



Financial Management
Bachelors of Business (Specialized in
HRM) – Study Notes
Chapter 8: Short Term Financing

Introduction

Current liabilities and short-term liabilities are debts or responsibilities of the company that must be settled in the period of a year or less. In summary, short term financing is very important in smoothing the daily operations of the company so that it would not be disrupted due to shortage of cash.

Spontaneous Financing

Spontaneous financing exists due to the daily activities of the company. For example, when the company's sales increases, the inventory must also be increased and these additional purchases are usually financed by trade credit.

Spontaneous financing can also exist as a result of the differences in timing between the actual cash flow with the cash flow that should have occurred. For example, a company had obtained the services of company's employee for the period of 1 - 15 January but payments were only made on 16 January.

The main sources for spontaneous financing are:

(a) Trade Credit

Trade credit is the credit facility offered by suppliers to customers. For suppliers, trade credits will be recorded in the balance sheet at the current assets section (account receivable). While for the customers, trade credits are located in the current liabilities section (account payable).

This financing source is obtained based on the trust by the suppliers to customers. The cost of trade credit cannot be obtained directly, as the suppliers usually would not charge any interest on the trade credits offered. However, when the suppliers offer discount, customers will bear a higher effective cost if the discounts were not taken.

Example 10.2

Inthi Company Plc Ltd has made a purchase on credit from the supplier for MVR800 on the terms of 3/10 net 30. If the company made the payment within 10 days, it will pay only MVR776 because the cash discount of MVR24 would be deducted from the invoice.

In summary, the company is assumed to have made a loan of MVR776 for the period of 20 days with the interest payment of MVR24. Therefore, with the assumption of 365 days a year, the annual cost borne by Inthi Company Plc Ltd as a result of foregoing the discount offered can be estimated as follows:

$$\begin{aligned}\text{Annual cost} &= \frac{\text{MVR } 24}{\text{MVR } 776} \times \frac{365}{20} \\ &= 0.564 \text{ or } 56.5\%\end{aligned}$$

Based on the calculation above, Inthi Company Plc Ltd had to bear the annual cost of 56.4% if it did not accept the discount offer of 3/10 net 30.

(b) Accruals

Accruals exist when there is a delay in payment. For example, the employees' salaries will only be paid at the end of each month and also the employees' salaries deduction (EPF and SOCSO) by the employer will only be made on the 20th of the month. Financing sources through accruals do not involve any costs. It is free to the company as long as it does not affect the credibility of the company.

Asset-Based Lending Goes Mainstream

BusinessFinance

A growing number of companies in search of inexpensive capital are leveraging various types of assets.

If you've assumed that asset-based lending is used only by companies in financial trouble, think again. Consider Chicago-based Hartmarx Corp., the manufacturer and marketer of 40-plus brands of men's and women's apparel, including such iconic names as Hart Schaffner Marx and Hickey-Freeman. For the past four years, the company has made a \$200 million asset-based revolving line of credit its primary credit facility. The loan, from Wachovia Capital Finance, is secured by Hartmarx's accounts receivable and inventory. "It makes sense because we're borrowing based on a specific need," says Glenn Morgan, executive vice president and CFO with the \$600 million company. Hartmarx's inventory and receivables balances peak toward the end of summer as retailers begin stocking their shelves for the holiday season. Because the loan amount available is tied to the level of these assets, the company can adjust its borrowings as its inventory and receivables increase and decrease. Although Hartmarx probably could switch to a

more traditional cash-flow loan, Morgan isn't planning to move. "We're satisfied with this facility. It's competitive in terms of the interest rate and terms," he says.

Asset-based loans are lines of credit that typically are secured by working-capital assets, including accounts receivable and inventory. Some also are backed by machinery and equipment. "Five to 10 years ago, asset-based financing was considered rescue financing and the lender of last resort," says Joyce White, the New York City-based president of Bank of America Business Capital. It was seen as a financing vehicle used only by companies whose financial performance couldn't support a cash-flow loan.

Asset-based financing also provides flexibility for businesses in a growth spurt, because the loan amount can increase along with the borrower's inventory and receivables. "An asset-backed loan can track the business growth," says Jim Occhiogrosso, senior vice president in charge of the asset-based lending division of Rosenthal & Rosenthal Inc. in New York City.

As Hartmarx's experience shows, asset-based loans can work very well for companies in cyclical industries, because the loan amount can fluctuate with the company's accounts receivable and inventory base. They also work well for businesses that are newer or in a turnaround phase and don't have a strong track record of financial performance on which to base a cash-flow loan.

Negotiated Financing

The sources of negotiated financing are often obtained formally from financial institutions. It has to undergo various procedures that have been predetermined. In this topic, we will focus on the

facilities provided by commercial banks, which are overdrafts and short-term loans only. Other financing sources that will be discussed are commercial papers and factoring.

(a) Overdraft

Overdraft is a credit facility provided by banks to its customers. It is channelled through the customer's current accounts, where the customer is allowed to withdraw money in excess of the balance in its current account. However, there is a limit set on the withdrawal. For example, Inthi Company Plc Ltd received an overdraft facility for MVR50,000. This means that the company can use the funds provided by the bank until the balance in its account reaches MVR50,000.

Overdraft facilities are very useful to a company that wishes to take the cash discount offered by the supplier. The cost that needs to be borne by the customer who uses the overdraft service is the interest that is applied based on the negative balance of the customer's current account.

(b) Bank Loans

Besides overdrafts, banks will also provide services for short-term loan facilities. To understand this negotiated financing via bank loans, see Example 10.3.

Example 10.3

Inthi Company Plc Ltd has obtained a bank loan of MVR200,000 for a period of 3 months at the rate of 15% per year. At the end of the period, Inthi Company Plc Ltd repaid the principal together with its interest. Before making calculations for the effective cost of the loan, the interest amount must be ascertained in advance.

$$\begin{aligned} \text{Interest} &= \text{MVR } 200,000 \times 0.15 \times \frac{1}{4} \\ &= \text{MVR } 7,500 \end{aligned}$$

$$\begin{aligned} \text{Effective cost} &= \frac{\text{MVR } 7,500}{\text{MVR } 200,000 \times \frac{1}{4}} \\ &= 0.15 \text{ or } 15\% \end{aligned}$$

If you look at the above example, the effective cost of 15% is the same with the rate of the bank loan. However, there are two characteristics in the cost of short-term loan that will make its value higher than the nominal interest rate. These characteristics are the compensating balance and the discounted interest.

(i) Compensating Balance

The compensating balance is the amount that must be kept in the bank account and remained as a balance throughout the loan period. The requirement for this compensating balance makes the actual amount received by the borrower to be less by the compensating balance amount. However, the interest is still calculated based on the entire loan. By using Example 10.3 and several additional information, we can see the effect of the compensating balance on the effective cost of the loan.

The bank that provides the loan imposed the condition for compensating balance to be 10% of the total loan. Assuming that Inthi Company Plc Ltd does not have the balance as required by the compensating balance. Calculate the effective cost of this loan.

To obtain the effective cost of this loan, we need to obtain the value for:

- ❖ Interest amount;
- ❖ Compensating balance; and
- ❖ Value of net loan

These information can be calculated as follows:

$$\text{Interest amount} = \text{MVR}200,000 \times 15\% \times \frac{1}{4} = \text{MVR}7,500$$

$$\text{Compensating balance} = \text{MVR}200,000 \times 10\% = \text{MVR}20,000$$

$$\text{Net loan} = \text{MVR}200,000 - \text{MVR}20,000 = \text{MVR}180,000$$

$$\begin{aligned} \text{Effective cost} &= \frac{\text{MVR}7,500}{\text{MVR}180,000 \times \frac{1}{4}} \\ &= 0.1667 \text{ or } 16.7\% \end{aligned}$$

Based on the calculation above, the effective cost of the loan is higher compared to the value before there was a compensating balance.

(ii) Discounted Interest

Through this characteristic, the borrower must pay interest when the loan amount is withdrawn. This means that the payment of interest has been settled in advance before the loan can be used. This condition makes the net amount obtained by the loan to be less than the amount borrowed. However, the effective cost still increases as the interest is made based on the entire loan.

By using Example 10.3, the calculation of interest, net amount and the effective cost for Inthi Company Plc Ltd are as follows:

$$\text{Interest amount} = \text{MVR}200,000 \times 15\% \times 1.4 = \text{MVR}7,500$$

Net loan = MVR200,000 - MVR7,500 = MVR192,500

$$\begin{aligned} \text{Effective cost} &= \frac{\text{MVR} 7,500}{\text{MVR} 192,500 \times \frac{1}{4}} \\ &= 0.15584 \text{ or } 15.6\% \end{aligned}$$

From the explanation above, it is clear that the condition of compensating balance and discounted interest will increase the cost of the company doing the borrowing.

(c) Commercial Papers

In Malaysia, the use of commercial papers is not widespread. Commercial papers are promissory notes for short-term debt that are issued by companies with strong financial standing. The issuance of this instrument is based on the confidence of investors toward the company's ability to repay the loan at the date that has been predetermined.

Commercial papers are issued at a discounted price where the selling price is the face value after deducting interest. The cost involved in the issuance of commercial papers comprised of all the expenditures that are directly involved in the issuance of this security. For example, a company that issues commercial papers will obtain the services of a merchant bank to sell it to the investors. All these expenditure must be taken into account in estimating the effective cost of financing through commercial papers.

Example 10.4

Inthi Company Plc Ltd will issue commercial papers that have a value of MVR20 million with a maturity period of 6 months. The interest rate for these commercial papers is 10%. The cost involved in issuing these commercial papers is MVR50,000.

The calculation of the effective cost is as follows:

$$\begin{aligned} \text{Interest amount} &= \text{MVR}20 \text{ million} \times 10\% \times \frac{1}{2} \text{ year} \\ &= \text{MVR}1 \text{ million} \end{aligned}$$

$$\begin{aligned} \text{Total cost} &= \text{Interest} + \text{Issuing cost} \\ &= \text{MVR}1 \text{ million} + \text{MVR}50,000 \\ &= \text{MVR}1.05 \text{ million} \end{aligned}$$

$$\begin{aligned} \text{Net loan} &= \text{MVR}20 \text{ million} - \text{MVR}1 \text{ million} \\ &= \text{MVR}19 \text{ million} \end{aligned}$$

$$\begin{aligned} \text{Effective cost} &= \frac{0.1105}{1 - 0.1105} \\ &= \frac{0.1105}{0.8895} \\ &= 0.1243 \text{ or } 12.43\% \end{aligned}$$

(d) Factoring

Factoring is a transaction that involves the purchase of account receivables or the invoices from supplier companies by the factoring companies. Financial institutions that conduct these factoring activities are known as factor. It comprised of takeover and administration of account receivables as well as the activity of collecting debt.

The cost of financing that is counted by factoring is the total financing and expenditure involved such as the factoring fee (1% to 3% from the invoice value), interest on deposit and reserves (a small percentage that is held by factor). The balance value of the invoice payable by factor will only be settled to the company when the entire account receivables have been collected.

Example 10.5

Inthi Company Plc Ltd has factorised the account receivable totaling MVR200,000. The credit period of the company is 60 days. The factoring fee is 3.5% of the invoice value while the reserves are at 7.5%. The interest rate that is charged on the deposit is 12% per year. When the deposit is received, the fees and interest must be settled. Based on previous practice of the company, it will give cash deposit of 60% of the invoice value.

The following is the effective cost of financing through factoring:

$$\begin{aligned} \text{Deposit} &= \text{MVR}200,000 \times 60\% = \text{MVR}120,000 \\ \text{Reserves} &= \text{MVR}200,000 \times 7.5\% = \text{MVR}15,000 \\ \text{Fees} &= \text{MVR}200,000 \times 3.5\% = \text{MVR}7,000 \\ \text{Interest} &= (\text{MVR}120,000 - \text{MVR}15,000 - \text{MVR}7,000) \times 12\% \times 2/12 \\ &= \text{MVR}1,960 \\ \text{Net amount} &= \text{MVR}120,000 - \text{MVR}15,000 - \text{MVR}7,000 - 1,960 \\ &= \text{RM}96,040 \end{aligned}$$

$$\begin{aligned} \text{Effective cost} &= \frac{\text{MVR}15,000 + \text{MVR}7,000 + \text{MVR}1,960}{\text{MVR}96,040 \times \frac{2}{12}} \\ &= 0.5598 \text{ or } 55.98\% \end{aligned}$$

Based on the calculation above, the effective cost of this financing is 55.98% and the company obtains a deposit of MVR96,040 for the period of 2 months with the cost of MVR8,960 (fees and

interest). If all the account receivable can be collected successfully, the balance of RM80,000 including reserves of RM15,000 will be given by the factor to Endah Company Sdn. Bhd.

A Trade Secret Comes to Light, Again

CFO

Globalization and customer consolidation are spurring renewed interest in trade-credit insurance.

Three years ago, Skyworks Solutions Inc. was in a quandary. Sales of its semiconductors were soaring and the company was eager to increase capacity and boost research and development. To finance the expansion, Skyworks wanted to tap a key asset – \$60 million in receivables – to use as collateral for a line of credit, but its bankers balked. For one thing, the chipmaker was operating in the red, with a heavy burden of debt from a merger. For another, 70 percent of its receivables were from customers in China and Korea. Spooked by the unfamiliar political and economic risks in Asia, Skyworks's American bankers were reluctant to extend credit.

Skyworks found a solution in a long forgotten and little-understood finance tool: trade-credit insurance. The Woburn, Massachusetts, company bought a policy to insure its receivables, which effectively guaranteed its money if a customer failed to pay its bill or significantly delayed payment. A few months later, Wachovia Bank approved a new \$50 million line of credit. Today, thanks in part to its timely financing deal, Skyworks is a significant player in specialty chips for cell phones and other handheld devices whose customers include wireless giants Nokia, Motorola, Samsung, and Siemens. Revenues have nearly doubled in the last three years, to \$785 million in 2004. And Skyworks is profitable, earning \$22.4 million last year. "The trade-credit insurance allowed us to unleash cash at a time when we needed to feed growth," says Paul Vincent, vice president of finance.

Trade-credit insurance has been around since the Civil War, but it never really caught on in the United States. Now, as a result of globalization and other

economic factors, CFOs are rediscovering this antique finance tool – and putting it to good use. Some use it simply to expand their available collateral base. Others want to insure receivables from far-flung customers in unstable or economically immature regions, or to reduce the risk of rapid expansion into new and untested sales territories. Still others buy it as a measure of protection in situations in which a single, large customer accounts for the bulk of their sales. Trade-credit insurance helps reduce the risk of financial catastrophe if a big customer declares bankruptcy. With more industries undergoing consolidation – think retail and telecom, to name just two – customer-concentration risk is a growing concern for many companies.

Bankers favor trade-credit insurance because it enables them to write more asset-backed loans. CFOs say trade-credit insurance is appealing in part because it buys them peace of mind at a relatively low cost. Skyworks's premium was less than 1 percent of the total amount of the receivables it used for security. (They were placed in a special-purpose entity that was fully consolidated for accounting purposes.) Skyworks's new policy enabled the company to negotiate a better interest rate than it would have gotten on an unsecured line of credit. Vincent says he has renewed the company's policy every year for the past three years, and intends to maintain the policy for years to come.

Skyworks is one of the few companies to rediscover trade-credit insurance. In the United States, fewer than 5 percent of companies buy it, according to the Credit Research Foundation, a nonprofit research group in Baltimore. In contrast, 40 percent of European companies do. Tradition and culture are key in explaining the disparity. Cross-border trade has been a fact of business life for centuries in Europe, yet many executives there harbor a deep mistrust of foreign receivables. Europeans also tend to have a lower tolerance for risk than Americans, says Neil Leary, CEO of Atradius Trade Credit Insurance Inc., the US unit of Amsterdam-based Atradius NV.

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