

Short-Term Financing

A. External

Bank overdraft facility can be arranged as a short-term finance facility. This is a credit limit offered by banks to firms that allows firms to issue payments for purchases or other business expenditures even if the balance at bank is zero. It provides liquidity on rolling credit basis which enables firms to keep refreshing the balance and continuing with the facility.

Bank loan for Trade finance is another possible option. A loan is different from overdraft in that a loan is a lump sum amount transferred to borrower's account while o/d is a rolling credit facility whereby payments are financed by the bank. Trade finance approval is usually quick to get and may or may not have to be secured with collateral. The bank might accept proof of healthy cash flows or ask for stock of goods to be provided as collateral which is not difficult to do.

Leasing and Hire purchase are also suitable short to medium term finance options for purchasing equipment or vehicles on installments. The firm gets immediate use of the asset while ownership of asset remains in the name of the bank or leasing company until a fixed number of installments are paid.

B. Internal

Short-term finance can also be arranged internally within a business organization such as cash sales, retained profit, reserves, disposal of assets, supplier's credit or even tax savings from depreciation. These are immediately available and free of cost.

Long-Term Financing

Large bank loans can be arranged for setting up a new business or expanding an existing one. However, this requires complex documentation and appraisal process. In addition, the bank would ask for collateral usually in the form of real estate or other valuable asset and yet offer loan up to a partial value of the collateral. The loan would be payable over several years at a interest rate lower than short-term finance.

Besides debt financing, a large business can also raise very large capital by issuing shares to the general public (IPO). Share capital is not only permanent but also free of cost since there is no interest payable. It can be raised quicker than bank loan and without collateral.

Factors influencing the choice of sources of finance;

The cost of funds

Different sources of funds have different costs. Interest rate on short-term finance is higher than long-term finance but due to short-term usage of funds, the total interest expense may be lower than long-term use of funds.

Uses of funds and the source of repayment

If the funds are required to purchase new fixed assets or business expansion, large amount of capital will be required for long-term. Hence, long-term sources of finance will be appropriate such as bank loan or, in the case of a large business, going public with issue of shares and bonds can also help raise very large capital. This is especially appropriate if earnings are not expected in the near future.

If the business expects to generate earnings in the near future, then short-term finance will be appropriate since the funds can be repaid promptly.

Sales forecasts

If the funds are required to finance temporary phases of liquidity crunch and the amount is expected to be repaid from current cash inflows, then short-term finance of smaller amounts will be appropriate, such as bank overdraft facility, retained profit or supplier's credit. If cash flows are expected to develop in the long run, then long-term finance should be arranged.

The firm's capital structure

The management has to decide the debt-equity ratio. If interest rates are low, high gearing ratio may be suitable by raising more long-term debt vs. equity. This would lower the average cost of funds if the interest rate is less than the dividend expected by shareholders. Additionally, long-term debt finance does dilute ownership and profit.

On the other hand, if interest rates are high, then equity (share capital) will be relatively cheaper. This is a permanent source of finance and there is no interest payable. However, it dilutes ownership and profits along with the risk of external interference and possibly the risk of acquisition.