Question: What do you mean by the trade credit and which type of trade credit is more appropriate for the firm that deals with extremely expensive merchandise?

Answer: Trade credit is source of short term financing. Now a days in the business system purchasers needn't to pay value of goods by the time of purchase rather they get the facility to repay the same after a particular period of time. Particular period of time it becomes the sources of funds.

"Trade credit is the credit granted by manufacturers, wholesalers, jobbers as an incident of sales." ------------**Gitman**

Trade credit is three types. They are given below-

I. Open account.

II. Notes payable

III. Trade acceptance

The above trade credit, notes payable is more appropriate for the firm when the buyer signs a promissory note to obtain trade credit; it shows up on the buyer's balance sheet as a trade note payable. Trade notes payable are used routinely in some industries that deal with extremely expensive merchandise, like furs and jewelry.

"Is trade credit free of cost"? Explain

It appears to be cost free since it does not involve explicit interest charges. But in practices, it involves implicit cost. The cost of credit may be transferred to the buyer via the increased price of goods supplied to him. The user of trade credit, therefore, should be aware of the costs of trade credit to make use of it intelligently. The reasoning that it is cost free can lead to incorrect financing decisions.

Credit Terms

Credit terms refer to the conditions under which the supplier sells on credit to the buyer, and the buyer is required to repay the credit. These conditions include the ***due date*** and the ***cash discount*** (if any) given for prompt payment. Credit terms indicate the length and beginning date of the credit period.

Due date is the date by which the supplier expects payment. ***Cash discount*** is the concession offered to the buyer by the supplier to encourage him to make payment promptly.

For example, as follows: **'3/15, net 45'.** This implies that a 3 percent discount is available if the credit is repaid on the 15th day, and in case the discount is not taken, the payment is due by the 45th day.

Stretching Accounts Payable

Stretching accounts payable—that is, paying bills as late as possible without damaging its credit rating. Such a strategy can reduce the cost of giving up a cash discount.

For Example: ABC Industries was extended credit terms of 2/10 net 30 EOM. The cost of giving up the cash discount, assuming payment on the last day of the credit period, was approximately 36.5% [2% * (365/20)]. If the firm were able to stretch its account payable to 70 days without damaging its credit rating, the cost of giving up the cash discount would be only 12.2% [2% * (365/60)].

Although stretching accounts payable may be financially attractive, it raises an important ethical issue: It may cause the firm to violate the agreement it entered into with its supplier when it purchased merchandise. Clearly, a supplier would not look kindly on a customer who regularly and purposely postponed paying for purchases.

Compensating balance

Compensating balance is a required checking account balance equal to a certain percentage of the amount borrowed from a bank under a line-of-credit or revolving credit agreement.

Banks frequently require compensating balances of 10 to 20 percent. A compensating balance not only forces the borrower to be a good customer of the bank but may also raise the interest cost to the borrower.

For example: Omayer Graphics, a graphic design firm, has borrowed Tk.1 million under a line-of credit agreement. It must pay a stated interest rate of 10% and maintain, in its checking account, a compensating balance equal to 20% of the amount borrowed, or Tk.200,000. Thus it actually receives the use of only Tk.800,000. To use that amount for a year, the firm pays interest of Tk.100,000 (0.10*Tk.1,000,000). The effective annual rate on the funds is therefore 12.5% (Tk.100,000/ Tk.800,000), 2.5% more than the stated rate of 10%.

If the firm normally maintains a balance of Tk.200,000 or more in its checking account, the effective annual rate equals the stated annual rate of 10% because none of the Tk.1 million borrowed is needed to satisfy the compensating-balance requirement. If the firm normally maintains a Tk.100,000 balance in its checking account, only an additional Tk.100,000 will have to be tied up, leaving it with Tk.900,000 of usable funds. The effective annual rate in this case would be 11.1% (Tk.100,000 / Tk.900,000).

Thus a compensating balance raises the cost of borrowing only if it is larger than the firm's normal cash balance.

Factoring Accounts Receivable

Factoring accounts receivable involves selling them outright, at a discount, to a financial institution. A factor is a financial institution that specializes in purchasing accounts receivable from businesses. Although it is not the same as obtaining a short-term loan, factoring accounts receivable is similar to borrowing with accounts receivable as collateral.

Factoring Agreement: A factoring agreement normally states the exact conditions and procedures for the purchase of an account. The factor, like a lender against a pledge of accounts receivable, chooses accounts for purchase, selecting only those that appear to be acceptable credit risks. Where factoring is to be on a continuing basis, the factor will actually make the firm's credit decisions because this will guarantee the acceptability of accounts.

Factoring is normally done on a notification basis, and the factor receives payment of the account directly from the customer. In addition, most sales of accounts receivable to a factor are made on a ***nonrecourse basis***, meaning that the factor agrees to accept all credit risks. Thus, if a purchased account turns out to be uncollectible, the factor must absorb the loss.

Typically, the factor is not required to pay the firm until the account is collected or until the last day of the credit period, whichever occurs first. The factor sets up an account similar to a bank deposit account for each customer. As payment is received or as due dates arrive, the factor deposits money into the seller's account, from which the seller is free to make withdrawals as needed. In many cases, if the firm leaves the money in the account, a surplus will exist on which the factor will pay interest. In other instances, the factor may make advances to the firm against uncollected accounts that are not yet due. These advances represent a negative balance in the firm's account, on which interest is charged.

Factoring Cost: Factoring costs include commissions, interest levied on advances, and interest earned on surpluses. The factor deposits in the firm's account the book value of the collected or due accounts purchased by the factor, less the commissions. The commissions are typically stated as a 1 to 3 percent discount from the book value of factored accounts receivable. The interest levied on advances is generally 2 to 4 percent above the prime rate. It is levied on the actual amount advanced. The interest paid on surpluses is generally between 0.2 percent and 0.5 percent per month.

Although its costs may seem high, factoring has certain advantages that make it attractive to many firms. One is the ability it gives the firm to turn accounts receivable immediately into cash without having to worry about repayment. Another advantage is that it ensures a known pattern of cash flows. In addition, if factoring is undertaken on a continuing basis, the firm can eliminate its credit and collection departments.

Commercial Paper

Commercial paper is a form of financing that consists of short-term, unsecured promissory notes issued by firms with a high credit standing. Generally, only large firms of unquestionable financial soundness are able to issue commercial paper. Most commercial paper issues have maturities ranging from 3 to 270 days. A large portion of the commercial paper today is issued by finance companies; manufacturing firms account for a smaller portion of this type of financing. Businesses often purchase commercial paper, which they hold as marketable securities, to provide an interest-earning reserve of liquidity.

Types/Sources/Instruments of Short Term Financing

1. **Spontaneous Financing**
   a. Trade Credit
      i. Open Account
      ii. Notes Payable
      iii. Trade Acceptance
   b. Advance Payment
   c. Accrued Expenses
2. **Money Market**
   a. Commercial Paper
   b. Banker's Acceptance
3. **Bank Loan**
   a. Unsecured Bank Loan
      i. Line of Credit
      ii. Revolving Credit
      iii. Compensating Balance
      iv. Transaction Credit
   b. Secured Bank Loan
      i. Accounts Receivable
      ii. Inventories

Financing by inventory as a Security

Inventory is the stock of the product a company is manufacturing for sale and components that make up the product. There are three types of inventories: raw materials, work-in-process and finished goods.

Raw materials are materials and components that are inputs in making the final product.

Work-in-process refers to goods in the intermediate stages of production.

Finished goods consist of the final products that are ready for sale.

Inventories represent a reasonably liquid asset and are, therefore, suitable as security for a short-term loan. The lender determines a percentage advance against the market value of the inventory as collateral. Funds are obtained against the security of inventory in order to finance the storage, processing or goods. Inventory is widely used as collateral against loans.

Annual cleanup

Annual cleanup is the requirement that for a certain number of days during the year borrowers under a line of credit carry a zero loan balance (that is, owe the bank nothing).

This means that the borrower must have a loan balance of zero—that is, owe the bank nothing—for a certain number of days during the year. Insisting that the borrower carry a zero loan balance for a certain period ensures that short-term loans do not turn into long-term loans.

Accrued Expenses

Accruals are liabilities for services received for which payment has yet to be made. The most common items accrued by a firm are wages and taxes. Because taxes are payments to the government, their accrual cannot be manipulated by the firm. However, the accrual of wages can be manipulated to some extent. This is accomplished by delaying payment of wages, thereby receiving an interest-free loan from employees who are paid sometime after they have performed the work. The pay period for employees who earn an hourly rate is often governed by union regulations or by state or federal law.