

Class: BSc

Subject : Business Finance

Chapter: Unit 2 Chapter 1

Chapter Name: Sources of Finance -1

Today's Agenda

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 3. Factoring
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1 Introduction

- Sources of finance for business are equity, debt, debentures, retained earnings, term loans, working capital loans, letter of credit, euro issue, venture funding, etc.
- These sources of funds are used in different situations. They are classified based on time period, ownership and control, and their source of generation. It is ideal to evaluate each source of capital before opting for it.
- On the basis of a time period, sources are classified as: long-term, medium-term, and short-term.

2 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.

There are different sources of short term finance :

1. Bank overdraft
2. Cash credits
3. Trade credit
4. Bills of exchange
5. Factoring
6. Commercial papers

2.1 Bank overdraft



An overdraft is a form of short-term borrowing from a bank where the borrower is granted a facility to draw money out of a current account such that it becomes negative, down to an agreed limit.

Features of bank overdraft :

1. The borrower pays interest only on the amount by which they are actually overdrawn.
2. No explicit capital repayments are made.
3. Overdrafts made to companies are usually secured by a floating charge.
4. The interest charged on an overdraft will usually be higher than on a loan of equivalent amount.
5. A bank can demand immediate repayment of an overdraft with no notice.



<https://economictimes.indiatimes.com/news/economy/finance/sbi-rejects-andhra-pradesh-governments-rs-6500-crore-overdraft/articleshow/86639592.cms>

2.2 Trade credit



Trade credit is an agreement between a company and one of its suppliers to pay for goods or services after they have been supplied.

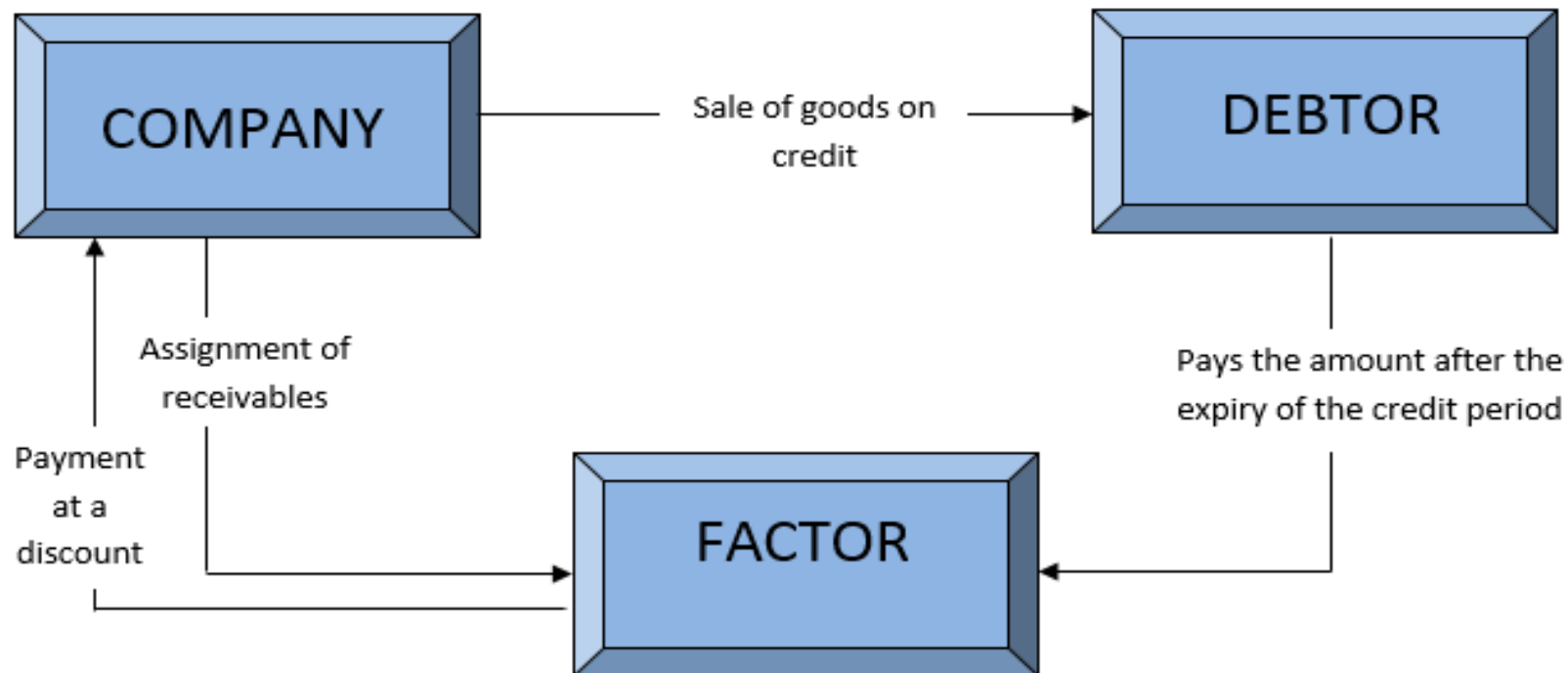
Features of Trade credit :

1. In most cases no explicit interest is charged.
2. In many industries, late payment is so common that explicit discounts can be negotiated for not using trade credit.
3. There are no formal legal instruments/acknowledgements of debt.
4. It helps the business focus on core activities.
5. The credit period is usually for a week, month, two months, six months or a year since it is not a long-term arrangement.

2.3 Factoring



Factoring is a type of finance in which a business would sell its accounts receivable (invoices) to a third party to meet its short-term liquidity needs. Under the transaction between both parties, the factor would pay the amount due on the invoices minus its commission or fees.



2.3.1 Non - recourse factoring



Non-recourse factoring is where the supplier sells on its trade debts to a factor in order to obtain cash payment of the accounts before their actual due date. The factor takes over all responsibility for credit analysis of new accounts, payment collection and credit losses.

Features:

1. Factor assumes credit risks associated with receivables.
2. Charges a higher commission.
3. Credit risk is assumed by Factor.

2.3.2 Recourse factoring



Recourse is a type of Factoring that happens when an entity has to sell the invoices to the client (factor) with the condition that the entity will purchase back any invoices that remain uncollected.

Features:

1. Recourse factoring only provides early payment of invoices.
2. It is a loan which is secured against the invoices, and has a value which automatically fluctuates with the amount that the company sells.
3. Credit risk remains with the original supplier.

2.4 Bills of exchange



A bill of exchange is effectively a claim to the amount owed by a purchaser of goods on credit and may be 'accepted' by a bank (for a fee). This means that the bank guarantees payment against the bill to whomsoever holds the bill at maturity. The bill can then be sold to raise short-term finance.

Features:

1. Bills of exchange are known as 'two name' papers because they carry both the name of the company which owes the money and the name of the accepting bank.
2. Where the endorser is an 'eligible' bank, the bill is known as an 'eligible bill of exchange' which is a very secure investment.
3. A bill of exchange is an instrument in writing.
4. The amount mentioned in the bill of exchange is payable either on-demand or on the expiry of a fixed period of time.

2.5 Commercial paper



Commercial paper is a single name form of short-term borrowing used by large companies. It comes in the form of bearer documents for large denominations which are issued at a discount and redeemed at par.

Features:

1. It is a short-term money market tool, including a promissory note and a set maturity.
2. It acts as an evidence certificate of unsecured debt.
3. It is subscribed at a discount rate and can be issued in an interest-bearing application.
4. The issuer guarantees the buyer to pay a fixed amount in future in terms of liquid cash and no assets.
5. A company can directly issue the paper to investors, or it can be done through banks/dealer banks.

2.5 Example

Top-rated firms such as Reliance Industries and non-banking finance companies including Bajaj Finance, Aditya Birla Finance and Tata Capital Financial Services raised Rs 21.97 lakh crore by selling CPs, show data from Primedatabase, an analytics firm.



https://economictimes.indiatimes.com/markets/bonds/cos-sold-record-cps-in-2021-will-it-be-the-same-in-2022/articleshow/88762403.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst

3 Medium term finance



Medium term refers to the time period of more than 12 months but less than five years. The time horizon in a medium-term investment is intermediate, the investor is expected to receive the return on investment.

There are different sources of medium term finance :

1. Hire purchase
2. Credit sale
3. Leasing
4. Bank loans

3.1 Hire purchase



A hire purchase agreement is an agreement to pay regular rental payments for the goods you hire and then to buy them at the end of the agreed period. Legal ownership passes to the buyer only when the final payment is made.

Features:

1. The payment of the installments is to be done by the buyer i.e., the hirer to the seller over the specified period of time.
2. Buyer gets the possession of the goods immediately.
3. In case of any default of installment payment by the hirer, the vendor has the right to repossess the goods. In that case, the payment already received by the vendor from hirer will be treated as hire charged for the period for which the goods were held.
4. The ownership of goods is transferred to the buyer only upon the payment of last installment.
5. The hire purchase installment amount includes the principal amount as well as the interest charged upon it.
6. Interest is generally charged on the flat rate

3.2 Credit sale



A credit sale is a normal sale of a good together with an agreement that payment will be made by a series of regular instalments over a set period of time. Legal ownership passes to the buyer at outset.

Features:

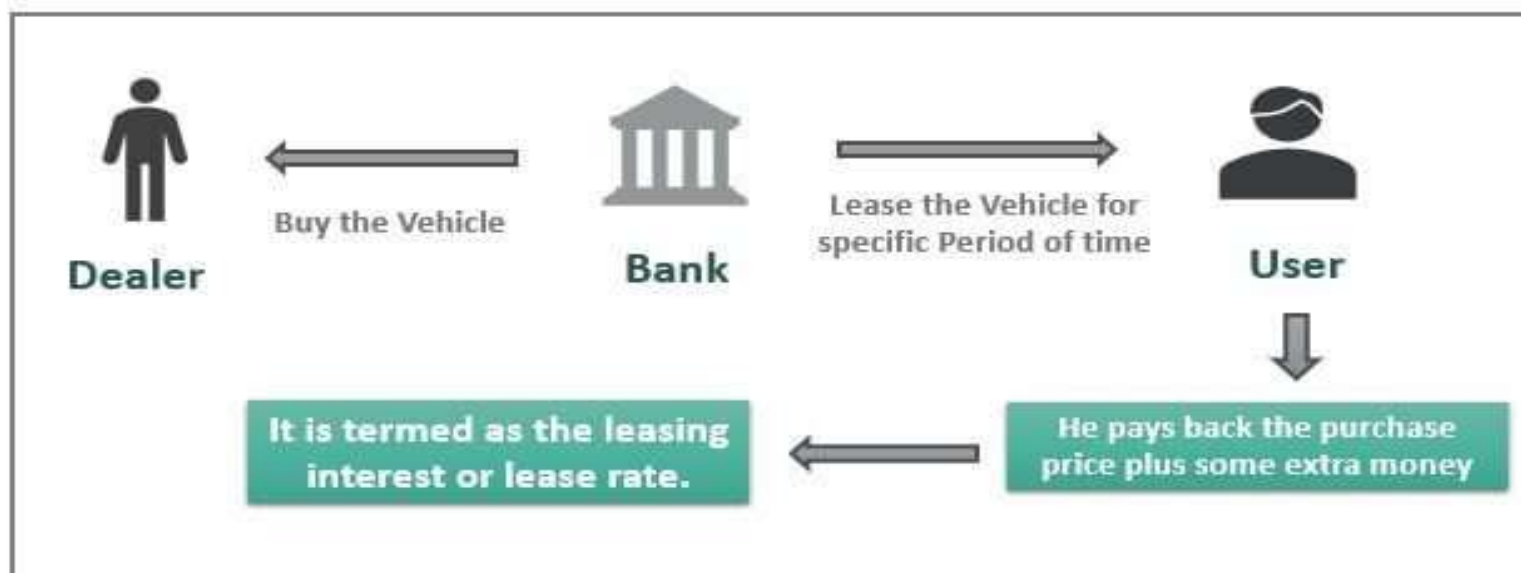
1. The seller cannot reclaim the goods even if the buyer defaults. All that the seller can do is to sue for payment through the courts.

3.3 Leasing



A lease is an agreement where the owner of an asset gives the lessee the right to use the asset over a period of time, in return for a regular series of payments. Legal ownership does not change hands.

Lease Rate



3.3.1 Types of Leasing

	Finance Lease	Operating Lease
Who owns the asset?	Leasing company	Leasing company
Who takes the risks and rewards of ownership?	Lessee	Leasing company
Who is responsible for maintenance and repairs?	Lessee	Leasing company if contract includes maintenance
Usual length of lease	Most of useful lifespan	Part of useful lifespan
Balance sheet treatment	On balance sheet	On or off balance sheet depending on accounting standards used

3.4 Bank loans



A bank loan is a form of medium-term borrowing from a bank where the full amount of the loan is paid into the borrower's current account and the borrower undertakes to make interest payments and capital repayments on the full amount of the loan.

Features:

1. Bank loans are usually secured on the borrower's assets using a floating charge, that is, all the assets of the company (or the individual) are assigned as security for the loan.
2. The interest rate is usually variable.
3. Loans are available where the borrower can take out the loan in instalments, giving the bank a few days' notice before each new bit is taken out. Such arrangements are called 'loan facilities'.



<https://indianexpress.com/article/business/banking-and-finance/yes-bank-crisis-rana-kapoor-arrested-bad-loans-6307485/>