

CHAPTER 5

FINANCING CURRENT ASSETS

Current asset investment policy has to be established with the firm's production policy and current asset financing policy.

Current asset financing policy is the manner in which the permanent and temporary current assets are financed. **Permanent current asset:** are those current assets that the firm holds even during slack times, where as **temporary current assets** are the additional current assets that are needed during seasonal or cyclical peaks.

Alternative Current asset financing Policies

A. Maturity Matching or "Self-liquidating approach.

The maturity approach calls for matching asset and liability maturities. This strategy minimizes the risk that the firm will be unable to pay off its maturing obligations. A firm could attempt to match exactly the maturity structure of its asset and liabilities.

Example, inventory expected to be sold in 30 days could be financed with a 30 day bank loan; a machine expected to last for 5 years could be financed with a 5 year loan; a 20 year building could be financed by a 20 year mortgage bond and so forth. Actually, of course, two factors prevent this exact maturity matching: 1) there is uncertainty about the lives of assets, and 2) some common equity must be used, and common equity has no maturity.

B. Aggressive approach

An aggressive strategy results in a relatively aggressive firm which finances all of its fixed assets with long term capital but part of its permanent current assets with short term, non-spontaneous credit. In this strategy the firm financing at least is seasonal needs, and possibly some of its permanent needs, with short term funds. The balance is financed with long term funds

C. Conservative approach

The most conservative financing strategy should be to finance all projected funds requirements with long term funds and use short term financing in the event of an emergency or an unexpected outflow of funds. It is difficult to imagine how this strategy could actually be implemented, since the use of short term financing tools, such as accounts payable and accruals, is virtually unavoidable.

Example, the following example is used to illustrate the cost and risk consideration on aggressive and conservative financing strategies.

NCN Company's estimate of current, fixed, and total asset requirements on monthly basis for the coming year is given columns 1, 2 and 3 of table 6.1. Columns 4 and 5 present a breakdown of the total requirement into its permanent and seasonal components. The

permanent component (column 4) is the lowest level of total assets during the period; the seasonal portion is the difference between the total funds requirement (i.e. total assets) for each month and the permanent funds requirement. By comparing the firm's fixed assets (column 2) to its permanent funds requirement (column 4), we see that the permanent funds requirement exceeds the firm's level of fixed assets. This result occurs because *a portion of the firm's current assets is permanent*. The permanent component of current assets is found by subtracting the level of fixed assets from the permanent funds requirements, which is 800 (13,800 - 13,000)

Month	Current asset 1	Fixed asset 2	Total asset 3= 1+2	Permanent funds requirement 4	Seasonal funds requirement 5=3-4
January	4,000	13,000	17,000	13,800	3,200
February	3,000	13,000	16,000	13,800	2,200
March	2,000	13,000	15,000	13,800	1,200
April	1,000	13,000	14,000	13,800	200
May	800	13,000	13,800	13,800	0
June	1,500	13,000	14,500	13,800	700
July	3,000	13,000	16,000	13,800	2,200
August	3,700	13,000	16,700	13,800	2,900
September	4,000	13,000	17,000	13,800	3,200
October	5,000	13,000	18,000	13,800	4,200
November	3,000	13,000	16,000	13,800	2,200
December	2,000	13,000	15,000	13,800	1,200
Monthly average					13,800
1,950					

Aggressive strategy

An aggressive strategy may finance the permanent portion of the firm's funds requirement (13,800) with long term funds and finance the seasonal portion (ranging from 0 in May to 4,200 in October) with short term funds. Much of the short term financing may be in the form of *trade credit (i. e accounts payable)*.

Cost consideration:

Under the aggressive strategy, average short term borrowing (seasonal funds requirement) is 1,950 and average long term borrowing (permanent funds requirement) is 13,800. If the annual

cost of short term funds needed is 3% and the annual cost of long term financing is 11%, the total cost of the financing strategy is estimated as follows:

Cost of short term financing = $3\% \times 1,950 = 58.50$

Cost of long term financing = $11\% \times 13,800 = \underline{1,518.00}$

Total cost = $\underline{1,576.50}$

The total annual cost of 1,576.50 will become more meaningful when compared to the cost of the conservative financing strategy. The relatively low cost of short term financing results from using a high amount of free trade credit.

Risk consideration:

The aggressive strategy operates with minimum net working capital, since only the permanent portion of the firm's current assets is being financed with long term funds. The level of net working capital is birr 800 (13,800 permanent funds requirement - 13,000 fixed assets)

The aggressive financing strategy is risky not only from the standpoint of low networking capital but also because the firm must draw as heavily as possible on its short term sources of funds to meet the seasonal fluctuations in its requirements. The risk associated with the aggressive strategy results from the fact that a firm has only a limited amount of short term borrowing capacity.

Conservative strategy

Long term financing of 18,000, which equals the firm's peak need (during October), is used under this strategy. Therefore all the required over the one year period, including the entire 18,000 forecast for October, are financed with long term funds.

Cost consideration:

In the preceding example the annual cost of long term funds was 11%. Since the average long term financing balance under this strategy is 18,000, the total cost of this strategy is 1,980 ($11\% \times 18,000$).

Risk consideration:

The 5,000 of net working capital (18,000 long term financing -13,000 fixed assets) associated with the conservative strategy should mean a very low level of risk for the firm. The firm's risk should also be lowered by the fact that the strategy does not require the firm to use any of its limited short term borrowing capacity.

Conservative versus aggressive strategy

Unlike the aggressive strategy, the conservative strategy requires the firm to pay interest on unneeded funds. The lower cost of the aggressive strategy therefore makes it more profitable than the conservative strategy. However, the aggressive strategy involves

much more risk. For most firms a tradeoff between the extremes represented by these two strategies should result in an acceptable financing strategy.

Advantages and Disadvantages of short term financing

The three financing policies are distinguished by the relative amounts of short term debt used under each policy. The aggressive policy called for the greatest use of short term debt, while the conservative policy called for the least. Maturity matching fell in between. Although using short term credit is generally riskier than using long term credit, short term credit does have some significant advantages.

The advantages of short term credit are:

A. **Speed:** a short term loan can be obtained much faster than long term credit.

B. **flexibility:** if the needs are for seasonal or cyclical, a firm may not want to commit itself to long term debt for three reasons:

1. Flotation costs are generally high when raising long term debt but trivial for short term credit.

2. Although long term debt can be repaid early, provided the loan agreement included a prepayment provisions, prepayment penalties can be expensive. Accordingly, if a firm thinks its need for funds will diminish in the near future, it should choose short term debt for the flexibility it provides.

3. Long term loan agreements always contain provisions, or covenants, which constrain the firm's future actions. Short term credit agreements are generally much less onerous in this regard.

C. **Lower interest rate:** the yield curve is normally upward sloping, indicating that interest are generally lower on short term than on long term debts.

The disadvantage of short term credits is the extra risk that the borrower must bear. Even though short term debt is often less expensive than long term debt, short term credit subjects the firm to more risk than does long term financing. This occurs for two reasons:

1. If a firm borrows on a long term basis, its interest costs will be relatively stable over time, but if it uses short term credit, its interest expense will fluctuate widely, at times going quite high. Many firms that had borrowed heavily on a short term basis simply could not meet their rising interest costs, and as a result bankruptcies hit record levels during that period.
2. If a firm borrows heavily on a short term basis, it may find itself unable to repay this debt, and it may be in such a weak financial position that the lender will not extend the loan; this too could force the firm into bankruptcy.

Sources of short term financing

If a firm does not have the cash and marketable securities to meet its cash budget shortfalls, it must raise funds externally. Most firms use short term financing to meet temporary shortfalls, while permanent capital (long term debt and equity) is used to meet long term capital requirements. The four primary sources of short term financing are:

1. accruals
2. accounts payable
3. bank loans, and
4. commercial paper

Accruals

Firm's balance sheet show accrued wages, income tax payables. Accruals increase automatically or spontaneously as a firm's operations expand. Further this type of debt is "free" in the sense that no explicit interest is paid on funds raised through accruals. However, a firm cannot ordinarily control its accruals the timing of wage payments is set by economic forces and industry custom, while tax payment dates are established by law. Thus, firms use all the accruals they can, but they have little controls over the levels of these accounts.

Accounts payable

Firms generally make purchases from other firms on credit, recording the debt as an accounts payable or trade credit. Trade credit is a spontaneous source of financing in the sense that it arises from ordinary business transactions. Lengthening the credit period as well as expanding sales and purchases generates additional financing from accounts payable.

Short term bank loan

Commercial banks, whose loans generally on firms' balance sheets as notes payable, are second in importance to trade credit as a source of short term financing. As a firm's financing needs increase, it requests additional funds from its bank. The key features of bank loans are:

- A. Maturity: although banks do make longer term loans, the bulk of their lending is on a short term basis
- B. Promissory note: when a bank loan is approved, the agreement is executed by signing a promissory note.
- C. Compensating balances: banks some times require borrowers to maintain an average demand deposit (checking account) balance equal to 10 to 20 percent of the face amount of the loan.
- D. Line of credit: a line of credit is an agreement between a bank and a borrower indicating the maximum credit the bank will extend to the borrower.

Commercial Paper

It is a type of unsecured promissory note issued by large, strong firms, and it is sold primarily to other business firms, to insurance companies, to pension funds, to money market mutual funds, and to banks.

The use of commercial paper is restricted to larger businesses that are exceptionally good credit risks. Commercial paper is rarely secured, but all other types of loans are often secured if this is deemed necessary.