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Sources of Short-term Finance

18.1 Introduction

In the previous lesson you have learnt about the various types of financial needs. The need for finance may be for long-term, medium-term or for short-term. Financial requirements with regard to fixed and working capital vary from one organisation to other. To meet out these requirements, funds need to be raised from various sources. Some sources like issue of shares and debentures provide money for a longer period. These are therefore, known as sources of long-term finance. On the other hand sources like trade credit, cash credit, overdraft, bank loan etc. which make money available for a shorter period of time are called sources of short-term finance. In this lesson you will study about the various sources of short-term finance and their relative merits and demerits.

18.2 Objectives

After studying this lesson, you will be able to:

- discuss the purpose served by short-term finance;
 - identify and explain the various sources of short-term finance;
 - outline the merits and demerits of short-term finance.;
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- describe the relative merits of trade credit and bank credit;
- explain the advantages and disadvantages of bill discounting;
- distinguish between bank over-draft and bank loans;
- differentiate between bank overdraft and cash credit.
- identify the types of securities required for bank credit.
- state the merits and demerits of customers advances as a source of short-term finance.
- enumerate advantages and disadvantages of instalment credit as a source of short-term finance.
- explains the benefits and drawbacks of finance from co-operative banks.

18.3 Purpose of Short-term Finance

After establishment of a business, funds are required to meet its day to day expenses. For example raw materials must be purchased at regular intervals, workers must be paid wages regularly, water and power charges have to be paid regularly. Thus there is a continuous necessity of liquid cash to be available for meeting these expenses. For financing such requirements short-term funds are needed. The availability of short-term funds is essential. Inadequacy of short-term funds may even lead to closure of business.

Short-term finance serves following purposes

1. It facilitates the smooth running of business operations by meeting day to day financial requirements.
 2. It enables firms to hold stock of raw materials and finished product.
 3. With the availability of short-term finance goods can be sold on credit. Sales are for a certain period and collection of money from debtors takes time. During this time gap, production continues and money will be needed to finance various operations of the business.
 4. Short-term finance becomes more essential when it is necessary to increase the volume of production at a short notice.
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5. Short-term funds are also required to allow flow of cash during the operating cycle. Operating cycle refers to the time gap between commencement of production and realisation of sales.

18.4 Sources of Short-term Finance

There are a number of sources of short-term finance which are listed below:

1. Trade credit
2. Bank credit
 - Loans and advances
 - Cash credit
 - Overdraft
 - Discounting of bills
3. Customers' advances
4. Instalment credit
5. Loans from co-operatives

1. Trade Credit

Trade credit refers to credit granted to manufactures and traders by the suppliers of raw material, finished goods, components, etc. Usually business enterprises buy supplies on a 30 to 90 days credit. This means that the goods are delivered but payments are not made until the expiry of period of credit. This type of credit does not make the funds available in cash but it facilitates purchases without making immediate payment. This is quite a popular source of finance.

2. Bank Credit

Commercial banks grant short-term finance to business firms which is known as bank credit. When bank credit is granted, the borrower gets a right to draw the amount of credit at one time or in instalments as and when needed. Bank credit may be granted by way of loans, cash credit, overdraft and discounted bills.

(i) Loans

When a certain amount is advanced by a bank repayable after a specified period, it is known as bank loan. Such advance is credited to a separate loan account and the borrower has to pay interest on the whole amount of loan irrespective of the amount of loan actually drawn. Usually loans are granted against security of assets.

(ii) Cash Credit

It is an arrangement whereby banks allow the borrower to withdraw money upto a specified limit. This limit is known as cash credit limit. Initially this limit is granted for one year. This limit can be extended after review for another year. However, if the borrower still desires to continue the limit, it must be renewed after three years. Rate of interest varies depending upon the amount of limit. Banks ask for collateral security for the grant of cash credit. In this arrangement, the borrower can draw, repay and again draw the amount within the sanctioned limit. Interest is charged only on the amount actually withdrawn and not on the amount of entire limit.

(iii) Overdraft

When a bank allows its depositors or account holders to withdraw money in excess of the balance in his account upto a specified limit, it is known as overdraft facility. This limit is granted purely on the basis of credit-worthiness of the borrower. Banks generally give the limit upto Rs.20,000. In this system, the borrower has to show a positive balance in his account on the last friday of every month. Interest is charged only on the overdrawn money. Rate of interest in case of overdraft is less than the rate charged under cash credit.

(iv) Discounting of Bill

Banks also advance money by discounting bills of exchange, promissory notes and hundies. When these documents are presented before the bank for discounting, banks credit the amount to customer's account after deducting discount. The amount of discount is equal to the amount of interest for the period of bill. This part has been discussed in detail later on in this chapter.

3. Customers' Advances

Sometimes businessmen insist on their customers to make some advance payment. It is generally asked when the value of order is quite large or things ordered are very costly. Customers' advance represents a part of the payment towards price on the product (s) which will be delivered at a later date. Customers generally agree to make advances when such goods are not easily available in the market or there is an urgent need of goods. A firm can meet its short-term requirements with the help of customers' advances.

4. Instalment credit

Instalment credit is now-a-days a popular source of finance for consumer goods like television, refrigerators as well as for industrial goods. You might be aware of this system. Only a small amount of money is paid at the time of delivery of such articles. The balance is paid in a number of instalments. The supplier charges interest for extending credit. The amount of interest is included while deciding on the amount of instalment. Another comparable system is the hire purchase system under which the purchaser becomes owner of the goods after the payment of last instalment. Sometimes commercial banks also grant instalment credit if they have suitable arrangements with the suppliers.

5. Loans from Co-operative Banks

Co-operative banks are a good source to procure short-term finance. Such banks have been established at local, district and state levels. District Cooperative Banks are the federation of primary credit societies. The State Cooperative Bank finances and controls the District Cooperative Banks in the state. They are also governed by Reserve Bank of India regulations. Some of these banks like the Vaish Co-operative Bank was initially established as a co-operative society and later converted into a bank. These banks grant loans for personal as well as business purposes. Membership is the primary condition for securing loan. The functions of these banks are largely comparable to the functions of commercial banks.

Intext Questions 18.1

Fill up the blanks with suitable words:

1. Short-term finance is essential for _____ day-today expenditure.
 2. Overdraft limit is granted on the basis of _____ of customer.
 3. Banks ask for _____ security while granting cash credit.
 4. While making payment on discounted bill, banks deduct _____ which is equal to the amount of interest for the period of bill.
 5. When suppliers extend credit to the buyers it is called _____.
 6. Under _____ and _____ cash does not flow in.
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18.5 Merits and Demerits of Short-term Finance

Short-term loans help business concerns to meet their temporary requirements of money. They do not create a heavy burden of interest on the organisation. But sometimes organisations keep away from such loans because of uncertainty and other reasons. Let us examine the merits and demerits of short-term finance.

Merits of short-term finance

- a) **Economical** : Finance for short-term purposes can be arranged at a short notice and does not involve any cost of raising. The amount of interest payable is also affordable. It is, thus, relatively more economical to raise short-term finance.
 - b) **Flexibility** : Loans to meet short-term financial need can be raised as and when required. These can be paid back if not required. This provides flexibility.
 - c) **No interference in management** : The lenders of short-term finance cannot interfere with the management of the borrowing
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concern. The management retain their freedom in decision making.

- d) **May also serve long-term purposes** : Generally business firms keep on renewing short-term credit, e.g., cash credit is granted for one year but it can be extended upto 3 years with annual review. After three years it can be renewed. Thus, sources of short-term finance may sometimes provide funds for long-term purposes.

Demerits of short-term finance

Short-term finance suffers from a few demerits which are listed below:

- a) **Fixed Burden** : Like all borrowings interest has to be paid on short-term loans irrespective of profit or loss earned by the organisation. That is why business firms use short-term finance only for temporary purposes.
- b) **Charge on assets** : Generally short-term finance is raised on the basis of security of moveable assets. In such a case the borrowing concern cannot raise further loans against the security of these assets nor can these be sold until the loan is cleared (repaid).
- c) **Difficulty of raising finance** : When business firms suffer intermittent losses of huge amount or market demand is declining or industry is in recession, it loses its creditworthiness. In such circumstances they find it difficult to borrow from banks or other sources of short-term finance.
- d) **Uncertainty** : In cases of crisis business firms always face the uncertainty of securing funds from sources of short-term finance. If the amount of finance required is large, it is also more uncertain to get the finance.
- e) **Legal formalities** : Sometimes certain legal formalities are to be complied with for raising finance from short-term sources. If shares are to be deposited as security, then transfer deed must be prepared. Such formalities take lot of time and create lot of complications.

18.6 Relative merits of Trade credit and Bank credit

You have already read about trade credit and bank credit. You also know that trade credit is extended by the supplier for a limited period to

facilitate purchases. Bank credit is obtained from banks and can be utilised for any purpose. The relative merits of trade credit and bank credit are as follows:-

- a) Trade credit is available only with purchase of raw material or finished goods. It serves a limited purpose. But bank credit can be utilised by the borrower for any purpose that he may have in view.
- b) In case of trade credit, payment has to be made after the expiry of credit period. However in case of bank credit (overdraft, cash credit, etc.) repayment after a certain period is not compulsory. The arrangement may be continued.
- c) No security is required to avail of trade credit. Banks generally ask for some security while advancing credit.
- d) Interest is not payable in case of trade credit, provided payments are made within the credit period. Interest has to be paid on bank credit in all circumstances.
- e) The terms and conditions of trade credit vary according to the custom and usage of trade. Bank credit is granted on the terms and conditions which generally are the same for all types of business.

18.7 Advantages and Disadvantages of Bill discounting

You have already read that commercial banks provide short-term loans by discounting bills of exchange or promissory notes. In such cases the banks deduct discount while making payment. The amount of discount is generally equal to the amount of interest for the remaining period of payment against the bill. This is known as discounting of bill. The advantages and disadvantages of obtaining finance from this source are listed below.

Advantages of Bill discounting

- a) **Immediate availability of cash:** By discounting the bill, the drawer gets cash immediately. He does not have to wait for the payment until the expiry of credit period stated on the bill.
 - b) **No extra security is to be offered:** Banks generally do not ask for any other security while making payment against the bill
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discounted. However, if a customer is interested, banks also grant him limit for discounting of bills. This limit is known as 'limit against discounted bills'. Usually banks ask for certain security while extending this limit. Such limit is obtained when drawing of bills of exchange is almost a regular feature in business.

- c) **Nature of liability for repayment:** Repayment of money advanced against discounted bill is the responsibility of the drawee of bills of exchange. Banks therefore approach the drawee, who is generally the acceptor of the bill, for payment after the due date on the bill. In case the drawee does not pay or refuses to pay, the drawer or the person who got payment after discounting the bill is held responsible for payment.

Disadvantages of Bill discounting

- (a) **Payment of interest in advance:** While discounting a bill, bank deducts the discount and balance is credited in customer's account. This discount is equal to the amount of interest for the remaining period of payment against the bill. Thus, a person receiving money through discounting of bill has to offer advance interest on the amount of the bill.
- (b) **Facility is subjected to the creditworthiness of parties involved :** Banks generally extend this facility after being satisfied with the creditworthiness of different parties involved. In case of doubt, the bank may ask for some security. Thus, it is not a very easily available facility.
- (c) **Additional burden in case of non-payment :** Bills not paid upon maturity are to be certified by Notary Public and a certain amount in the form of noting charges is paid. Thus, it becomes an additional burden.

Intext Questions 18.2

Fill up the blanks choosing the right alternative from those within brackets.

1. Raising funds for short-term purposes is _____ (costly, economical).
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2. Short-term finance _____ serve long-term purpose (may, does not)
 3. Trade credit is for a _____ period of time but bank credit may be extended. (specific, uncertain)
 4. Payment after a specific date is _____ in case of bank credit. (compulsory, not compulsory)
 5. Discounting of bill _____ cash immediately (provides/does not provide).
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18.8 Distinction between Bank Overdraft and Bank Loan

- a) **Charge of interest** : Interest is charged only on the overdrawn amount in the case of bank overdraft, but in the case of bank loan, interest is charged on the entire amount of loan.
 - b) **Amount of borrowing** : The amount of borrowing is limited in case of bank overdraft, but bank loan may be for any amount depending upon the securities offered by the borrower against the loan.
 - c) **Renewal procedure** : The renewal procedure is very simple in the case of overdraft. Banks require positive balance to be shown in the customer's account on the last Friday of every month. But loans are to be paid back after the expiry of credit period. For renewal, fresh negotiations are to be made.
 - d) **Security** : Overdraft facility is generally granted by banks purely on the basis of credit worthiness of the customer, but for bank loan security of tangible assets is an essential requirement besides the personal security of the borrower.
 - e) **Rate of interest** : Rate of interest is generally higher in case of bank loan.
 - f) **Flexibility** : Bank overdraft is more flexible than bank loan. Money can be withdrawn, deposited and again withdrawn within the limits. But in case of bank loan the amount sanctioned is fixed.
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- g) **Economical** : Bank overdraft is more economical because interest is paid only on the amount drawn in excess of the balance. However in case of bank loan interest is paid on the whole amount of loan, whether it is withdrawn or not.
- h) **Repayment** : Bank overdraft can be repaid conveniently by the customer. But the amount of entire bank loan has to be repaid on the expiry of credit period. It appears to be more burdensome.

18.9 Distinction between Bank Overdraft and Cash Credit

- a) Cash credit is a separate arrangement of credit granted by a bank to a firm. The firm may or may not have an account with the bank. Overdraft is granted to an account holder purely on the basis of his credit-worthiness. Credit worthiness is decided by the financial soundness of past dealings of the customer with the bank.
- b) In case of cash credit, the amount of credit is placed in a separate account of the borrower. Overdraft limit is generally granted to an existing account of the customer.
- c) The amount of credit in case of cash credit depends upon the value of securities offered. But overdraft limit is decided on the average balance of the customer in his account.
- d) Overdraft is granted without the security of tangible assets. But for cash credit security of tangible assets is an essential requirement.

18.10 Types of Securities required for Bank credit

Loans and advances are granted by bank on personal security of the borrower as well as on the security of some tangible assets, besides the standing of the firm. Thus securities against bank credit may be of two types:

- (i) Personal security
- (ii) Security of tangible assets.

Personal security means the credit-worthiness of the borrower. Banks

judge the credit-worthiness of the borrower on the basis of his financial soundness and past dealings with the bank.

The following tangible assets are accepted by banks for extending short-term finance:

- a) **Moveable goods** : Stock of raw materials and finished goods are accepted by banks as security against bank credit. In case of non-payment, these goods are sold and money is recovered by banks.
 - b) **Shares and stock** : Shares and stock that are quoted on a recognised stock exchange are accepted as security against bank credit. The borrower is required to deposit the share certificate alongwith a transfer deed signed by him.
 - c) **Documents of title to goods** : Bill of lading, Railway Receipts (RR), Goods Receipt (GR), Warehouse warrant are various documents which are recognised as documents of title to goods. To secure credit from bank, the borrower may deposit any of these documents with bank after duly endorsing the same in favour of the bank. This enables the bank to deal with the goods in case of default in repayment.
 - d) **Fixed deposit receipts** : It is a receipt issued by bank as evidence of fixed deposit made by the customer. Banks grant loan on the security of this receipt. The interest charged on loan is higher than the interest allowed on deposit. Banks normally grant loan upto 90% of the value of such receipts.
 - e) **Life insurance policies** : Banks extend credit on the basis of life insurance policy upto the amount of surrender value of such receipts.
 - f) **Jewellery or precious metals** : This type of security may be offered to borrow money for private as well as for business purposes. Proprietary concerns sometimes offer jewellery or other precious metals to obtain credit.
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- g) **Other securities** : Besides the assets and documents mentioned above, banks also accept National Savings Certificate (NSC), Indira Vikas Patra (IVP), Kisan Vikas Patra (KVP) to grant short-term credit.

Intext Questions 18.3

Write 'T' against sentences which are true and 'F' against those which are false.

- (i) Limit in case of cash credit is generally less than that in case of bank overdraft.
- (ii) Bank overdraft is granted on the basis of credit-worthiness of customer.
- (iii) The method of charging interest is same in case of bank overdraft and cash credit.
- (iv) Banks do not open separate account while advancing cash credit.
- (v) Besides personal security of borrower, banks insist upon the security of tangible goods while granting loan.

18.11 Merits and Demerits of Customers' advances as a source of Short-term Finance

Customers' advance refers to advance made by the customer against the value of order placed. It is, thus, a part payment of the value of goods to be supplied later.

Merits

- (a) **Interest free**: Amount offered as advance is interest free. Hence funds are available without involving financial burden.
 - (b) **No tangible security** : The seller is not required to deposit any tangible security while seeking advance from the customer. Thus assets remain free of charge.
 - (c) **No repayment obligation** : Money received as advance is not to be refunded. Hence there are no repayment obligations.
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Demerits

- (a) **Limited amount** : The amount advanced by the customer is subject to the value of the order. Borrowers' need may be more than the amount of advance.
- (b) **Limited period** : The period of customers' advance is only upto the delivery goods. It can not be reviewed or renewed.
- (c) **Penalty in case of non-delivery of goods** : Generally advances are subject to the condition that in case goods are not delivered on time, the order would be cancelled and the advance would have to be refunded along with interest.

18.12 Advantages and Disadvantages of Instalment credit as a source of Short-term Finance

As you have already studied in this chapter, instalment credit is a system under which a small payment is made at the time of taking possession of the goods and the remaining amount is paid in instalments. Instalment money is inclusive of interest. Advantages and disadvantages of this system are given below:

Advantages

- (i) **Immediate possession of assets** : Delivery of assets is assured immediately on payment of initial instalment (down payment).
 - (ii) **Convenient payment for assets and equipments** : Costly assets and equipments which cannot be purchased due to inadequacy of long-term funds can be conveniently purchased on payment by instalments.
 - (iii) **Saving of one time investment** : If the value of asset or equipment is very high, funds of the business are likely to be blocked if lumpsum payment is made. Instalment credit leads to saving on one time investment.
 - (iv) **Facilitates expansion and modernisation of business and office** : Business firms can afford to buy necessary equipments and machines when the facility of payment in instalments is available.
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Thus, expansion and modernisation of business and office are facilitated by instalment credit.

Disadvantages

- (i) **Committed expenditure** : Payment of instalment is a commitment to pay irrespective of profit or loss in the business.
- (ii) **Obligation to pay interest** : Under instalment credit system payment of interest is obligatory. Generally sellers charge a high rate of interest.
- (iii) **Additional burden in case of default** : Sellers sometimes impose stringent conditions in the form of penalty or additional interest, if the buyer fails to pay the instalment amount.
- (iv) **Cash does not flow** : Like trade credit, instalment credit facilitates the purchase of asset or equipment. It does not make cash available which can be utilised for all needful purposes.

18.13 Benefits and Drawbacks of Finance from Co-operative Banks

Benefits

- (i) Loans from co-operative banks are easily available to farmers and small businessmen involving minimum formalities.
 - (ii) Co-operative banks provide a convenient means of borrowing. Loans are generally granted at a lower rate of interest.
 - (iii) Sometimes co-operative banks organise training programmes for members to familiarise them with the various avenues of business and regarding proper utilisation of loan money.
 - (iv) Being a member of a cooperative bank, the borrower can participate in the management and also share in the profits of the society.
 - (v) Co-operative loans create a sense of thrift and self-reliance among the low income group.
 - (vi) Loans are generally given for productive purposes and that helps to develop the financial and social status of the people.
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Drawbacks

- i) Loan from co-operative banks is available only to members.
- ii) Co-operative banks find it difficult to ensure repayment of loan money due to inadequate information about the need and utilisation of funds by the borrower. There is little scrutiny of the repaying capacity of the loan seeker at the time of granting loan.
- iii) Inadequate resources and lack of trained personnel for management have restricted the spread of co-operative banking facilities.
- iv) Co-operative banks depend largely on the support of the Government. Therefore Government rules and regulations sometime create hurdles for the borrowers.
- v) Credit from co-operative banks is available only for limited purposes.

Intext Questions 18.4

Write 'T' against the sentences which are true and 'F' against those which are false.

- 1. Instalment credit facilitates purchase of assets and equipments.
 - 2. Customers' advances do not make cash immediately available.
 - 3. Loans from co-operative banks are easily available to farmers for productive purposes.
 - 4. Repayment is not made in case of customers' advances.
 - 5. Co-operative credit facilitates replacements and renovation.
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18.14 What you have learnt

Short-term finance is required by business firms to meet day to day expenses. It facilitates the smooth running of business operations. It enables holding of stocks of raw materials and finished products, helps to increase the volume of production at short notice and bridges the time gap between commencement of production and realisation of sales.

There are a number of sources of short-term finance : (i) Trade Credit, (2) Bank credit including loans and advances, cash credit, overdraft and discounting of bills, (3) Customers' advances, (4) instalment credit, and (5) Loans from co-operative banks.

Short-term finance is helpful to business in meeting temporary requirements of funds without a heavy burden of interest. It is a flexible source of finance. When necessary, it may also serve long-term purposes through renewal. However interest has to be paid on short-term borrowing, irrespective of profit or loss. It also needs security of assets to be provided by the borrower.

Trade credit is available only in connection with purchase of raw materials and finished goods. Bank credit can be used for any purpose. No security is required to be provided to avail of trade credit. Bank credit is usually granted against security of assets.

Bill discounting as a source of finance has certain advantages and disadvantages. Cash is immediately available without the necessity of any security. No payment is involved unless the bill is dishonoured by the drawee. However, interest is payable in advance by way of discount. The facility is available on the basis of the customer's credit worthiness.

Bank overdraft differs from bank loan with respect to interest payable, amount of credit available, security required, renewal procedure and flexibility of use.

Distinction between bank overdraft and cash credit lies in the nature of two arrangements. Overdraft is granted to an account holder on the basis of his creditworthiness and average balance in the account. The cash credit limit is decided depending on the volume of security offered.

Bank credit is granted against either the personal security of the borrower or security of tangible assets or both. Tangible securities may consist of movable goods, shares and stock, documents of title to goods, fixed deposit receipt, life insurance policy, jewellery, or savings certificates like Indira Vikas Patra.

Customers' advance as a source of short-term finance is interest free, requires no tangible security and involves no repayment obligation. But it is available in limited amount and for a limited period. It also involves penalty if goods are not delivered on time.

Instalment credit facilitates possession of assets on payment of only the initial instalment. Costly assets and equipments can be procured conveniently without long-term investment of capital. It thus facilitates expansion and modernisation of business. However, it involves commitment to pay instalments irrespective of profit or loss, as well as carrying the interest burden on the amount due for payment. It does not make cash available.

Loans from co-operative banks are easily available at lower rate of interest. It also creates a sense of thrift and self-reliance among poorer people. But loans are available only to members and for limited purposes. Repayment of loan is not assured due to lack of adequate information about the need and utilisation of funds by the borrower.

18.15 Terminal Exercise:

1. Why short-term finance is a necessity for business enterprises?
2. List the various sources of short-term finance.
3. Under what circumstances bank credit is preferable to trade credit.
4. Enumerate the various points of difference between cash credit and bank overdraft.
5. What are the differences between bank loan and bank overdraft?
6. Write any five equipments which you think should be taken on instalment credit. Give reasons for your answer.
7. What are the merits of customers' advance.

18.16 Answers to Intext Questions

- 18.1 1. meeting 2. credit worthiness 3. collateral
4. discount 5. trade credit 6. trade credit, instalment credit.
- 18.2 (1) economical (2) may (3) specific
(4) not compulsory (5) provides.
- 18.3 (i) False (ii) True (iii) True (iv) False (v) True
- 18.4 (i) True (ii) False (iii) True (iv) True (v) False
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