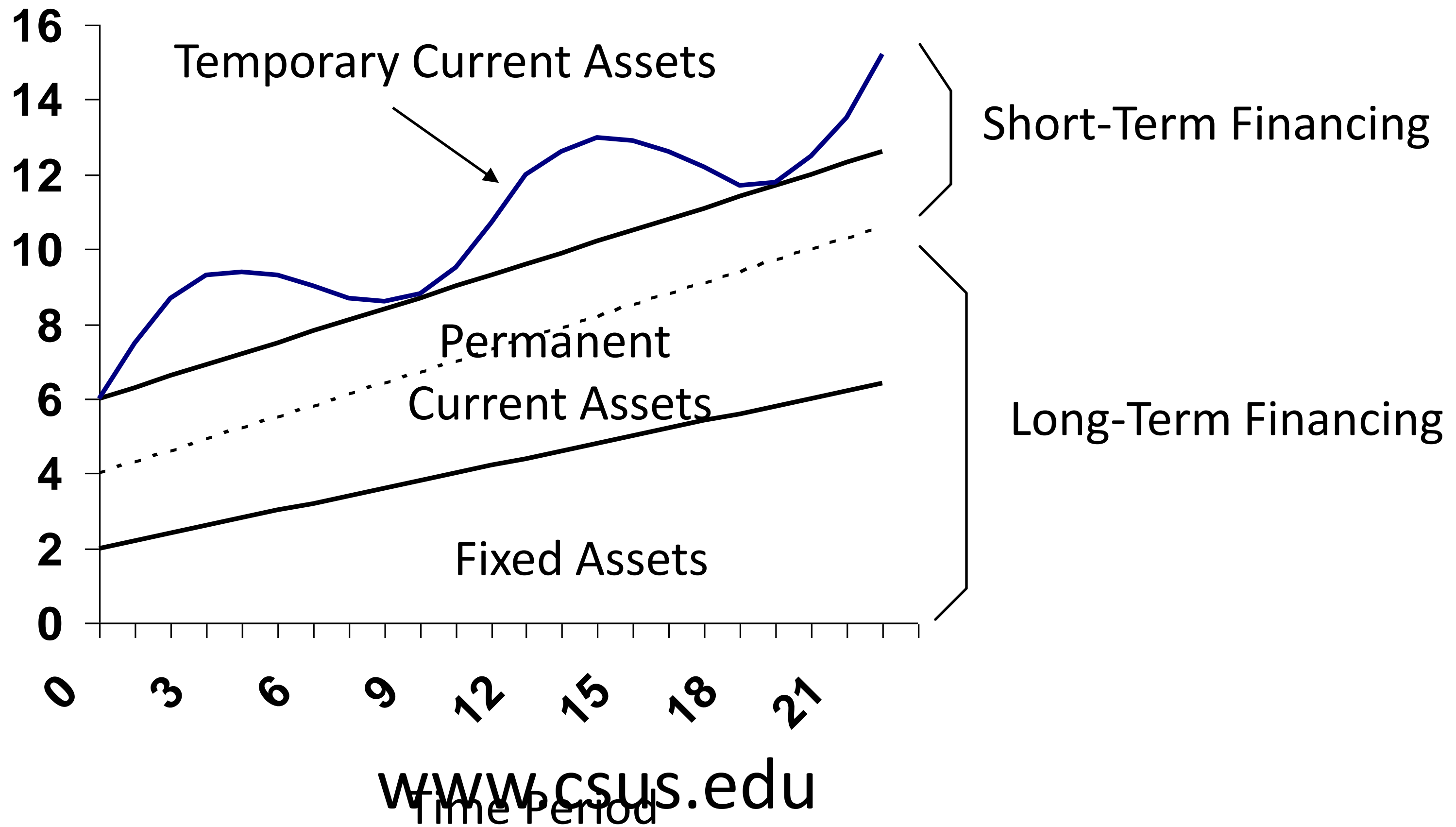
Aggressive Financing
(Higher Risk - Higher Expected Return)



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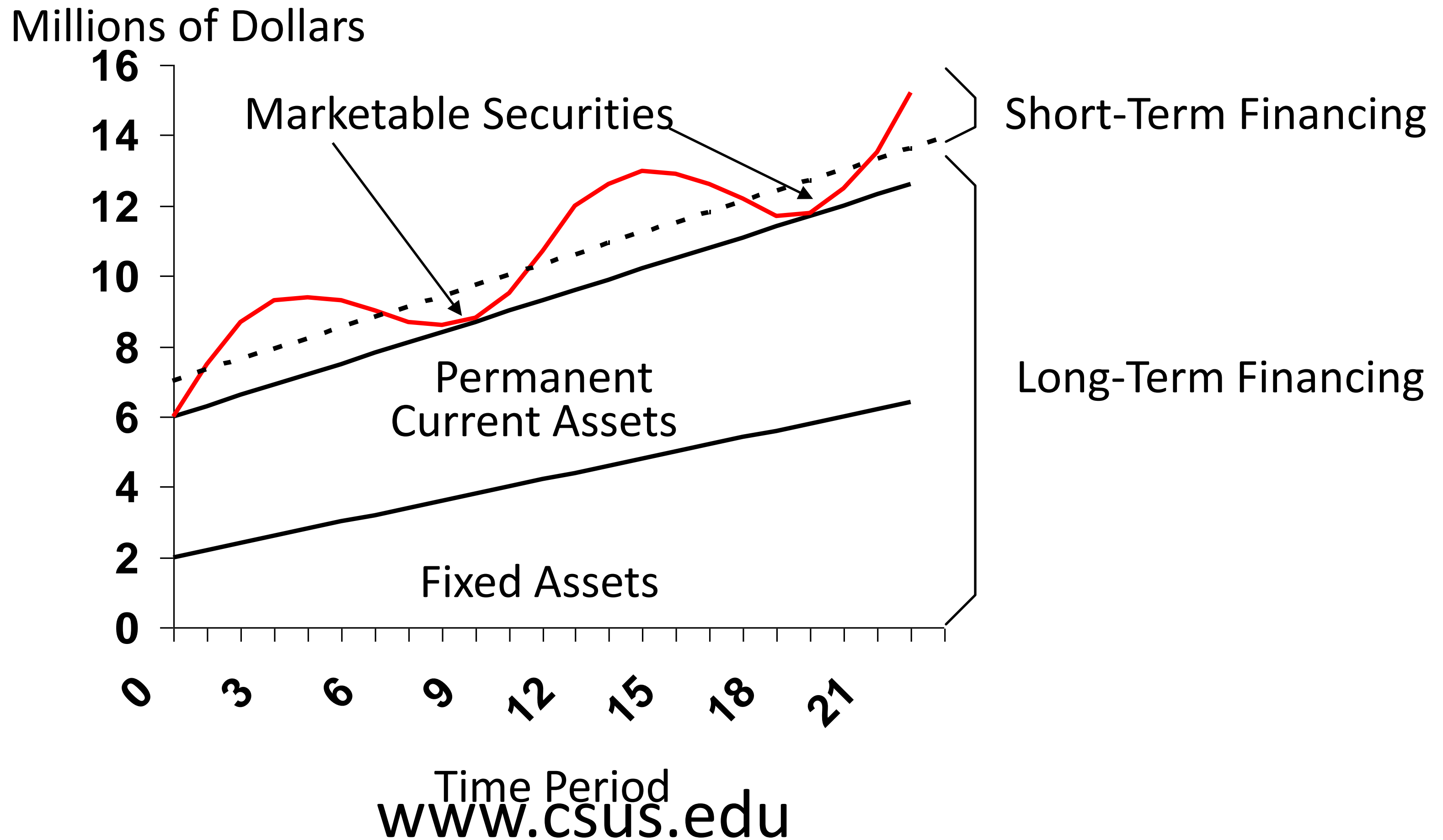
Conservative Financing (Lower Risk - Lower Expected Return)



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Trade Credit

- A very large source of short-term credit
- Example of terms: 2/10, net 60
- Free Trade Credit: Credit received during the discount period.
- Costly Trade Credit: Loss of discount if you do not pay within the discount period. Compare the % cost with the cost of funds from other sources.

Source:www.csus.edu/indiv/s/schafferb/133chapter082002.pp

Simple Interest Bank Loans

- A single payment of principal and interest on the maturity date of the loan.
- One-year loan:

$$\text{Effective Annual Rate} = \frac{\text{Interest}}{\text{Principal}}$$

- Less than one-year loan: (Approximation)

$$\text{Effective Annual Rate} = \left(\frac{\text{Interest}}{\text{Principal}}\right)\left(\frac{360}{\text{Days Loan is Outstanding}}\right)$$

$$= (\text{Interest Per Period})(\text{Number of Interest Periods})$$

Discount Interest

- A single payment is made on the maturity date of loan. The interest charge, however, is paid in advance.
- One-year loan:

$$\text{Effective Annual Rate} = \frac{\text{Interest}}{\text{Principal - Interest}}$$

- Less than one-year loan: (Approximation)

$$\text{Effective Annual Rate} = \left(\frac{\text{Interest}}{\text{Principal - Interest}}\right)\left(\frac{360}{\text{Days Loan is Outstanding}}\right)$$

$$= (\text{Interest Rate Per Period})(\text{Number of Interest Periods})$$

Compensating Balance

- One year loan:

$$\text{Effective Annual Rate} = \frac{\text{Interest}}{\text{Principal - CB}}$$

$$\text{CB} = \text{compensating balance}$$

- Less than one year loan: (Approximation)

$$\text{Effective Annual Rate} = \left(\frac{\text{Interest}}{\text{Principal - CB}}\right)\left(\frac{360}{\text{Days Loan is Outstanding}}\right)$$

$$= (\text{Interest Rate Per Period})(\text{Number of Interest Periods})$$

- Note: If a firm normally carries excess balances with the bank, an adjustment must be made.
- *www.csus.edu/indiv/s/schafferb/133chapter082002.pp*

Add-On Interest (Installment Loans)

- Approximation:

$$\text{Approximate Annual Rate} = \frac{\text{Interest}}{(\text{Principal})/2}$$

- Note: If a more precise annual rate is desired, use the approach discussed in the text.

- *www.csus.edu/indiv/s/schafferb/133chapter082002.pp*

Commercial Paper

- Unsecured promissory notes issued to the public by large corporations is called commercial paper.
- **Major Advantage to Issuer**
  - Interest rate is typically below the prime rate.
- **Disadvantage to Issuer**
  - Banks provide a certain degree of loyalty, commitment, and flexibility to their customers (willing to help customers who have "temporary" problems). Dealers in commercial paper are much more impersonal.
- **Direct Paper** (Finance Paper) – Issued by finance companies (e.g., GE Credit) directly to institutional investors.
- **Dealer Paper** – Sold by companies through a dealer network.
- *www.csus.edu/indiv/s/schafferb/133chapter082002.pp*

Uses of Collateral in Short-Term Financing

- ***Pledging Accounts Receivable***
  - Using receivables selected by the lending institutional as collateral for a loan.
- ***Factoring Receivables***
  - Receivables are sold outright to a finance company.
- ***Inventory Financing***
  - Borrowing against inventory to acquire additional funds.
- ***Note:*** Accounts receivable and inventory financing can be quite expensive.
- *www.csus.edu/indiv/s/schafferb/133chapter082002.pp*

References:

- *www.csus.edu*

Financing Current Assets

- Working capital financing policies
- A/P (trade credit)
- Commercial paper
- S-T bank loans

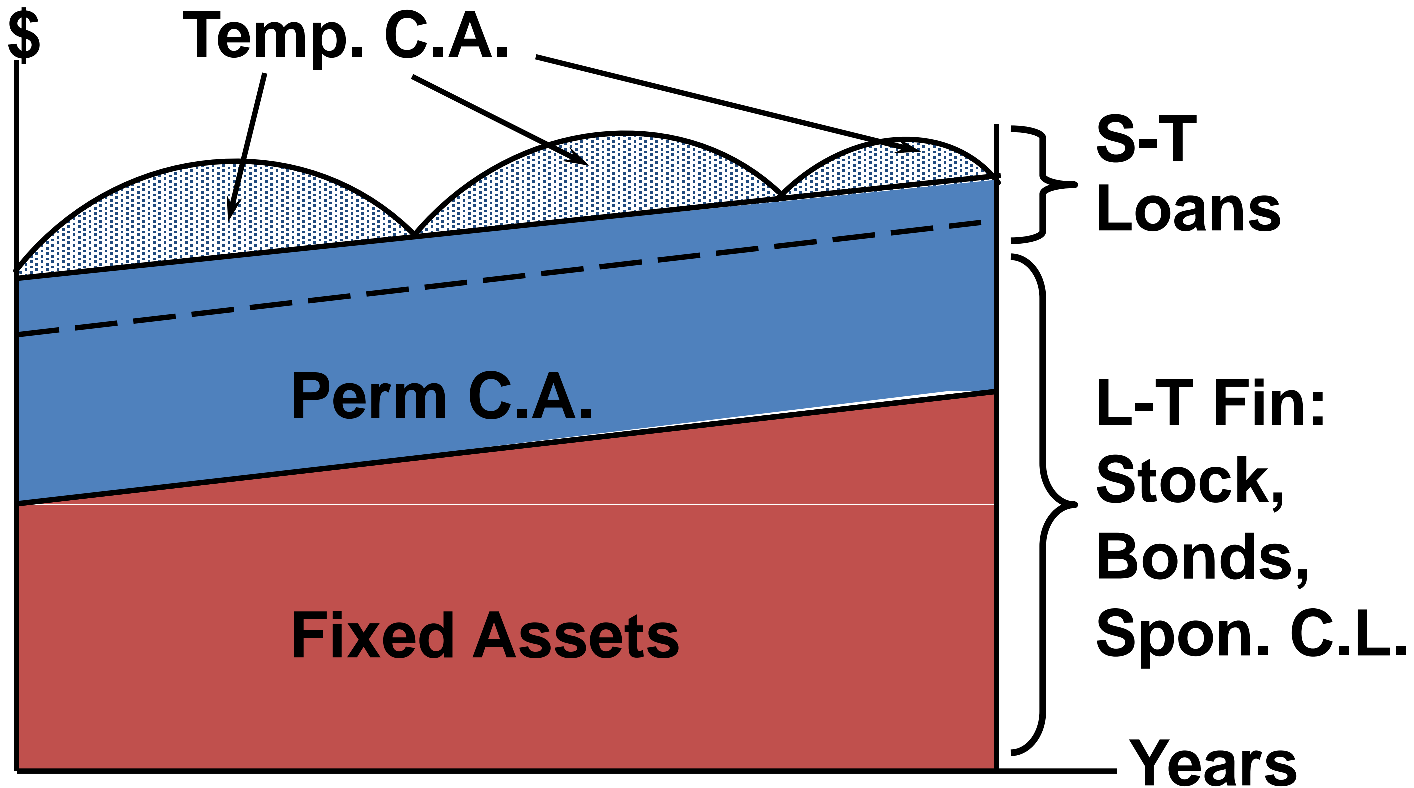
Source: staff.uny.ac.id

Working capital financing policies

- Moderate – Match the maturity of the assets with the maturity of the financing.
- Aggressive – Use short-term financing to finance permanent assets.
- Conservative – Use permanent capital for permanent assets and temporary assets.

Source: staff.uny.ac.id

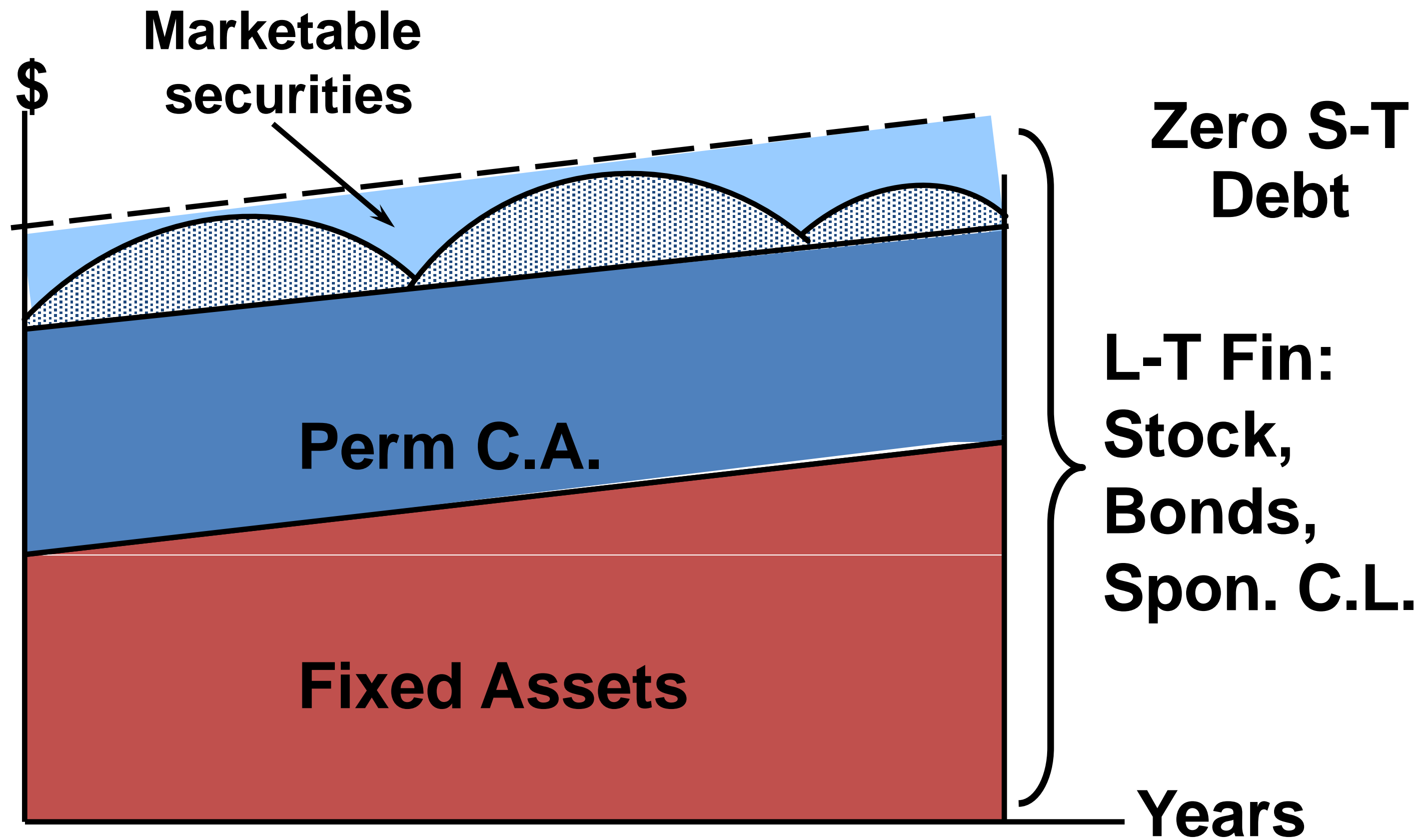
Moderate financing policy



Lower dashed line would be more aggressive.

Source: *staff.uny.ac.id*

Conservative financing policy



Short-term credit

- Any debt scheduled for repayment within one year.
- Major sources of short-term credit
  - Accounts payable (trade credit)
  - Bank loans
  - Commercial loans
  - Accruals
- From the firm's perspective, S-T credit is more risky than L-T debt.
  - Always a required payment around the corner.
  - May have trouble rolling over loans.
  - Source: *staff.uny.ac.id*

Advantages and disadvantages of using short-term financing

- Advantages
  - Speed
  - Flexibility
  - Lower cost than long-term debt
- Disadvantages
  - Fluctuating interest expense
  - Firm may be at risk of default as a result of temporary economic conditions.
  - Source: *staff.uny.ac.id*

Accrued liabilities

- Continually recurring short-term liabilities, such as accrued wages or taxes.
- Is there a cost to accrued liabilities?
  - They are free in the sense that no explicit interest is charged.
  - However, firms have little control over the level of accrued liabilities.
  - *Source: staff.uny.ac.id*

What is trade credit?

- Trade credit is credit furnished by a firm's suppliers.
- Trade credit is often the largest source of short-term credit, especially for small firms.
- Spontaneous, easy to get, but cost can be high.
  - *Source: staff.uny.ac.id*

Commercial paper (CP)

- Short-term notes issued by large, strong companies. B&B couldn’t issue CP--it’s too small.
- Commercial Paper trades in the market at rates just above T-bill rate.
- Commercial Paper is bought with surplus cash by banks and other companies, then held as a marketable security for liquidity purposes.

– *Source: staff.uny.ac.id*

Bank loans

- The firm can borrow $100,000 for 1 year at an 8% nominal rate.
- Interest may be set under one of the following scenarios:
  - Simple annual interest
  - Discount interest
  - Discount interest with 10% compensating balance
  - Installment loan, add-on, 12 months
  - *Source: staff.uny.ac.id*

Must use the appropriate EARs to evaluate the alternative loan terms

- Nominal (quoted) rate = 8% in all cases.
- To compare loan cost rates and choose lowest cost loan.
- We must make comparison on EAR = Equivalent (or Effective) Annual Rate basis.

– *Source: staff.uny.ac.id*

Simple annual interest

- "Simple interest" means no discount or add-on.

Interest = 0.08($100,000) = $8,000

k_{NOM} = EAR = $8,000 / $100,000 = 8.0%

For a 1-year simple interest loan, k_{NOM} = EAR

Source: staff.uny.ac.id

Discount interest

- Deductible interest = 0.08 ($100,000)
  = $8,000
- Usable funds = $100,000 - $8,000
  = $92,000

INPUTS	1		92	0	-100
	N	I/YR	PV	PMT	FV
OUTPUT		8.6957			

What is a secured loan?

- In secured loan, the borrower pledges assets as collateral for the loan.
- For short-term loans, the most commonly pledged assets are receivables and inventories.
- Securities are great collateral, but generally not available.
   - *Source: staff.uny.ac.id*

Factoring

- 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.

Types of Factoring

Recourse and Non-Recourse Factoring

- In a recourse factoring arrangement, the factor has recourse to the client if the receivables purchased turn out to be bad, the risk of bad debts is to be borne by the client and the factor does not assume the risks of default associated with receivables the difference between recourse and non-recourse factoring is mainly on account of risk factor.

– Source: *staff.uny.ac.id*

Advance and Maturity Factoring:

- Factoring arrangement, certain percentage of receivables is paid in advance to the client, the balance being paid on the guaranteed payment date.
- But, in case of maturity factoring, no advance is paid to the client and the payment is made to the client only on collection of receivables or the guaranteed payment date as may be agreed between the parties. Maturity factoring consists of the sale of accounts receivables to a factor with no payment of advance funds at the time of sale.

3. Conventional or Full Factoring:

- In conventional or full factoring, the factor performs almost all the services of factoring including non-recourse and advance factoring.

– Source: *staff.uny.ac.id*

- **Domestic and Export Factoring:**
- In domestic factoring three parties are involved, namely, the selling firms (client), the factor and the customer of the client (buyer).
- In export factoring, four parties are involved namely, the exporter (selling firm or client), the importer or the customer, the export factor and the import factor. Since, two factors are involved in the export factoring; it is also called two-factor system of factoring.
- Source:http://www.accountingnotes.net

- **Benefits of Factoring:**

A firm that enters into factoring agreement is benefited in a number of ways

(a) It ensures a definite pattern of cash inflows from the credit sales.

(b) It serves as a source of short-term finance.

(c) It ensures better management of receivables as factor firm is a specialised agency for the same.

(d) It enables the selling firms to transfer the risk of non-payments, defaults or bad debts to the factoring firms in case of non-recourse factoring.

Source:http://www.accountingnotes.net

(Cont…)

(e) It relieves the selling firms from the burden of credit management

(f) It saves in cost as well as space as it is a substitute for in-house collection department.

(g) In provides better opportunities for working capital management.

(h) The selling firm is also benefited by advisory services rendered by a factor.

Source: *staff.uny.ac.id*

- **Limitations of Factoring:**

The following are important limitations of factoring

(i) The high cost of factoring as compared to other sources of short-term finance,

(ii) The perception of financial weakness about the firm availing factoring services, and

(iii) adverse impact of tough stance taken by factor, against a defaulting buyer, upon the borrower resulting into reduced future sales.

Source:http://www.accountingnotes.net

References

- Source:http://www.accountingnotes.net/
- Source:http://www.accountingnotes.net
- *Source: staff.uny.ac.id*

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