Accounting treatment of corporate financing by short-term sources

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Abstract

The function of financing is one of the primary functions of each company. It consists of making three fundamental decisions: decisions about investing, financing decision and the decision on the distribution of dividends. Financing of companies differs by maturity, by the origin of the source of funding, according to the owner of the use of financial resources and in accordance with the different accounting treatment of business events according to International Accounting Standards and the Croatian Financial Reporting Standards.

This paper presents the specifics of financing sources by short maturities, and the treatment for short term financing through loans, factoring, issuing commercial papers and spontaneous financing. The funds raised by short term financing are commonly used to perform operations or to settle outstanding obligations. Short term financing is used because of the benefits arising from the timing factors. The basic advantages of short term financing are the ease of loan approval, the cost of capital and flexibility.

Key words: *Croatian Financial Reporting Standards, International Accounting Standarsd, short term financing, sources of financing*

1. Pojam financiranja

In the wider sense, the financing involves a dynamic process of obtaining money for current and developmental needs of businesses, investments in cash, refund and dynamic process of harmonization (Orsag, 1997, p. 5-6). The place where the supply and demand of funds meet each other is called the financial market. Financial markets can be organized or spontaneous. In a broader sense, the financial market includes credit market and the interbank money market. The main actors in the financial market are the initial and final bidders seeking the funds, likewise there are primary and secondary markets. With regard to the duration of the claim under the securities financial markets can be divided into:

- money market and
- capital market.

Money market is a market of short-term securities and the capital market is the market of long-term securities. The main financial goal of the company is maximizing the profit to the owners of capital and the survival of the company. This goal is a logical consequence of the system of private property. That is why it's normal that owners tend to themselves provide maximum economic benefits, because of maximization of assets, wealth and well-being of the owner which is also the chief financial company's business goal. Financial strength is the auxiliary objective of financial management and financial management. The quality of financial strength determines the ability of business. Therefore, if there is no quality or ability to pay, finance, investment, etc. there is no possibility of good management and survival of the company.

In the conditions the globalization of business and turbulent environment companies need to create strategies which include flexibility and the ability to anticipate changes in the environment. To survive and grow companies have to build sustainable competitive advantages. Competitive advantage occurs when a company uses strategies which do not use current or potential competitors. Therefore, every financial manager needs to obtain funding under the most favorable conditions in the global markets, ensuring that the financial plans, financial control and performance measurement.

1.1. Types of financing

According to the period of the availability of the sources, financing is divided into: (Marković, 2000, p. 6-7):

a) SHORT-TERM FINANCING – In this financing sources are short in duration and are available for a period of one year. It is used for financial investments in current assets (working capital). Current assets can be funded using several forms of short-term financing:
   - spontaneous financing,
   - secured and unsecured financing,
   - emission of commerical papers and
   - other sources.

Spontaneous financing includes accruals and trade credits. Short-term secured and unsecured funding includes financial institutions typically commercial banks that approve short-term loans without coverage. Unsecured short-term loans are loans that creditors approve on the basis of creditworthiness, primarily liquidity situation of debtor.

Secured short-term financing can be realized by loans of financial institutions or issuing of debt or equity securities. Secured loans are almost the rule in foreign trade, as in the case of lending to new businesses. Secured short-term loans of financial institutions are granted on the basis of collateral coverage.

In the case of financing by issuing commercial paper funds can be obtain generally only for big companies with a high rating. This applies especially to raise funds in convertible currencies in the international market, such as Europeanmarket of commercial papers.

The Bank, as a rule approve a credit line to the company as the basis for the emission of papers, and the companies are able to eliminate because of risk of non-payment customer records, to obtain funds at rates lower than bank interest rate for first-class borrowers The Bank, as a rule approve a credit line to the company as the basis for the emission of papers, so the companies are able, because of eliminating of risk of non-payment customer records, to obtain funds at rates lower than bank interest rate for first-class borrowers (Vidučić, p. 318, 326).

Other sources are sources which can be used temporarily, or in very specific conditions. This may include funds of depreciation which, when they are available in the account, can be used except for the financing of long-term investment and financing current assets.

b) MEDIUM-TERM FINANCING – in this form of financing sources are available for a period of 1 to 5 years. It is used for medium-term investment in machinery, equipment and the like which can't be financed from short-term or long-term sources because of unfavorable conditions for obtaining short-term loans by issuing commercial papers, shares, bonds and the like.

c) LONG-TERM FINANCING – in this form of financing sources take a long time and are available for more than 5 years. They may be:

- 1) TERM SOURCES – which have maturity deadline longer than 5 years (long-term loans, emission of bonds and the like).
- 2) NO-TERM SOURCES – which don't have maturity deadline and which are permanently avaible (long-term capital, retained earnings, etc..). These sources make permanent capital of the company and are used for a financial investment in long-term assets and the development of the company.

1.2. Funding rules

On the basis of scientific knowledge and experience of market economy both the money and other property, there are numerous funding rules.

The application of these rules in practice should provide "healthy" financing implying permanent solvency and profitability.

Funding rules do not provide a direct answer to the question of how the company should be funded in every credit situation.

Funding rules should be applied flexibly, because it just shows the direction the company should seek appropriate solutions.

Important funding rules are (Orsag, 2011, p. 142):

Horizontal fundung rules – give guidelines how should be the relationship between the individual parts of assets and the individual components of liabilities (sources), in order to achieve and maintain solvency and profitability of the company.

Vertiacl fundung rules – give guidelines how should be the ratio of the individual parts of passive, funding sources at the origin (your own or someone else's sources), per availability of resources (short- or long-term).

Other rules of financing – in these other rules it is important to emphasize rule of financing 2: 1 and 1: 1.

According to this rule of financing 2:1 company needs to one half of current assets financed out of current liabilities, and the other from long-term sources.

Rule of financing 1:1 requires that the sum of cash, short-term securities and short-term receivables is equal to the sum of short-term funding sources.

2. Financing company with short-term sources

2.1. Financing by issuing commercial papers

Commercial paper is the portable, short-term debt securities (maturity of up to one year), issued on behalf of, in dematerialized form, which is a direct, unconditional and unsecured obligation of the issuer, and allows the issuer to settle short-term needs, so that the issuer, depending on market conditions, issue tranche of of papers, which is within the limits established by the program.

Some of the advantages of financing through an issue of commercial papers for issuer are:

- financing at a competitive market rate and to reduce the cost of financing,
- reducing credit exposures to commercial banks,
- allows the release of assets from mortgage,
- quick source of funding without unnecessary paperwork,
- diversification of funding sources,
- access to the market of short-term securities,
- allows more efficient access to the market of long-term securities,
- after the establishment of the program allows the raising of funds within three days.

The maturity of individual tranches of commercial papers is typically 91, 182 or 364 days, however tranches may be issued for other maturities whereby maturity can't be shorter than 7 or longer than 364 days. In Croatia, as compared to American and European practice of issuing commercial paper, commercial papers are issued with slightly longer term. Secondary market of commercial papers is still illiquid. But this trend is present in American practice where secondary trading commercial papers is almost negligible. There is the common for investors to buy commercial papers with the intention of holding them to maturity.

Commercial paper is an unsecured marketable "bonds" with a maturity of one (1) year. The issuer of commercial papers agrees to the buyer (owner) of commercial papers to pay the amount indicated on the commercial paper (nominal value) plus the agreed interest on the maturity date.

By selling commercial papers, these companies borrow short-term funds on money market as a rule from a large number of small creditors, natural and legal persons (Orsag, 2011, p. 27-30.). The success of emission (sales) of commercial papers affects (Marković, 2000):

a) *interest rate carried by commercial paper*, must be greater than the interest rate on a fixed-term one-year savings to be paid by the bank.

b) *discounts on goods* - ("sweetening agents") in order to attract as many customers issuer is often committed to their products or other goods sold at a discount if goods are paid commercial bills in their respective facilities.

c) *bank support*, to make investments in commercial papers less risky and to attract more customers, companies often issue commercial papers whose payment (principal and interest) bank guarantees. Commercial papers can be paid prior to the maturity date, but not earlier than three months from the date of issue. The main advantage of commercial papers as short-term source of financing is that they are as a rule cheaper than short-term loans to commercial banks. In developed countries, the interest rate on commercial papers is the generally 1% to 6% lower than the basic rate of bank loans to companies, the highest rank.

Since the commercial papers are long-term securities, for their issue it doesn't need authorization of the competent authority, is already sufficient decision by the appropriate bodies of the issuer. Commercial papers read as follows at nominal value, but they are being sold at a discount. Their prices are expressed as a percentage of the nominal value. For issuer of commercial papers discount is , in the sale of, expense and deferred income and for investors future income. On maturity date the issuer pays the holder of the commercial papers a nominal fee and to recorded interest expense.

Unlike traditional bank loans, of commercial papers issue of can be achieved in a very short period of time, provided that there is already outlined program of issuing and that specific tranche can be sold to interested investors within a few days. It is important to emphasize that the issuing short-term commercial papers can be financed only by large companies with many years of business.

Unlike bank loans issuance of commercial papers implies collecting funds from different investors (banks, pension funds, insurance companies ...). Therefore borrowing is not limited to credit limits specified by the banks, and this type of financing be cheaper from a bank loan.

2.2. Financing by short-term loans

Financial institutions, generally commercial banks, approve loans. As reimbursement for liquidity, the bank charged fixed or variable interest rates. Interests on short-term loans are generally fixed. There are loans with no cover-uninsured and to insured loans with collateral (Vidučić, 2012, p. 322). Unsecured short-term loans are loans that creditors approve the credit standing, primarily liquidity of creditors. These are: the overdraft line of credit, revolving credit and loan transaction. Secured short-term loans are: loan based on the pledged securities, loan, based on the pledge of receivables, factoring receivables and loans based on the stock.

Except commercial banks, short-term loans are given and by companies which can borrow to each other. Benefits of financing on short term loans are reflected in availability of small companies that do not participate in the capital market and money market so that bank loan is the only available option of borrowing.

2.3. Spontaneously financing

Short-term assets can be financed and with spontaneous financing - accruals and trade credit. The funding under the accruals is a result of a continuous course of business - the use of resources on a daily basis, with payment services and to meet commitments at specified time intervals. In this way the company uses interest-free loan. Examples include staff salaries, contributions and taxes which are paid subsequently in relation to the work performed (Vidučić, 2012, p. 318).

Commercial (commodity) loan is a loan which suppliers approve to customers by delivering their goods with the option of paying within the approved period. The size of this loan varies depending on the amount of procurement and customer reputation. Terms of approving these types of loans depend on general conditions in the economy, the nature and character of industry suppliers and customers. Restrictive monetary policy will result in a lower availability of credit, and thus trade (commodity) loan.

2.4. Other sources

Other sources represent sources which can be used temporarily, exceptionally and under certain conditions. Thoughts on funds of depreciation which, when they are available on the account, can be used except for financing fixed assets and for financing current assets. Furthermore, other sources are considered, exceptionally, reserve funds (reserves) in the capital accounts and funds long-term provisions for future risks and costs up to the time of use.

3. Accounting treatment of corporate financing by short-term sources

3.1. Issue of commercial papers

The company sells commercial papers with a discount. Per maturity the holder of commercial papers pays a nominal value (Brkanić, 2012, p. 473). Discount is the difference between the nominal value and the selling value of the commercial papers for the issuer. Discount is, at the time of maturity, charged to expenses.

Example:

1. *Trading company emitted on 10 February 2014, commercial papers with a nominal value of 300 000 kunas. Maturity is on 20 June 2014 Commercial papers were sold with a discount the purchase price for 90% of from nominal value (270 000 kunas).*
2. *On 20 June 2014 trading company pays a nominal value of commercial papers in the amount of HRK 300,000 and records the cost of the discount.*

No	Decription	Account No.	Amount	
			Owes	Seeks
1)	Giro account in the bank Obligations arising from commercial papers Discount costs of the future period	1000 2120 193	270.000 30.000	 300.000
2)	Obligations arising from commercial papers Giro account in the bank	2120 1000	300.000 	 300.000
2a)	The cost of the discount (discount interest on securities) Discount costs of the future period	4735 193	30.000 	 30.000

3.2. Short-term liabilities to credit institutions

Short term liabilities to credit institutions are obligations for short-term loans from banks or other financial institutions and liability for exceeding the bank account with overdraft facilities granted by commercial banks whose repayment period of no longer than 12 months (Brkanić, 2012, p.477).

Example:

1. *The bank allocated to the XY Ltd. a loan of 20 000 kunas over a period of 6 months at an interest rate of 6% meniannually.*

2. *XY Ltd. paid by the bank in the first annuity, which consists of 3.333 kunas for the repayment quota and the 200 kunas for the calculation interest rates for the first period of the loan disbursement.*

No	Decription	Account No.	Amount	
			Owes	Seeks
1)	Giro account in the bank Liabilities for short-term loan in the bank	1000 2150	20.000	 20.000
2)	Cost of the interest on bank loan Liabilities for short-term loan in the bank Giro account in the bank	4730 2150 1000	200 3.333	 3.533

3.3. Short-term loans received from other companies

During the signing the contract of the loan, interest may but doesn't need necessarily to be arranged.

Example:

1. *Borrower XX Ltd. signed a loan agreement in the amount of 40.000 kunas for a period of 4 months with lenders YY Ltd.*
2. *The agreed interest rate is 12% per annum. For the first mont interest is being calculated.*
3. *The first annuity is paid in the amount of 10.400 kunas out of which 400 kunas is related to the liabilities of the contracted interest.*

No	Decription	Account No.	Amount	
			Owes	Seeks
1)	Giro account in the bank Liability for short-term loan from the company YY Ltd.	1000 214	40.000	 40.000
2)	Cost of the interest on loan Liability for the agreed interest	4732 232	400	 400
3)	Giro account in the bank Liability for short-term loan from the company YY Ltd. Liability for the agreed interest	1000 214 232	 10.000 400	10.400

3.4. Commercial (commodity) loan

This kind of loan is the most common in the period up to 12 months.

Example:

1. *Company XY Ltd. bought the products from other company (supplier) and received a bill in the amount of 20.000 kunas (including VAT). Company XY Ltd. gets payment deferral the account for 60 days.*
2. *After the expiry of 60 days company XY Ltd. paid the account to the supplier.*

No	Decription	Account No.	Amount	
			Owes	Seeks
1)	Products in stock VAT Payables	6300 1400 220	16.000 4.000	 20.000
2)	Obveze prema dobavljačima Payables	220 1000	20.000	 20.000

4. Conclusion

Short-term funding sources have maturities up to one year, and they are financing current activity and liquidity of subjects. The main advantage of financing with commercial papers reflected in greater flexibility and the lower costs compared to short-term bank loans. But despite these lower costs large companies largely use short-term bank loans. In addition to these advantages as the main disadvantage is the inability of financing of small companies through commercial papers, so they are left only short-term bank loan as a form of financing in the short-term. Except of financing with commercial papers, short-term loans and the spontaneous sources, companies have access to other sources of short-term financing used in exceptional circumstances.

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