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Course Title: Financial Management/Finance for Non Finance Managers/Global Treasury Management

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Objectives

At the end of this course delegates will be able to understand the following:

Module One

The nature, elements and importance of working capital, management of inventories, accounts receivable, accounts payable and cash, determining working capital needs and funding strategies

Module Two

Overview of treasury management and function of treasury management

Module Three

Financial questions required for good decisions on financial management for the business especially in the areas of:

- Investment in non-current assets
- Sustaining the company through initial loss-making periods
- Investment in current assets.

Essential Reading:

Akinsulire, Oye (2011), *Financial Management*, 7th Edition, Lagos, Ceemol Ltd.

Pre-reading:

Brigham, E.F and Daves, P.R. (1980), *IntermediateFinancial Management*, Mason, South-Western, Pg. 658.

Further reading

Weissman, I. and Goldstein, M.(1996), "Bankers' Acceptance Financing--The Link to Financing Global Market Activity", CPA Journal, 66(8), pg.64

MODULE ONE

WORKING CAPITAL MANAGEMENT

1. The nature, elements and importance of working capital

2. Management of inventories, accounts receivable, accounts payable and cash

3. Determining working capital needs and funding strategies

The Nature, Elements and Importance of Working Capital

What is Working Capital?

Working capital is the net of current assets minus current liabilities. That is working capital is equal to the value of raw materials, work-in-progress, finished goods inventories and accounts receivable less accounts payable.

What is the aim of Working Capital Management?

The aim of working capital management is to achieve balance between having sufficient working capital to ensure that the business is liquid but not too much that the level of working capital reduced profitability.

What is meant by the term Liquidity?

Liquidity means that the business has sufficient inventory and cash so that it can trade without its cash or inventory depleting

Why is Working Capital Management important?

Working capital management is essential for the long-term success of a business. No business can survive if it cannot meet its day-to-day obligations. A business must therefore have clear policies for the management of each component of working capital.

Management of Inventories, Accounts Receivable, Accounts Payable,and Cash

Can the level of working capital be fixed for all organisations and why?

• Different industry types require different levels of working capital. Service industries need little to no inventory whereas retailers need more. Depending on the retailer's business their inventory will also vary. Manufacturers will probably require more because they need raw material stocks, work-in-progress and finished goods. Retailers may sell for cash therefore having few receivables and producers may have trade customers and have greater receivables.

• If supply deliveries are uncertain the level of inventory will be greater

. • If the level of activity increases specifically sales then inventory, receivable and payables will increase.

• The company's operating cycle will also determine the level of working capital

What is the Operating Cycle?

The operating cycle is the length of time between the company's outflow on raw materials, wages and other expenditures and the inflow of cash from the sale of goods.

What are the characteristics of the Operating Cycle?

The operating cycle is made up of three elements:

• The inventory turnover days

• The average receivable collection days

• The average payable days

How is the Operating Cycle calculated?

Inventory days + receivable days - payable days = operating cycle

• Inventory days = Inventory / Cost of sales x 365days

• Receivable days = Receivables / Sales x 365

• Payable days = Payables / Cost of sales x 365

What is the importance of the Operating Cycle?

The operating cycle is important because it determines the amount of working capital a business needs. If you can have the operating cycle you will have the working capital requirement of the business. If the turnover period for inventories and accounts receivable lengthen, or the payment period to accounts payable shortens, then the operating cycle will lengthen and the investment in working capital will

What is Overtrading?

Overtrading is the term applied to a company which rapidly increase its turnover without having sufficient capital backing. Overtrading is risky because short-term finance can be withdrawn relatively quickly if creditors lose confidence in the business or if there is a general tighten in the economy. The problem with overtrading is not that the company is unprofitable it is that the company has simply run out of cash.

What are the Characteristics of Overtrading?

• More intensive utilisation of existing fixed assets

• More intensive use of working capital

• Reliance more heavily on short-term sources such as overdraft and trade creditors

• Increase in debtors as stock increases

• Declining liquidity

How can a overtrading be measured?

Overtrading can be measured using Liquidity Ratios:

• Current Ratio = Current Assets / Current Liabilities

A measure of how much of total current assets is financed by current liabilities. A ratio of 2:1 or greater is considered a safe measure.

• Quick Ratio = Current Assets – Inventory / Current Liabilities A measure of how well current liabilities are covered by liquid assets. A ratio of 1:1 means that we are able to meet our existing liabilities if they fall due at once out of very liquid current assets.

• The bank balance of a company is a good indication of overtrading if changes from a surplus to a deficit and continues to rise

• If payable days are getting longer, that suggests that the cash position is worsening.

• If the level of activity rises sharply then this may be an indication of overtrading.

Determining Working Capital needs and Funding Strategies

What is a good solution to Overtrading?

A good solution to overtrading would be to convert short-term financing with long-term financing.

Working Capital can be funding either by Short-term Finance or Long-term Finance, what are the advantages and disadvantages?

Advantages of short term finance:

• Cheaper Short-term finance is cheaper than long-term finance because lenders would demand a greater compensation for having their money tied up for long periods.

• Flexible Short-term finance is more flexible than long-term finance because the amount of finance needed will fluctuate over the operating cycle. A business will only pay interest on the amount of overdraft (short-term) utilised whereas with long-term the business will pay fixed interest even though the loan is not fully utilised.

• Easy to arrange an overdraft is simple to arrange and is normally unsecured against the company's assets. It does not need any of the formalities that go with setting up long-term finance.

Advantages of long-term finance:

• The fund are permanent and will run for the full term of the loan as a pose to overdrafts which is repayable on demand which could seriously damage the company

• There is no need to continually renew the finance. Equity for example will not normally be repaid.

What are Permanent Current Assets?

Permanent current assets are the normal level of stock and debtors that the company needs in order to keep the business going. The company will always need a certain amount of stock and having sell these stock they will have the level of debtors that result from selling these stock.

What are Fluctuating Current Assets?

These are the levels of current assets that fluctuate up and down with the seasonal nature of the business.

Aggressive Funding Policy: This is where the organisation uses short-term funds to finance its permanent working capital. This is cheaper but high risk because short-term funds can be recalled on demand.

Conservative Funding Policy: This is where the organisation uses long term funding for the permanent working capital.

What are some Short-term Sources of Finance?

• Factoring – the debts of the company are effectively sold to a factor

• Invoice Discounting – selected invoices are used as security against which the company may borrow funds.

• Trade Credit – the delay of payment to suppliers on credit terms, no interest funding • Overdrafts – Short-term borrowings from a financial institution

• Bank Loans – Loans between one and three years

• Bills of Exchange – an agreement to pay a certain amount at a certain date in the future

Asset Specific Sources of Finance

• Hired Purchase

• Finance Lease

• Operating Lease

What are the advantages/disadvantages to offering Credit?

Advantages

• Offering credit encourages customers to take up our goods

Disadvantages

*Bad debts

*Slow payers that increase working

*Administration of the sales

*Debt collection

• capital • ledger •

Credit Management

There are three aspects to credit management:

• Assessing credit status Deciding the terms on which Day to Day management

• credit will be offered

• How to assess credit status – Bank references, trade references, published accounts, credit rating agencies and company's own sales records.

How do we calculate the cost of financing receivables?

The receivable balance needs to be financed and it is important that a company knows how much the receivables are costing it in the course of a year. The interest rate to be applied to receivables will usually be the overdraft rate that is financing the working capital.

Interest cost = Receivables balance X Interest rate

Discounts

Discounts encourage customers to pay early. The cost of the discount is balanced against the savings the company received from a lower receivables balance and a shorter average collecting period.

Advantages/Disadvantages of early settlement discounts:

Advantages:

• debtor balance and hence the interest charge

• Early payment reduces bad debt arising

Disadvantages:

• If discounts are too high it will cost the company

• If discounts are too low many customers will not take it

*Greater uncertainty as to who not reduce bad debts

* Customer may pay over normal but still take the cash discount?

What is factoring

There are three main factor services

*Debt collection and

* Credit insurance – with recourse and without recourse

*Financing

What are the advantages and disadvantages of factoring?

Advantages

(i) Improves cash flow

(ii) Saving in internal administration cost

(iii). Useful for small and fast growing organization whose credit department may not be able to keep up.

(iv). Reduction in the need for day to day management control.

(v) Debt collection is outsourced therefore managers have more time to run the organization.

(vi). The factor is experienced in enforcing credit terms leading to lower level of outstanding debts

Disadvantages

(i). It is more costly than an efficiently run internal credit control department

(ii). Factoring has a bad reputation associated with falling company and this may cause many company to be concerned that the company has cash flow problems/falling hence they may not feel confident to continue with the business.

(iii). Customers do like dealing with a factor

(iv). Customers like to think that their suppliers will manage their own affairs

(v). Difficult to revert to internal credit control

(vi).Factor is more aggressive towards the company's customers because their main concern is collection and not customer care.

Managing Inventory

There needs to be balance between the benefits and cost of holding stock. The benefits of holding stock are that it allows the business to sell a range of goods which is immediately available to customers However, holding stock incurs costs, in particular, opportunity cost of money tied up in stock

They are four types of cost associated with stock:

1. Ordering cost

2. Holding cost

3. Stock-out cost

4. Purchase cost

Ordering costs are the costs relating to the placing of orders. These include clerical, administrative and accounting costs of placing an order exclude costs materials ordered.

Holding costs is the total annual cost. These include the warehousing and cost related to storing/holding stock and excludes costs of the material ordered.

Stock-out costs are the costs relating to the lost contribution through loss of sales, the lost future contribution through loss of customers, the cost of emergency orders of materials and the cost of production stoppage

Purchase costs are the cost of what is bought

What is the Economic Order Quantity?

The economic order quantity is the reorder quantity which minimises the total cost of holding and ordering materials over a given time period. The size of the order placed will affect the total holding cost and ordering costs over the year. If the company has a policy of placing large orders rather than small orders then the total annual holding costs will increase. However, if the order size increases the sales will decrease and so the total annual cost of placing costs and ordering costs over the year. If the co number of orders needed to satisfy the year’s the orders will fall.

Just In Time

The basic aim is to eliminate or minimise inventory. The theory holds that stock is only needed if there are inefficiencies in the production process, that is, the business need stock because they cannot schedule the work accurately, quality problems, inflexible work practices. The idea behind Just-in-time is that if you can eliminate the inefficiencies and can plan and deliver production process to a fixed time schedule then inventory is either unnecessary or at least minimised. However, for this to work the suppliers must also be JIT suppliers.

Managing Cash:

Cash like inventory is another balancing act, the company needs cash to be able to run the business while at the same time trying not to keep idle cash which generates little or no return and costs mo to fund

There are three methods for managing cash:

1. Miller-Orr model

2. Baumol model

3. Cash budget

The Miller-Orr Model:

This a model that considers the level of cash that should held in a period of uncertainty. This involves studying cash movement over a period of time to get an idea of how cash fluctuate with no control in place. The organization will then set lower and upper limit. These limits are set using a formula (given in exam). If cash exceeds the upper limit the cash should be invested. If the cash falls below the lower limit, more cash will be needed in order to operate

• Transaction cost is the cost of investing or realizing cash until the limit are reached

• Variance is a measure of uncertainty or dispersion

. • Interest rate is the rate of interest per day.

• The upper limit is simply the lower limit plus the spread

• Return point = lower limit + 1/3 of the spread)

• The model is based on uncertainty of cash flow

*The model is designed to offer a way of controlling cash balances on a day to day basis

*If transaction cost increases the spread cost also increases and vice versa.

*If interest cost increases the spread cost also increases and vice versa

Baumol model

This is the use simply the use of the EOQ model to manage cash.

Cash Budget

A cash budget is a statement of all the inflows and outflow of cash for a given period. We are only concerned with the inflow and outflow. Non cash flows such as depreciation are ignored.

MODULE TWO

Treasury Functions

1.0 Introduction

- The Treasury Department of a bank is the centre stage and primary abode of risks in any organisation such as bank.

- Indeed, risk management is and must be the primary focus of a Bank Treasurer and his team members in cooperation with Management as a single slip can cost the bank a fortune.

- However, in this particular instance, the attention is on treasury management tools and techniques.

A primary objective for the corporate treasury is to maintain sufficient liquid funds to support current and potential needs. This objective could be addressed by maintaining surplus liquid funds to cover all possible shortfalls, but such a policy would destroy economic value, as short-term rates of deposits would rarely exceed the cost of capital paid to obtain these liquid funds. The optimal alternative is therefore to maintain access to potential sources of liquidity, such as bank overdrafts, commercial paper facilities, short-term loan lines, and so on. Although reliance on bank finance has to an extent been reduced by the growth of the capital markets, loan finance remains a key component of corporate finance in most countries.

For borrowing, the treasurer must first determine the period during which funding is needed, and required currency. Then the treasurer evaluates the available funding methods, such as debt securities (commercial papers, bonds, medium term notes) and bank loans (either committed or uncommitted). It is very important for the treasurer to match maturity and currency of funds with the company's assets. That means to finance fixed assets with long-term funds (long-term loans or corporate bonds), and current assets with short-term tools (commercial papers, overdraft and revolving credit facility, etc.). That means, borrowing will include the selection of lenders and borrowing vehicles that best serve the business and the lenders. Just as credit agreements will control the methods of borrowing, treasury must also develop an investment policy that discusses the level of risk taken through investments of excess cash.

Treasury function
The treasury function is responsible for the following areas: (a) **Liquidity** (i.e. working capital) – measuring, monitoring and managing **cash flow to protect solvency**. (b) **Funding** (i.e. long-term finance) – creating an **optimal mix of equity and debt** to meet capital expenditure and investment requirements. (c) **Financial risk management** – **identifying potential risks** and their impact and taking action to mitigate these.

The stability of the company's cash flows to achieve the company's profit and solvency objectives is the key aim of treasury.

1.1 The Structure of the Treasury Function

Treasury activities

Treasury tends to **concentrate on the physical flow of funds**, **cash and financial risk** as compared to accounting and corporate finance, which deal predominantly with the recording or evaluation of transactions. In general, treasury usually adopts a more active role in the organization than other sections of the finance function. Originally the activities were carried out within the general finance function, but today are often separated into a treasury department, particularly in large international companies. Reasons for the change include:

(a) increase in size and global coverage of the companies

(b) increasingly international markets

(c). increase in sophistication of business practices

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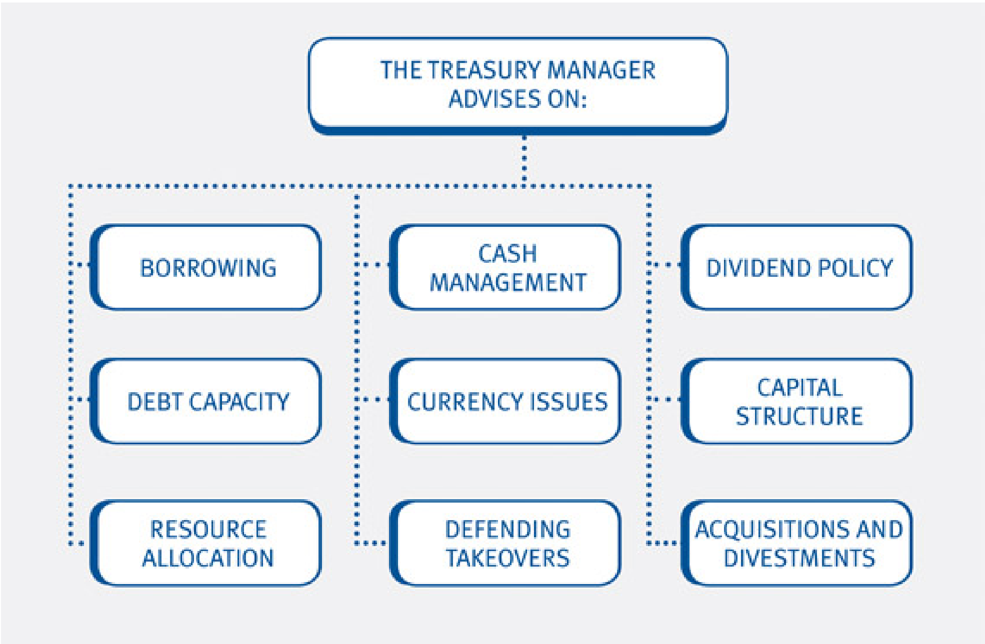

1.2 Financial Tasks Within Institutions and the Role of Treasury

The general mission of the treasury department is to manage the liquidity of a business. This means that all current and projected cash inflows and outflows must be monitored to ensure that there is sufficient cash to fund company operations, as well as to ensure that excess cash is properly invested. While accomplishing this mission, the treasurer must engage in considerable prudence to ensure that existing assets are safeguarded through the use of safe forms of investment and hedging activities.

Detail of Treasury Functions

In order to accomplish its mission, the treasury department must engage in the following activities:

- *Cash forecasting*. Compile information from around the company to create an ongoing cash forecast. This information may come from the accounting records, the budget, capital budget, board minutes (for dividend payments) and even the CEO (for expenditures related to acquisitions and divestitures).
- *Working capital monitoring*. Review the corporate policies related to working capital, and model their impact on cash flows.

- *Cash concentration*. Create a system for funneling cash into a centralized investment account, from which cash can be most effectively invested.
- *Investments*. Use the corporate investment policy for allocating excess cash to various types of investments, depending on their rates of return and how quickly they can be converted into cash.
- *Grant credit*. Issue credit to customers, which involves management of the policy under which credit terms are granted.
- *Fund raising*. Determine when additional cash is needed, and raise funds through the acquisition of debt, sale of stock, or changes in company policies that impact the amount of working capital required to run the business.
- *Risk management*. Use various hedging and netting strategies to reduce risk related to changes in asset values, interest rates, and foreign currency holdings.
- *Credit rating agency relations*. Keep any credit rating agencies informed of the company's financial results and condition, if these agencies are providing ratings on the company's marketable debt issuances.
- *Bank relations*. Keep the company's bankers apprised of the company's financial condition and projections, as well as any forthcoming changes in its need for borrowed funds.
- *IT systems*. The department maintains treasury workstations that provide it with information about cash holdings, projections, market conditions, and other information.
- *Reporting*. The treasurer provides the senior management team with reports concerning market conditions, funding issues, returns on investment, cash-related risks, and similar topics.
- *Mergers and acquisitions*. The department may advise on the company's acquisition activities, and may be called upon to integrate the treasury functions of an acquiree.
- Management of liquidity and risk on a global basis including the linkage of local operations into pooling structures. We assess the benefits of regional treasury centers, netting and re-invoicing arrangements and evaluate options including intercompany lending, receivables financing and outsourcing. We review available short term investment and funding options based on analysis of country and regional opportunities and each client’s unique tax objectives and situation. Our understanding of tax issues, bank capabilities, commercial, regulatory and cultural considerations enables us to provide practical recommendations.

In essence, treasury functions revolve around the monitoring of cash, the use of cash, and the ability to raise more cash. All other tasks of the department support these functions.

1.3 TREASURY RISK MANAGEMENT IN FINANCIAL INSTITUTIONS

‘A man has deprived himself of the best knowledge there is in the world if he has deprived himself of the knowledge of the Bible. On the foundation of this book (Bible), Civilization has been built & sustained”. - Dickson Bible Study Guides, South Africa.

Treasury Department and Risks

What is Risk

- Risk as the effect of uncertainty on objectives, whether positive or negative. Risk is a key element of every human endeavour as every decision in private, public and business lives are laced with risk content, being the possibility, usually, of a negative deviation from the expected results.

- Every bank is today embracing Enterprise Risk Management, ERM, as a pillar of good corporate governance.

- Committee of Sponsoring Organisation of Treadway Commission in its treatise: COSO Enterprise Risk Management – Integrated Framework, (2004) defines ERM as “…..a process, effected by an entity’s board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risks to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity’s objectives.”

- **Risk Management**

- This is the identification, assessment and prioritisation of risks followed by co-ordinated and economical application of resources to minimise, monitor and control the likely impact of undesirable events on Organisational objectives, or to maximise the realisation of opportunities there from.

- Risk Management gives comfort to the stakeholders that the Organisation is being effectively managed and helps the Organisation confirm its compliance with corporate governance requirements.

- Broadly speaking, risks are of two types: operational risks (traceable to people, processes, policies, technology, equipment, etc.);

Strategic risks (associated with regulations, legal and institutional environment and other externalities)

- **Definition –**

(i). Operational Risk

- **The 'risk of loss resulting from inadequate or failed internal processes, people and systems or from external events"**

- **Major types of Operational Risk recognized by Basel Accord are:**
- **PROCESS**
- **PEOPLE**
- **SYSTEMS**
- **EXTERNAL EVENTS**

PROCESS Risk:

- Incorrect/untimely transaction execution
- Accounting and taxation errors
- Inadequate record keeping
- Inadequate segregation of duties
- Lack of supervision
- Product complexity

<u>PEOPLE Risk</u>

- Fraud,
- Employee illness and injury
- Staff competence

- **<u>Systems Risk:</u>**
- Hardware and/or software failure
- System downtime, Power outages

- Computer hacking or viruses
- Unauthorized access to information and system security compromises, Data Integrity
- **External Events**
- Fire or natural disaster
- Failure of suppliers or outsourced operations
- Theft, robbery caused by anybody outside the bank

(ii). Market Risk

The risk of loss resulting from adverse movements in the level or volatility of market prices, interest rate instruments, equities, commodities, or currencies.

- ❑ Foreign exchange risk: this is the risk of losses on trading positions due to adverse exchange rate movements;
- ❑ Equity position risk: this is the risk of losses on share trading positions due to adverse movements in share prices;
- ❑ Interest rate position risk: this is the risk of losses on trading positions due to adverse interest rate movements;
- ❑ Commodity position risk: this is the risk for banks trading commodities from adverse movements in commodity prices;
- ❑ Risk from large exposures: on certain market positions. With large exposures, the risk is higher because the impact will be larger if an adverse events occurs.

(iii). Liquidity Risk

- ❑ Liquidity risk is the potential for loss to a bank arising from its inability to meet its obligations (e.g. maturing deposits, loan disbursements, maintenance of liquidity ratio prescribed by regulatory authorities etc) without incurring unacceptable cost or losses.
- Basel Committee of Banking Supervision defines liquidity as “the ability to fund increases in assets and meet obligations as they come due, without incurring acceptable losses’’.

(iv). Credit Risk

- ▪ Credit Risk is defined as the risk of counterparties failing to honour their financial obligations both on- and off –balance sheet.

- In other words, it is the exposure of earnings and capital to potential losses which may arise from non- payment of obligations by the counterparties.

Regulatory/Compliance Risk

- Compliance Risk is the current and prospective risk to earnings or capital arising from violations of, or nonconformance with, laws, rules, regulations, prescribed practices, internal policies, and procedures, or ethical standards.
- The Compliance function is responsible for ensuring that the Bank continuously manages its regulatory risk.
- The management of regulatory risk comprises ensuring compliance with all the statutory and regulatory requirements.
- The Compliance function is therefore responsible for ensuring compliance with all rules imposed on the business by regulators/supervisors.

Strategic Risk

- **…**failure to identify and appropriately manage risk at a strategic level has a far greater potential impact on organisational fortunes than insured or tightly-controlled operational risk'
- *Sharman and smith (2004)*
- Strategic Risk is the risk of a loss arising from a poor strategic business decision.
- It is the risk associated with future business plans and strategies, e.g. plans for entering new business lines, expanding existing services, mergers and acquisitions etc.
- It can thus have a significant effect on the firm's revenues, earnings, market share, product offerings, etc.

Legal Risk

- There are situations where an institution may not be able to enforce a contract against a counterparty.
- In this context, legal risk is the possible risk of loss due to the unenforceable contract.

Governance Risk

- Corporate Governance CG is commonly used to describe the way business organizations are managed or the system by which a corporation is directed and controlled

- The CG structure specifies the distribution of rights and responsibilities among different participants in the corporation such as the BOD (Board of directors), managers, shareholders, employees, regulators, investors, media, business partners, consumers & the community at large and spells out the rules and procedures for making decisions on corporate matters.
- Inability to apply the CG principles can lead to governance risk

Reputation Risk

Reputation risk is the risk to the reputation of an organization with external groups, such as the general public, customers and potential customers, the government and suppliers.

- Simply put, an organization should be able to ask **"Who do people say we are?"**
- Damage to a company's reputation can eventually have a strong adverse impact on business.

Overview of Treasury Functions

The general mission of the treasury department is to manage the liquidity of a business. This means that all current and projected cash inflows and outflows must be monitored to ensure that there is sufficient cash to fund company operations, as well as to ensure that excess cash is properly invested. While accomplishing this mission, the treasurer must engage in considerable prudence to ensure that existing assets are safeguarded through the use of safe forms of investment and hedging activities.

Detail of Treasury Functions

In order to accomplish its mission, the treasury department must engage in the following activities:

- *Cash forecasting*. Compile information from around the company to create an ongoing cash forecast. This information may come from the accounting records, the budget, capital budget, board minutes (for dividend payments) and even the CEO (for expenditures related to acquisitions and divestitures).

- *Working capital monitoring*. Review the corporate policies related to working capital, and model their impact on cash flows. For example, looser credit results in a larger investment in accounts receivable, which consumes cash.

- *Cash concentration*. Create a system for funneling cash into a centralized investment account, from which cash can be most effectively invested.

- *Investments*. Use the corporate investment policy for allocating excess cash to various types of investments, depending on their rates of return and how quickly they can be converted into cash.

- *Grant credit*. Issue credit to customers, which involves management of the policy under which credit terms are granted.

- *Fund raising*. Determine when additional cash is needed, and raise funds through the acquisition of debt, sale of stock, or changes in company policies that impact the amount of working capital required to run the business.

- *Risk management*. Use various hedging and netting strategies to reduce risk related to changes in asset values, interest rates, and foreign currency holdings.

- *Credit rating agency relations*. Keep any credit rating agencies informed of the company's financial results and condition, if these agencies are providing ratings on the company's marketable debt issuances.

- *Bank relations*. Keep the company's bankers apprised of the company's financial condition and projections, as well as any forthcoming changes in its need for borrowed funds. The discussion may extend to the various services provided by the banks to the company, such as lockboxes, wire transfers, ACH payments, and so forth.

- *IT systems*. The department maintains treasury workstations that provide it with information about cash holdings, projections, market conditions, and other information.

- *Reporting*. The treasurer provides the senior management team with reports concerning market conditions, funding issues, returns on investment, cash-related risks, and similar topics.

- *Mergers and acquisitions*. The department may advise on the company's acquisition activities, and may be called upon to integrate the treasury functions of an acquiree.

In essence, treasury functions revolve around the monitoring of cash, the use of cash, and the ability to raise more cash. All other tasks of the department support these functions.

MODULE THREE

SOURCES OF FINANCE

INTRODUCTION

Finance generally oils the wheel of business, without which the business will grind to a halt. Financing of business begins with the pooling of equity funds together by the entrepreneur and shareholders up to the time the business receives its first receipts from its customers and clients. This process continues as working capital finance moves and changes in character from stocks to debtors, bank balances and cash and back to stocks and so on. The process continues *ad infinitum*.

Many financial questions are needed to make good decisions on financial management for the business especially in the areas of:

- Investment in non-current assets
- Sustaining the company through initial loss-making periods
- Investment in current assets.

A cash-flow forecast is an essential tool in planning capital needs. Typically, suppliers of capital will want forecasts for three to five years. One of the biggest dangers facing new successful businesses is overtrading, where they try to do too much with too little capital. Most businesses know that capital will be needed to finance non-current assets, but many overlook that finance is also needed for fixed assets that will not bring in cash, but need for the operations of the business. When capital is raised, the company has to decide what to do with it, and there are two main uses:

- investment in non-current assets
- investment in current assets, including leaving it as cash

TYPES OF SOURCES OF FINANCE

There are two main types of sources of finance which are;

- Internal Sources of Finance and
- External Sources of Finance

Internal Sources of Finance: Internal financing is the term used to describe a situation where firm uses its profits as a source of capital for new investment, rather than distributing them to firm's owners and other investors or obtaining capital elsewhere. This is the finance or capital which is generated internally by the business unlike finances such as loan which is externally arranged from banks or financial institutions. Internal sources of finance include owner's investment (start-up or additional capital), retained profit, sale of stock, sale of fixed assets and debt collection.

i. ***Start-up or Additional Capital***: This usually comes in form of personal savings. If a business doesn't have the assets to finance projects, the owners can introduce their personal finances to contribute to the business. This provides an alternative to seeking external investors or loans and allows the owners to retain control over the business.

ii. ***Retained Earnings***: Retained earnings are an easy *source* of *internal financing* to use because they are liquid assets. Retained earnings are the portion of net income that is retained in a company and not paid out.

iii. ***Sale of Stock***: If a company has stock holdings in other companies, the stocks can be divested and the proceeds used as a source of financing of current project. However, a company should be careful not to decrease its current assets to levels less than its current liabilities, as this may prevent the company from paying off its debts.

iv. ***Sale of Fixed Assets***: Fixed assets are those assets that are not easily converted to cash. Typically, these assets include equipment, property and factories. Because these assets take time to convert to cash, they cannot be relied on for short-term access to finance. However, a company can sell off some equipment or even property to invest in the business. This is particularly useful if the company'sneeds have outgrown some of the fixed assetse.g. obsolete equipment or machines can be sold to purchase newer equipment.

v. ***Debt Collection***: Debtors are liquid assets i.e. can be easily converted to cash and can be relied on for short-term access to funds to finance short term projects of a company.

External Sources of Finance: External financing is used to describe funds that firms obtain from outside of the firm. It is contrasted to internal financing which consists mainly of profits retained by the firm for investment. There are many kinds of external financing. The two main ones are equity issues and debt finance. Others include trade credit, accounts payable, and taxes owed to the government. External financing is generally believed to be more expensive than internal financing, because the firm often has to obtain it at a cost.

CLASSIFICATION OF SOURCES OF FINANCE

The known sources of external finance are widely classified into three groups namely short, medium and long term sources of finance. Short term sources of finance are those usually repayable in one year and are most suitable for financing shortfalls in working capital. Medium term sources are repayable within one to five years and are most suitable for financing short to medium term projects. The long terms sources are repayable from five years and above and are mostly suitable for financing capital intensive projects.

Short Term Sources of Finance

Short-term sources of finance are usually available for up to one year. This means that the source is normally available from a few days to one year and implies that once it is sourced {received}, it must be repaid within one year. Short-term finance by its nature cannot be used to finance fixed assets because of the short holding period. It is normally used for working capital purposes to enable it to be quickly liquidated or repaid.

Main Sources

1. **Bank Overdraft***:* This is one of the sources of finance available from the bank on short-term basis. Bank overdraft is available to holders of current accounts only. The bank usually allows the customer to issue cheques in excess of the customer's balance that the bank simply pays. The bank normally charges interest on outstanding overdrawn balance on overnight basis. The balance in the current account swings form credit to debit when the customer pays into the account and when he is borrowing respectively. The debit balance of the current account is the overdrawn balance. As customers pay into the accounts the balance reduces enabling the account to swing back to credit. The instrument used is the cheque through the current account. Sometimes the bank allows the customer to draw against cheques paid in but not yet cleared. Interest charges are low and related to the prime-lending rate that is the minimum lending rate at which the bank grants loans. The interest rate charged is a function of:
   i. The relationship between customer and the bank and
   ii. The level of interest rate in the economy as a whole.

   Overdrafts are subject to expiry and renewal by the bank. Its flexibility has made it one of the most popular sources of short-term finance for business. If a customer exceeds the agreed limit, collateral may be required. Interest charges are deductible for tax payments.

Advantages of Bank Overdraft

i. Overdraft facility is usually easy to avail compared to long term loans which may require more paperwork;
ii. A bank overdraft is usually helpful for a business where it has cash flows moving in an out many times during a month;
iii. An overdraft facility allows managing cash flow gaps that might arise due to timing mismatch;
iv. It helps to maintain a good payment history as any payment made via cheque does not bounce due to insufficient funds, which may have been made against some receivable, which may come a couple of days later;
v. It also aids in ensuring that timely payments are made and no late payments penalties are faced, as payments would be made even if there is no balance in the account;
vi. Overdraft facility is flexible in the nature that one may take it whenever required for whatever amount (up to the limit allotted) and for even as less as one or two days;
vii. Since the interest is calculated only on the amount of funds utilized, there are great savings in the interest cost when compared to a normal loan taken on fixed interest rate

Disadvantages of Bank Overdraft

i. Overdraft facility comes with a cost usually higher than the other sources of borrowing. Also if one goes above or exceeds the overdraft limit, the charges thereby are much higher;
ii. Overdraft facility is a temporary loan and undergoes regular revisit by the bank. Hence, it runs a risk of decrease in the limit or withdrawal of the limit;

iii. Bank overdraft facility may at times be secured against inventory or other collateral like shares, life insurance policies etc., hence company may run risk of those assets being seized, if it fails to meet payments.
iv. Availability of overdraft facility may make the company less strict on the collection of debtors' payment.

2. **Commercial Paper (CP)**: This is an instrument that allows the business to raise money from third parties rather than from banks directly. Large well-known companies issue them. They are unsecured debt notes and are issued through the banks. Very often, the bank establishes a line of credit which gives the borrower access to cash that can be used {if there be need} to pay off the paper at maturity. Maturity of a commercial paper is normally less than 270 days but most are issued for 180 days. The bank does not even guarantee the paper. Coupon (Interest) rate charged is stated on the paper. The issuing bank charges a commission for its services. Therefore the cost to the borrowing company is:
    i. Issuing bank's commission (0.5% flat on the amount raised)
    ii. Coupon rate

Advantages of Commercial Paper

i. A commercial paper is sold on an unsecured basis and does not contain any restrictive conditions;
ii. As it is a freely transferable instrument, it has high liquidity;
iii. It provides more funds compared to other sources. Generally, the cost of CP to the issuing firm is lower than the cost of commercial bank loans;
iv. A commercial paper provides a continuous source of funds. This is because their maturity can be tailored to suit the requirements of the issuing firm. Further, maturing commercial paper can be repaid by selling new commercial paper;
v. Companies can park their excess funds in commercial paper thereby earning some good return on the same.

Disadvantages of Commercial Paper

i. Only financially sound and highly rated firms can raise money through commercial papers. New and moderately rated firms are not in a position to raise funds by this method;
ii. The size of money that can be raised through commercial paper is limited to the excess liquidity available with the suppliers of funds at a particular time;
iii. Commercial paper is an impersonal method of financing. As such if a firm is not in a position to redeem its paper due to financial difficulties, extending the maturity of a CP is not possible.

3. **Trade Credit**: This is a major source of short-term finance for small and big companies. It is created when the business purchases goods for resale or manufacture and the seller allows a period of credit. This often comes without any formal agreement between the company and the seller. Suppliers only need to be assured of the credit worthiness of the business to be allowed the credit facility. The business pays for the goods purchased later on the terms stipulated by the supplier/seller. It is an unsecured credit facility as the supplier may not require the company to deposit collateral or any form of security and therefore the cost can be high, if there is a cash discount or the goods supplied are priced higher than on open market.

Various types of trade credit exists

i. Trade acceptances
ii. Notes payable
iii. Open account

Trade acceptances involves a formalized agreement through the use of a bill of exchange while *notes payable*only requires that the company to acknowledge its debt formally and are more common in international trade. *Open account* is the commonest type that allows the customer to settle accounts on regular basis.

Advantages of Trade Credit

i. Trade credit is a convenient and continuous source of funds;
ii. Trade credit may be readily available in case the credit worthiness of the customers is known to the seller;
iii. Trade credit needs to promote the sales of an organisation;
iv. If an organisation wants to increase its inventory level in order to meet expected rise in the sales volume in the near future, it may use trade credit to, finance the same;
v. It does not create any charge on the assets of the firm while providing funds.

Disadvantages of Trade Credit

i. Availability of easy and flexible trade credit facilities may induce a firm to indulge in overtrading, which may add to the risks of the firm;
ii. Only limited amount of funds can be generated through trade credit;
iii. It is generally a costly source of funds as compared to most other sources of raising money.

4. **Debt Factoring**: This is a method of raising short term financing which involves an institution known as a Factor. The factor is an organised financial institution specialising in financing trade debts. The company makes available its receivables to the factor that provides cash to the company. A factor performs three basic functions

i. Provision of finance for business against the security of trade debts.

ii. Managing the client's sales ledger.
iii. Insures the business receivables against the risk of loss.

The factor makes available between 75%-90% of the trade debts available and pays the balance after it has collected the debts. The charges are about 1.5%-2.5%, which is mostly deductible from the balance. This way the business is saved the waiting period and can collect cash immediately and avoid the cost of administering and collecting the debts. A disadvantage may be the cost of the method.

Advantages of Debt Factoring

i. Obtaining funds through factoring is cheaper than financing through other means such as bank credit;
ii. With cash flow accelerated by factoring, the client is able to meet his/her liabilities promptly as and when these arise;
iii. Factoring as a source of funds is flexible and ensures a definite pattern of cash inflows from credit sales. It provides security for a debt that a firm might otherwise be unable to obtain; (iv) It does not create any charge on the assets of the firm;
iv. The client can concentrate on other functional areas of business as the responsibility of credit control is shouldered by the factor.

Disadvantages of Debt Factoring

i. This source is expensive when the invoices are numerous and smaller in amount;
ii. The advance finance provided by the factor firm is generally available at a higher interest cost than the usual rate of interest;
iii. The factor is a third party to the customer who may not feel comfortable while dealing with it.

5. **Invoice Discounting**: This is a method that involves the sale of the receivables (debts) of the company to an institution specializing in this function- the Factor. The factor makes immediate payment of an agreed percentage of the actual value of the debt while it attends to collecting the debt from the debtors. With this method, only the financing aspect is used as a result of the misconception and misunderstanding of people on the involvement of a factor in managing the accounting books of the business. It is believed that the use of a factor's full services connotes illiquidity and financial instability resulting from management inability to manage the credits side of the company and therefore likely liquidation. The cost of finance is restricted to the fees for making finance available.

Advantages of Invoice Discounting

i. Invoice discounting is comparatively quicker and faster method to procure cash than applying for a Cash Credit in which credit institutions or banks take quite a lot of time in credit appraisal of the borrower.

ii. Invoice discounting releases cash that has been locked in customer invoices for a long period of time.
iii. Invoice discounting converts the company's account receivable (debtors) into liquid cash. This may even be useful in cases or emergencies.
iv. Invoice discounting provides improved cash flow since generally 80% of the advance invoice amount (receivable) can be converted into cash thereby aiding shorter working capital cycles.
v. Cash can be obtained without using any assets as collateral; only invoices to which customers are yet to pay are to be submitted for the transaction.
vi. The company can choose to grow sales in terms of cash or credit. Sales that are on credit can be converted into cash quickly and the company need not bother much about the liquidity issue which comes with credit sales, if invoice discounting process is in place.
vii. In case of invoice discounting, confidentiality can be maintained by the discounting houses. The suppliers and customers need not know about the borrowings of the company against sales invoices.
viii. The borrowing company can obtain the cash it needs whereas the customer can be given the credit period. This creates a win-win situation for the company and the company's customer which in turn helps in building a healthy relationship with customers.

Disadvantages of Invoice Discounting

i. The financial institutions providing invoice discounting generally charge a fee which becomes additional cost to the company. This decreases the profit margins for the borrowing company.
ii. Some people perceive invoice discounting as a stigma over the company, hence, excessive reliance on invoice discounting may not be taken very positively by all stakeholders.
iii. Most financial institutions allow borrowing only on commercial invoices. If a company deals with general public then that company may not be eligible for invoice discounting.
iv. Excessive usage of invoice discounting facility may cause management to be non-focused on strengthening credit norms for debtors.

6. **Bills discounting**: This is a situation where term bills of exchange are discounted and the drawer of the bills receives funds before its maturity. Discounting in its ordinary meaning is a situation where money is lent on a term negotiable instrument or a reduced figure that is calculated according to the risk perception of the acceptor. The discount is the interest deducted by the provider of finance from the face value of the bill before maturity. Once the bill of exchange has been prepared and accepted, the holder finds a discount house or bank that will make finance available based on the value of the bill less a discount. This is done when the financial institution is satisfied with the acceptor's name and signature. The

financial institution holds the bill till maturity and when he makes a demand on the acceptor to pay.

Advantages of Bills Discounting

i. No tax at source is deducted while making the payment charges which is very convenient to companies as their tax liabilities is reduced;
ii. The rates of discount on bills are better than those available on ICDs;
iii. The quantum and duration of investments are very flexible.

Disadvantages of Bills Discounting

i. Absence of Bill Culture
ii. Discouragement of rediscounting among banks
iii. Difficulty in ascertaining genuine trade bills
iv. Limited foreign trade
v. Absence of acceptance services.

7. **Franchise**: A franchise is an alternative to raising more capital for growth. This short term finance is more suitable for a business expansion. It is a method whereby a business is expanded on less capital than needed otherwise. There are two parties to a franchise namely the franchisee (the one who wants to establish a business or expand an existing business) and the franchisor (the one who lend his trade name to the franchisee). Under a franchise arrangement, the franchisee pays the franchisor for the right to operate his (franchisee) business under the franchisor's trade name. The franchisor then charge the franchisee a franchise fee to cover the set-up costs while the Franchisor also bares some certain costs. Then the franchisee makes some subsequent regular payments (a percentage of his business turnover) to the franchisor for operating profit.

Advantages of Franchise

i. A franchise provides franchisees with a certain level of independence where they can operate their business.
ii. A franchise provides a franchisee an established product or service which may already enjoy widespread brand-name recognition.
iii. A franchise provides benefits of a pre-sold customer base which would ordinarily take years to establish. A franchise increases the chances of business success because the franchisee is associating with proven products and methods.
iv. Franchises may offer consumers the attraction of a certain level of quality and consistency because it is mandated by the franchise agreement.
v. Franchises offer important pre-opening support such as site selection design and construction, financing, training, grand-opening program and ongoing support programs.

Disadvantages of Franchise

i. The franchisee is not completely independent.
ii. Franchisees are required to operate their businesses according to the procedures and restrictions set forth by the franchisor in the franchisee agreement.
iii. It is quite costly as the franchisee must pay an initial franchise fee in addition to ongoing royalties and advertising fees.
iv. Franchisees must be careful to balance restrictions and support provided by the franchisor with their own ability to manage their business.
v. A damaged, system-wide image can result if other franchisees are performing poorly or the franchisor runs into an unforeseen problem.
vi. The term (duration) of a franchise agreement is usually limited and the franchisee may have little or no say about the terms of a termination.

8. **Acceptance Credit/Bankers Acceptance**: This is a draft **{**BOE} or an order to pay specifying the amount and the date. It is normally drawn on an individual bank by a business firm and becomes a banker's acceptance when the bank commits itself on it by signing, "accepted" on it. By its acceptance of the bill drawn by the customer/business, the bank assumes a primary liability to pay the holder of such bill. The bank usually evaluates the customer and considers the arrangement as if it were lending to it. Banker's acceptances are traded in the money market before its maturity that is: usually before 6 months.

Advantages of Acceptance Credit

i. Permits seller of goods to offer buyer extended payment terms while allowing for immediate funding.
ii. Foreign users access the foreign exchange at lower rates than might be available in their own countries.
iii. Rates are often lower than rates tied to prime.
iv. Cash flow, i.e., when goods underlying the B/A are sold, the proceeds are used to repay B/A.

Disadvantages of Acceptance Credit

- Financing can only be extended for a maximum of six months for B/A to be considered eligible.
- Federal Reserve regulations restrict this type of financing, e.g., underlying shipments must correspond to the tenor (terms of agreement) of the B/A.

9. **Accruals**: These are amounts being owed for services by the business but yet to be paid and deferred till a more acceptable or plausible date. A perfect example of accrual is tax payable that may not be paid until the end of the accounting period. Another type is wages that can be held back until it is due for payment. This source of finance is usually cheap as it is without any cost to the business.

Advantages of Accruals

i. Accruals provide the advantages of comparability and communication, because it communicates the activities that occurred during the period. For example, if the company earned revenue during the current month, this revenue appears on the income statement.
ii. The company may not receive payment until the following month, but users of the income statement can see that the company engaged in income-producing activities during the current month.
iii. Companies who use this method can compare their financial activities with other companies'.

Disadvantages of Accruals

i. Accruals require the company to spend more time reviewing transactions and incur additional labor costs.
ii. Companies who use accruals need to analyze each account monthly. These companies need to determine if activities need to be recorded because they occurred even though no financial exchange took place.
iii. The company needs to pay staff to review the accruals accounts.

Other Forms of Short Term Sources of Finance

1. **Borrowing from Co-operatives***:* this is a method that involves a member of a Thrift and Credit cooperative society seeking funds from the cooperative to establish business or the working capital for his or her business. To qualify for such facility the borrower must have been a member of the cooperative society and have contributed for a number of months. Amount borrowed is often a multiple of contribution and must be repaid within the period of time agreed. However the amount that can be borrowed from a cooperative is limited to the contribution of the co-operator because the total loan is a multiple of it. Interest rate charged are however implicitly lower than other forms of short-term finance.

2. **Borrowing from Friends and Relatives***:* This is a good source of finance for the starting business especially the sole proprietorship. Sometimes the source can be available for longer than short term but very unreliable. Default is very high and there are often no interest rate charges

Medium Term Sources of Finance

This is a method of financing that last between one year and five years. Medium term financing can, in some cases last beyond 5 years depending on the financial regulations. This means that repayment of funds sourced under this category must be made within the period stipulated in the agreement. It is usually characterized by agreements between the lender and the borrower and can be regarded as a fairly stable source of finance.

Main Sources

1. **Bank Term Loan**: Bank term loan are medium term source of financing in that its maturity ranges between 3-5years. The period could be longer in certain cases. The repayment of this loan involves a periodic installmental payment over the entire loan period. Bankers normally provide term loans to their clients when they make applications. The bank makes the approval after fully considering the risk of the project, the integrity and experience of the company. Interest rate charged is higher than overdraft. Collaterals are often required to back such borrowing. Often the bank monitors such projects to its completion in order to avoid diversion of funds. Since term loans are made for certain projects, the future and projected cash flow of the projects are examined before such loans are made. The borrower is expected to agree and conform to a structured agreement and repayment plan.

Advantages of Bank Term Loan

(i) Banks provide timely assistance to business by providing funds as and when needed by it.
(ii) Secrecy of business can be maintained as the information supplied to the bank by the borrowers is kept confidential;
(iii) Formalities such as issue of prospectus and underwriting are not required for raising loans from a bank. This, therefore, is an easier source of funds;
(iv) Loan from a bank is a flexible source of finance as the loan amount can be increased according to business needs and can be repaid in advance when funds are not needed.

Disadvantages of Bank Term Loan

i. Funds are generally available for short periods and its extension or renewal is uncertain and difficult;
ii. Banks make detailed investigation of the company's affairs, financial structure etc., and may also ask for security of assets and personal sureties. This makes the procedure of obtaining funds slightly difficult;
iii. In some cases, difficult terms and conditions are imposed by banks. for the grant of loan. For example, restrictions may be imposed on the sale of mortgaged goods, thus making normal business working difficult.

2. **Venture Capital**: this is a medium term finance that involves provision of finance for a new business process or system. It is also common for businesses undergoing a reengineering or restructuring program. Venture capital is normally provided by rich and comfortable organisations. Basically, the under listed sources are recognised as sources of venture capital finance.
   i. ***Wealthy Families***: they have traditionally provided start up capital to businesses started by young people with ideas bright enough to command finance.

Rockefeller's family in the USA and MKO Abiola in Nigeria {during their lifetime} have provided this source of finance.

ii. ***Banks***: banks have formed groups to enable them advance loans in venture capital forms at various times. Bankers may at times pool resources together under syndication arrangements to enable them spread the risk involved. While borrowers agree to pay by instalments. SMEs fund being run by the banks today is a form of venture capital fund.
iii. ***Other large Non-Banking Industrial Firms or Companies*: ** have been known to finance venture capital requests and in some cases have established subsidiaries to perform this role e.g. NNPC.
iv. ***Industrial Investors***: referred to the "angels" individually provide venture capital for reengineered and restructured businesses in the United States.
v. ***International Organisations***: such as OPEC and a number of multinational companies provide venture capital worldwide through established subsidiaries.

Stages of Venture Capital Financing

i. ***Seed Money Stage***: this involves the amount needed to develop the idea, concept and the product.
ii. ***Start Up***: this is the financing for firms that started within the past year. It is normally for product development and marketing.
iii. ***First Round financing***: manufacturing and sales of the product is done at this stage and is available when the start up funds is fully expended.
iv. ***Second Round Financing***: funds for continuous working capital is provided here and is to enable the company stabilize.
v. ***Third Round Financing***: is available when the company is considering an expansion though it is making money. It is also known as "mezzanine" financing.
vi. ***Fourth Round Financing***: is for the firm that is ready to go public within a short period. It is also called bridge financing

Costs of venture capital can be high since it is very risky. Businesses may unwittingly be inviting new shareholders for the firm if they are unable to pay by seeking venture capital. The major problem with this is the exiting of the venture capitalist.

Advantages of Venture Capital Financing

i. New innovative projects are financed through venture capital which generally offers high profitability in long run.
ii. In addition to capital, venture capital provides valuable information, resources, technical assistance, etc., to make a business successful.

Disadvantages of Venture Capital Financing

i. It is an uncertain form of financing.
ii. Benefit from such financing can be realized in long run only.

3. **Project Financing**: this is usually the funding of a project directly by a financial institution. The proceeds from the project are sufficient to repay the capital {the principal} amount with interest. The security of such finance is the project and the advance is self–liquidating. The borrower‘s financial standing or position is less important. However, the loan is made after a careful analysis.

Advantages of Project Financing

i. Project financing allows the promoters to undertake projects without exhausting their ability to borrow amount for traditional projects.
ii. Limits financial risks to a project to the amount of equity invested.
iii. Enables raising more debts as lenders are sure that cash flows from the project will not be siphoned off for other corporate uses.
iv. Provides stronger incentives for careful project evaluation and risk assessment.
v. Facilitates the projects to undergo careful technical and economic review.
vi. Eliminates the dependency on alternative nature of funding a project.
vii. Facilitates the arrangement of liability financing and credit improvement, accessible to the project but unavailable to the project sponsor.
viii. Enables the diversification of the project sponsor’s investments to reduce political risk.
ix. Gives more incentive for the lender to cooperate in an atmosphere of a troubled loan.
x. Enables to have prolonged credit opportunities.
xi. Matches specific assets with specific liabilities.

Disadvantages of Project Financing

i. Complexity of the process due to the increase in the number of parties and the transaction cost.
ii. Expensive as the project development and diligence process is a costly affair.
iii. It becomes more complex due to lengthy documentation and prolonged negotiations.
iv. Requires broad risk analysis and evaluation to be performed.
v. Requires qualified people for performing the complicated procedures of project finance.
vi. Obligations regarding the trust fund account need to be clearly specified.
vii. Higher level of control which might be exercised by the banks, which might bring conflict with the businesses or contracts.

4. **Leasing**: this is a contractual agreement between a lessee, which provides for the provision of an asset by the leasor to the lessee in return for regular rental payments. The ownership of the asset leased is reverts to the leasor while the use of such asset is with the lessee. It is an alternative to the purchase of an asset in order to acquire its services. There are **three types** of lease agreements that can take any of the **twooptions**. <u>Financial lease</u> and <u>operating lease</u> arrangements can be direct lease, sale and leaseback and leveraged leasing.
   i. ***Financial lease***: this refers to a situation where the leasor transfers substantially all the risks and rewards of ownership of an asset to the lessee. Rental payable

will be sufficient over the period to repay the cost to the lessee in addition to a fair return. The lessee is responsible for maintenance, insurance and other costs during the lease period. The term of the lease is for the major part or all the useful economic life before its eventual transfer to the lessee at a fee. This type of lease is non-cancellable.

ii. ***Operating lease***: this differs from finance lease with respect to calculability and maintenance of assets and its insurance. An operating lease can be cancelled after proper notice has been given to the lessor within the lease agreement .it is the responsibility of the lessor to pay for maintenance and insurance costs. Lease arrangements can be any of *direct* leases where the business acquires an asset it does not previously own. *Sale andlease back* occurs when a firm sells an asset it already owns to a lessor and immediately leases such an asset for a specific term. The lease relieves the cash in the amount of the sales price of the asset and uses the asset over the term of the lease. In addition the lessee must make periodic rental payment through the term of the lease and give-up the scrap value. Leveraged leasing involves three parties

a. the lessee
b. the leasor
c. the lender

The lender helps to provide finance for the acquisition of the asset to be leased. Usually the lessor supplies equity fund to 20% - 30% of the purchase price and borrow the remainder from the third party lender. Leasing is thus a very important method of finance.

Advantages of Leasing

i. It enables the lessee to acquire the asset with a lower investment;
ii. Simple documentation makes it easier to finance assets;
iii. Lease rentals paid by the lessee are deductible for computing taxable profits;
iv. It provides finance without diluting the ownership or control of business;
v. The lease agreement does not affect the debt raising capacity of an enterprise;
vi. The risk of obsolescence is borne by the lesser. This allows greater flexibility to the lessee to replace the asset.

Disadvantages of Leasing

i. A lease arrangement may impose certain restrictions on the use of assets. For example, it may not allow the lessee to make any alteration or modification in the asset;
ii. The normal business operations may be affected in case the lease is not renewed;
iii. It may result in higher payout obligation in case the equipment is not found useful and the lessee opts for premature termination of the lease agreement; and
iv. The lessee never becomes the owner of the asset. It deprives him of the residual value of the asset.

5. **Hire Purchase:** This is another method of acquiring an asset and thus medium term finance. It is an arrangement where the seller of an asset receives an initial payment and the purchaser agrees to make a regular and periodic payment to the owner or the seller of the asset. The hirer or the purchaser will become the eventual owner of the asset when the last installment is paid. The initial down payment is normally deducted from the full purchase price of the asset while the rest is spread over the period of installment payment, which will include interest charges. Interest payment is deductible for tax purposes. Hire purchase and leasing help the business to conserve funds and maintain liquidity, though at a cost. Unlike bank borrowing, they do not restrict the borrowing capability of the company.

Advantages of Hire Purchase

i. Hire purchase allows a business to obtain assets without the need to pay a large lump sum up-front.
ii. Businesses can have the use of up to date equipment immediately
iii. Payments are spread over a period of time which is good for budgeting
iv. Immediate use of assets without paying the entire amount.
v. Expensive assets can be utilized as the payment is spread over a period of time.
vi. Fixed rental payments make budgeting easier as all the expenditures are known in advance.
vii. Easy accessibility as it is a secured financing.
viii. No need to worry about the asset depreciating quickly in value as there is no obligation to buy the asset.
ix. Once all repayments are made the business will own the asset

Disadvantages of Hire Purchase

i. It is an expensive method compared with buying with cash.
ii. Total amount paid towards the asset will be higher than the cost of the asset.
iii. Long duration of the rental payments.
iv. Ownership only at the end of the agreement. The hirer cannot modify the asset till then.
v. Addition of any covenants increases the cost.
vi. If the hired asset is no longer needed because of any change in the business strategy, there may be a resulting penalty.

6. **Mortgages**: This is a loan agreement by which a business borrows from a lending institution and gives the institution the right of ownership of the property given as security and power to possess the property if the loan is not repaid. It is usually available for *freehold* and *leasehold* properties. The residual year of leasehold must exceed the agreed tenure or term of the mortgage. Pension funds and insurance companies provide this form of finance. It is one of the most important methods of acquiring a property and can be provided by Building Societies and Savings and Loans companies. Mortgage financing can be very good because of the usually long tenure of repayment. Interest charges are usually in excess of base interest rate. There are two forms of mortgage loans

i. ***Equitable Mortgage:*** involves a simple or no deposit of title documents with the lender {mortgagee} and the completion of the charge papers are not required by the mortgagee. The lender will surrender the documents to the mortgagor on the full repayment of the loan.

ii. ***Legal Mortgage***: involves the completion of charge forms and deposit of title documents with the lender who in turn registers the document with the land registry for noting. This way the lender's interest is protected. Furthermore the law of Nigeria requires that before the registration of the lender's interest, the governor's consent to the mortgage must be obtained to perfect the transaction. Perfection of the transaction allows the lender to exercise his right of mortgagee to recover the property in the event of default by the mortgagor.

Advantages of Mortgages

i. Business has the use of the property
ii. Payments are spread over a period of time which is good for budgeting
iii. Once all repayments are made the business will own the asset.

Disadvantages of Mortgages

i. This is an expensive method compared to buying with cash
ii. If business does not keep up with repayments the property could be repossessed

Long Term Sources of Finance

Long-term finance represents one of the means through which the business finances its capital assets. The common methods are:

1. Bonds/ debentures/Loan Stock
2. Preferred stock or preference shares
3. Common stock or ordinary shares.

Bonds/Debentures/Loan stock

This is an instrument commonly used by companies to raise funds on long-term basis. It is a long-term promissory note issued by the firm with maturity of more than 10 years. It is a certificate issued by a company promising to pay back borrowed money at a fixed rate of interest on a specified date. Loan stock is a long-term debt capital raised by a company for which interest is paid, usually half yearly and commonly at a fixed rate of interest irrespective of the value of the stock on the market. Loan stock/debentures might be redeemable or irredeemable. Redemption dates for redeemable stock might cover a period of time they but must be redeemed by the latest specified date and can be redeemed at the option of the company at any time after the earliest specified date. The schedule of payment of interest and repayment of principal is usually specified in the document under the company seal. Trustees who hold the trust deeds are empowered to act on behalf of the debenture holders should the company default in the payment of interest and principal as stated in the document. Loan stocks are usually secured against the property of the company. The following are the various types:

i. ***Fixed Charge***: is where a debenture is charged on a particular asset, the company cannot dispose the asset while the debenture is outstanding. If the company should default, the asset concerned will be taken over. Then a receiver will be appointed to possess and sell it for the benefit of the debenture holders.
ii. ***Floating Charge***: is a charge on all the assets of the company as they exist from time to time but assets already charge under fixed charges are exempted. Floating charges does not prevent the company from using such assets. Floating charges "***crystallize"*** when the company defaults in its interest payment or redemption at maturity.
iii. ***Debenture***: can be irredeemable or redeemable. Most debentures are redeemable which means that the debenture has a set for date for repayment of principal, while irredeemable means that no date is set for repayment.
iv. ***Loan Stock/Debenture***: can be convertible to equity shares or common shares if it is *convertible*. Other varieties of debenture are *collaterised Trust Bond, floating rate or variable rate bonds and income bonds.*

Advantages of Debentures

i. It is preferred by investors who want fixed income at lesser risk;
ii. Debentures are fixed charge funds and do not participate in profits of the company;
iii. The issue of debentures is suitable in the situation when the sales and earnings are relatively stable;
iv. As debentures do not carry voting rights, financing through debentures does not dilute control of equity shareholders on management;
v. Financing through debentures is less costly as compared to cost of preference or equity capital as the interest payment on debentures is tax deductible.

Disadvantages of Debentures

i. As fixed charge instruments, debentures put a permanent burden on the earnings of a company. There is a greater risk when earnings of the company fluctuate;
ii. In case of redeemable debentures, the company has to make provisions for repayment on the specified date, even during periods of financial difficulty;
iii. Each company has certain borrowing capacity. With the issue of debentures, the capacity of a company to further borrow funds reduces.

Preference Shares

This is a kind of shares that combine the features of both bonds and common stock. It resembles bond in the sense that dividends are fixed in amount and similar to common stock because it has no fixed maturity date. When dividend are not paid, the company is not forced to bankruptcy and dividends in preferred stock are fixed, and thus the stockholders do not share in the residual earnings of the firm, but are limited to their stated annual dividends except when the preference shares are ***participating.*** The dividends can be ***cumulative*** or ***non-cumulative.*** With cumulative preference a share, the right to an unpaid dividend is carried forward for payment in future while for non-cumulative dividends; the unpaid dividends are lost forever. Shareholders cannot vote in general meetings of the company. Preference shareholding is not popular because of the basic disadvantages mentioned above.

Advantages of Issuing Preference Shares

i. Preference shares provide reasonably steady income in the form of fixed rate of return and safety of investment;
ii. Preference shares are useful for those investors who want fixed rate of return with comparatively low risk;
iii. It does not affect the control of equity shareholders over the management as preference shareholders don't have voting rights;
iv. Payment of fixed rate of dividend to preference shares may enable a company to declare higher rates of dividend for the equity shareholders in good times;
v. Preference shareholders have a preferential right of repayment over equity shareholders in the event of liquidation of a company;
vi. Preference capital does not create any sort of charge against the assets of a company.

Disadvantages of Issuing Preference Shares

i. Preference shares are not suitable for those investors who are willing to take risk and are interested in higher returns;
ii. Preference capital dilutes the claims of equity shareholders over assets of the company;
iii. The rate of dividend on preference shares is generally higher than the rate of interest on debentures;
iv. As the dividend on these shares is to be paid only when the company earns profit, there is no assured return for the investors. Thus, these shares may not be very attractive to the investors;
v. The dividend paid is not deductible from profits as expense. Thus, there is no tax saving as in the case of interest on loans.

Ordinary Shares/ Stock

The ordinary shares are otherwise known as common stock. The shareholders represent the legal owners of the company as ordinary shares represent units of ownership. The holders have residual earnings from the total earnings. The returns on their stocks are expected be high because they carry the entire risk associated with the company. They control the activities of the company through their power to vote. They get appointed to the board through their shareholding and payments of dividends to the shareholders are after such dividends have been approved by the shareholders in a general meeting. Each time the company floats ordinary shares through a public issue, when new shareholders buy ordinary shares in the company the shareholding structure gets diluted. Ordinary shareholders cannot redeem or claim their investment back from the company but can have such shares sold. There are different types of ordinary shares:

i. ***Preferred Ordinary Shares***: their dividend is fixed and usually paid before other shareholders.
ii. ***Deferred Ordinary Shares***: they are the residual beneficiaries after all claims.
iii. ***Founders Share***: this is the share belonging to the founders of the business. They are a type of deferred ordinary shares.

However the Nigerian Stock Exchange does not allow different types of shares.

Method of Raising Common Stock for Publicly Quoted Company:

1. ***Stock Exchange Introduction***: This is the process of getting the company quoted either in the main market or in secondary market. This happens where there are sufficient shareholders.
2. ***Placing***: this is done by offering the shares to a specific group of investors. For example, institutional investors can be requested to buy such shares.
3. ***Offer for Sale***: this happens when the shares being sold already been bought by another investor who wants to sell such shares and recoup his investment. Funds from such public sales do not go to the company but to investors seeking to sell such shares.
4. ***Offer for Subscription***: the company through the agency of an issuing house offers the shares to the public. The proceeds of issues go to the company.
5. ***Offer for Sale by Tender***: investors are requested to send application for shares with the price they will like to take it up after the company must have quoted the minimum offer price of the shares. The price at which the shares are fully sold is called ***the striking price***. The stock exchange ensures that all shares are taken-up at the same price.
6. ***Right Issue***: this is method of raising finance for the business from the existing shareholders. This method avoids dilution in control as the proportion of shareholding is maintained. The cost of issue is also lower than offer for subscription.

Advantages of Issuing Equity Shares

i. Equity shares are suitable for investors who are willing to assume risk for higher returns;
ii. Payment of dividend to the equity shareholders is not compulsory. Therefore, there is no burden on the company in this respect;
iii. Equity capital serves as permanent capital as it is to be repaid only at the time of liquidation of a company. As it stands last in the list of claims, it provides a cushion for creditors, in the event of winding up of a company;
iv. Equity capital provides credit worthiness to the company and confidence to prospective loan providers;
v. Funds can be raised through equity issue without creating any charge on the assets of the company. The assets of a company are, therefore, free to be mortgaged for the purpose of borrowings, if the need be;
vi. Democratic control over management of the company is assured due to voting rights of equity shareholders.

Disadvantages of Issuing Equity Shares

i. Investors who want steady income may not prefer equity shares as equity shares get fluctuating returns;
ii. The cost of equity shares is generally more as compared to the cost of raising funds through other sources;
iii. Issue of additional equity shares dilutes the voting power, and earnings of existing equity shareholders;
iv. More formalities and procedural delays are involved while raising funds through issue of equity share.

DETERMINANTS OF SOURCES OF FINANCE

The financial needs of a business are of different type namely long term, short term, fixed and fluctuating etc. Therefore, business firms resort to different types of sources for raising funds. Short-term borrowings offer the benefit of reduced cost due to reduction of idle capital, but long term borrowings are considered a necessity on many grounds. Similarly equity capital has a role to play in the scheme for raising funds in the corporate sector. As no source of funds is devoid of limitations, it is advisable to use a combination of sources, instead of relying only on a single source. A number of factors affect the choice of this combination, making it a very complex decision for the business. The factors that affect the choice of source of finance are briefly discussed below:

1. **Purpose and Time period**: Business should plan according to the time period for which the funds are required. A short-term need for example can be met through borrowing funds at low rate of interest through trade credit, commercial paper, etc. For long term finance, sources such as issue of shares and debentures are more appropriate. Similarly, the purposes for which funds are required need to be considered so that the source is matched with the use. For example, a long-term business expansion plan should not be financed by a bank overdraft which will be required to be repaid in the short term.

2. **Cost**: There are two types of cost viz., the cost of procurement of funds and cost of utilising the funds. Both these costs should be taken into account while deciding about the source of funds that will be used by an organisation.

3. **Form of Organisation and Legal Status**: The form of business organisation and status influences the choice of a source for raising money. A partnership firm, for example, cannot raise money by issue of equity shares as these can be issued only by a joint stock company.

4. **Risk Profile**: Business should evaluate each of the sources of finance in terms of the risk involved. For example, there is a least risk in equity as the share capital has to be repaid only at the time of winding up and dividends need not be paid if no profits are available. A loan on the other hand, has a repayment schedule for both the principal and the interest. The interest is required to be paid irrespective of the firm earning a profit or incurring a loss.

5. **Financial Strength and Stability of Operations**: The financial strength of a business is also a key determinant. In the choice of source of funds business should be in a sound financial position so as to be able to repay the principal amount and interest on the borrowed amount. When the earnings of the organisation are not stable, fixed charged funds like preference shares and debentures should be carefully selected as these add to the financial burden of the organisation.

6. **Control**: A particular source of fund may affect the control and power of the owners on the management of a firm. Issue of equity shares may mean dilution of the control. For example, as equity share holders enjoy voting rights, financial institutions may take control of the assets or impose conditions as part of the loan agreement. Thus, business firm should choose a source keeping in mind the extent to which they are willing to share their control over business.

7. **Flexibility and Ease**: Another aspect affecting the choice of a source of finance is the flexibility and ease of obtaining funds. Restrictive provisions, detailed investigation and documentation in case of borrowings from banks and financial institutions for example may be the reason that business organisations may not prefer it, if other options are readily available.

8. **Tax Benefits**: Various sources may also be weighed in terms of their tax benefits. For example, while the dividend on preference shares is not tax deductible, interest paid on debentures and loan is tax deductible and may, therefore, be preferred by organisations seeking tax advantage.

9. **Effect on Credit Worthiness**: The dependence of business on certain sources may affect its credit worthiness in the market. For example, issue of secured debentures may affect the interest of unsecured creditors of the company and may adversely affect their willingness to extend further loans as credit to the company.

Illustration

The working capital (operating) cycle of a business is the length of time between payment of materials entering into stock and receipts of the proceeds of sales. The table below gives information extracted from the annual account of management plc for the past three years. You are required to: -

1. Calculate the length of the working capital cycle assuming 365 days in a year.
2. List the possible actions that might be taken to reduce the length of that cycle.

Management plc. - Extract from Annual Accounts.

	Yr 1	Yr 2	Yr 3
Stock: Raw Material	108,000	145,800	180,000
Work- in- progress	75,600	97,200	93,360
Finished goods	86,400	129,600	142,875
Purchases	518,400	702,000	720,000
Cost of goods sold	756,000	972,000	1,098,360
Debtors	172,800	259,200	297,000
Sales	864,000	1,080,000	1,188,000
Trade Creditors	86,400	105,300	126,000

Solution

(1) The operating cycle can be summarized as follows:

1. Receive raw materials
2. Pay for raw materials
3. Issue raw materials
4. Finished goods
5. Sell goods

6. Receive money from debtors.

Days taken can be computed	Year 1	Year 2	Year 3
1 – 3	Days	Days	Days
Raw Material x 365 Purchase	76.04 10,800 x 365 518,400	75.8 145,800 x 365 702,000	91.3 180,000 x 365 720,000
1-2 Trade Creditor x 365 Purchase	(60.8) 86,400 x 365 51,840	(54.8) 105,300 x 365 702,000	(63.9) 126,000 x 365 720,000
3-4 WIP x 365 Cost Of Sales	36.5 75,600 x 365 75,600	36.5 75,600 x 365 765,600	31.0 93,360 x 365 1,098,360
4-5 Finished Goods x 365 Cost Of Sales	41.7 86,400 x 365 756,000	48.7 129,680 x 365 972,000	47.5 142,875 x 365 1,098,360
5-6 Debtors x 365 Credit Sales	73 172,800 x 365 864,000	87.6 259,200 x 365 1,080,000	91.3 297,000 x 365 1,188,000
Total length of Cycle	166.4	193.8	197.2

(ii) Reduction in the length of the cycle can be achieved by reducing the length of any of the individual periods between 2 and 6 i.e

(a) delaying payments for raw materials – consequent loss of goodwill from supplier and/or prompt discounts;

(b) speed up production times or reduce production volumes – problems with labour in changing from existing practices;

(c) reduce finished goods stockholdings-increased risk of stock-outs with consequent loss of customer goodwill.

(d) reduce credit given. This is unpopular with customers who may take their custom elsewhere

(2) Starting with the year 3 position

	N
Currently: Sales	1,188,000
Cost of Sales	1,098,360
Gross Profit	89,640
(7.5% of Sales)	

If Sales are reduced by 25%, the annual gross profits will be reduced by 7.5% x 25% x N1, 188,000 = N22,410.

The overall effect on annual cash flow will be:

	N
Cost of credit control	20,000
Gross profit forgone	22,410
Bad debts saved	(30,000)
	12,410

Discounted at 9% gives :

$$\text{NPV of } \frac{N12,410}{0.09} = N137,889$$

INTERNATIONAL WORKING CAPITAL

INTRODUCTION

The working capital management is an indispensable part of the total financial management of an enterprise that has a superior impact on profitability, liquidity and overall performance of the enterprise irrespective of its nature. In fact, working capital is a circulatory money investment that takes place right from the input stage to output. Management of working capital is intricate on account of two important reasons, namely, fluctuating nature of its amount, and a need to maintain a proper balance between current assets and non-current assets in order to maximize profits. The importance of working capital in an industry cannot be over stressed, as it is one of the important causes of success or failure of an industry.

Working capital management in international context involves managing cash balances, account receivable, inventory, and current liabilities when confronted with political, foreign exchange, tax, and liquidity constraints. It also includes the need to borrow short-term funds to finance current assets from both in-house banks and external local and international commercial banks. The overall goal is to lessen funds tied up in working capital. This should augment return on assets and equity. It should also improve efficiency ratios and other evaluation of performance parameters .

A Multinational Corporation can be defined as an entity, which has branches, or subsidiaries spread over many countries. Since multinational corporations have operations in different countries, the financial transactions will also be denominated in multiple currencies. Consequently, financial management of shortterm assets and liabilities in an MNC is much more

important and complex in nature. It involves management of current assets and current liabilities denominated in different currencies. The management of working capital is vital to the financial strength of businesses of all sizes. The amounts invested in working capital are often high in proportion to the total assets employed and so it is essential that these amounts are used in an efficient and effective way. (Padachi,2006). Working capital starvation is generally credited as a major cause if not the major cause of small business failure in many developed and developing countries (Rafuse, 1996). The success of a firm depends ultimately, on its capability to generate cash receipts in excess of disbursements. The cash flow problems of many small businesses are intensified by poor financial management and in particular, the lack of planning cash requirements (Jarvis, 1996). The study is an objective evaluation of the working capital management of multinational firms to examine the international cash management operations, approach of performing international sales, procedure for performing foreign exchange activities.

2. TECHNIQUES OF INTERNATIONAL WORKING CAPITAL MANAGEMENT

i) International Cash Management:

International Cash management is the process of managing the cash flow and liquidity of a company doing business accross the world and management of processes and risks related to cash flow and capital optimisation. Cash management covers a range of activities with the purpose of being in control of the cash flow of the company and efficient management of funds.Efficient cash flow management is crucial for every company. International money managers try to attain on a worldwide basis the traditional domestic objectives of cash management:

(i) bringing the company's cash resources within control as quickly and efficiently as possible and

(ii) achieving the optimum conservation and utilization of these funds. Accomplishing the first goal requires establishing accurate, timely forecasting and reporting systems, improving cash collections and disbursements, and decreasing the cost of moving funds among affiliates. The second objective is achieved by minimizing the required level of cash balances, making money available when and where it is needed, and increasing the risk-adjusted return on those funds that can be invested.

A brief summary of international cash management techniques are revalued below.

(a). Electronic Funds Transfers:

Electronic funds transfer (EFT) is the electronic exchange or transfer of money from one account to another, either within a single financial institution or across multiple institutions, through computer-based systems. Online electronic funds transfer is much more secure than traditional wire transfers. There are no unexpected agent fees, and no need for the recipient to carry large amounts of cash.The term covers a number of different concepts:

• Card-holder-initiated transactions, where a cardholder makes use of a payment card.

• Direct deposit payroll payments for a business to its employees, possibly via a payroll service bureau

. • Direct debit payments, sometimes called electronic checks, for which a business debits the consumer's bank accounts for payment for goods or services.

• Electronic bill payment in online banking, which may be delivered by EFT or paper check.

• Transactions involving stored value of electronic money, possibly in a private currency.

• Wire transfer via an international banking network (carries a higher fee in North America).

(**b)Wire Transfers**

Wire transfer or credit transfer is a method of electronic funds transfer from one person or institution (entity) to another. A wire transfer can be made from one bank account to another bank account or through a transfer of cash at a cash office. Wire transfer systems are intended to provide more individualized transactions than bulk payment systems. Different wire transfer systems and operators provide a variety of options relative to the immediacy and finality of settlement and the cost, value, and volume of transactions.

Central bank wire transfer systems, such as the Federal Reserve's Fed Wire system in the United States are more likely to be real time gross settlement (RTGS) systems. RTGS systems provide the quickest availability of funds because they provide immediate "real-time" and final "irrevocable" settlement by posting the gross (complete) entry against electronic accounts of the wire transfer system operator. Other systems such as CHIPS provide net settlement on a periodic basis.

More immediate settlement systems tend to process higher monetary value time-critical transactions, have higher transaction costs, and a smaller volume of payments. Currency transaction risk (because of market fluctuations) may be reduced (in part) by immediacy of settlement. CHIPS (Clearing House Interbank Payment System) and SWIFT (Society for

Worldwide Interbank Financial Telecommunications) are two computerized systems of international wire transfers A primary benefit offered by SWIFT lies in the standardization of the transfer process, which significantly reduces errors by providing a singular means of communication between correspondent banks.

In addition, "SWIFT has evolved into one of the least costly, securest, most rapid means of transmitting . . . instructions" (Aggarwal and Baker, 1991).Most international transfers are executed through SWIFT, a co-operative society founded in 1974 by seven international banks, which operate a global network to facilitate the transfer of financial messages. Using these messages, banks can exchange data for the transfer of funds between financial institutions. The society also acts as a United Nations– sanctioned international standards body for the creation and maintenance of financial-messaging standards. Each financial institution is assigned an ISO 9362 code, also called a Bank Identifier Code (BIC) or SWIFT Code. These codes are generally eight characters long. Bank-to-bank wire transfer is considered the most secure international payment method. Each account holder must have a proven identity. Chargeback is unlikely, although wires can be recalled. Information contained in wires is transmitted securely through encrypted communications methods. The price of bank wire transfers varies greatly, depending on the bank and its location; in some countries, the fee associated with the service can be costly.

(c) Payments Netting:

Payment netting is defined as the arrangement between two counterparties to net all payments in a single currency owed between them on a given value date. For each value date and for each traded currency, the parties will aggregate and net all payments owed between them to arrive at a single currency. The payoff from multilateral netting systems can be large relative to their expense. For instance, "many companies find they can eliminate 50% or more of their inter company transactions through multilateral netting, with annual savings in foreign exchange transaction costs and bank transfer charges that average about 1.5% per dollar netted" (Shapiro, 1992).

Netting of cash flows or obligations is a means of reducing credit exposure to counterparties: Payment netting reduces settlement risk: If counterparties are to exchange multiple cash flows during a given day, they can agree to net those cash flows to one payment per currency. Term used when one party pays the net amount due when partially offsetting swap payments are due on the same date. Multinational corporations, by virtue of their presence in different countries, have access to much wider international money markets. Hence, there is a need for the finance manager to develop a strategy to meet the actual requirement of the MNC which proposes either to mobilize the funds or to deploy the surplus cash in investments.

The objective of cash management is

(i) to maximize the return by proper allocation of short-term investments and (ii) to minimize the cost of borrowing by borrowing in different money markets.

To achieve the above objective, the MNCs have to evolve a strategy by taking the following aspects into consideration:

i) The borrowing cost in a particular currency and the relationship between nominal interest rate between the currencies and anticipated exchange rates of the currencies (International Fisher effect).

ii)The exchange risk of the MNC consequent to the firm's exposure in different currencies with regard to the receivables and payables.

iii) The level of risk acceptable to the management of the MNC. iv)The availability of tools for hedging.

v) Tax structure prevailing in various countries. vi) Political environment and the consequent risk relating to various countries.

(d) Cash Pooling

Cash pooling is a financial management strategy that allows companies to maximize both the current credit and debit positions so that the corporation receives the most benefit from those positions. In addition, cash pooling can help the company to avoid a number of costly bank fees, as well as help reduce the opportunity of damaging the reputation of the corporation because of negative balances on a bank account. In effect, cash pooling helps the make the most of the resources that are available. There are a few different approaches to cash pooling that will aid in cash management for both small and large companies. One basic approach to cash pooling involves the application of a cash management technique known as notional cash pooling. This approach involves transferring sufficient funds into one of the companies more active bank accounts to maintain a balance that will preclude the expenses of monthly finance charges or insufficient funds charges. From this perspective, the company achieves a higher net profit by eliminating unnecessary expenses.