

## Short-term business finance

Short-term business finance includes instruments which service a financing need for a period of less than one year. These include overdrafts, debtors factoring, debtors management, and promissory notes.

### Overdraft

An overdraft is a bank lending arrangement. An overdraft arrangement is usually subject to an annual review by the bank. An overdraft is usually repayable on demand by the lender and is generally used for working capital needs rather than for major capital projects.

#### Advantages

- ✦ An overdraft is a convenient way of borrowing money and paying accounts by cheque, with interest charged on the daily overdrawn balance outstanding.
- ✦ An overdraft provides short-term finance on a needs basis.
- ✦ Amounts may be drawn or repaid at any time.
- ✦ Amounts of any denomination are able to be drawn.
- ✦ Subsidiaries or other persons may be granted drawing rights.

#### Disadvantages

- ✦ Interest rates may be varied at the lender's discretion.
- ✦ The amount overdrawn is repayable on demand.
- ✦ Hidden costs of establishment fees, unused fees, limit fees, commitment fees, and administration fees may increase the cost of this facility considerably.

### Debtors – factoring

Factoring involves selling debts, which are usually trade debts, to a purchaser (the factor) for a discounted price. Many small businesses have few assets to offer as security for working capital finance, except stock and debtors. A business which only provides services has debtors, but no stock. Factoring is a method of obtaining finance by selling the right to receive payment at a future date in exchange for receiving a discounted amount now.

#### Retention account

The factor may hold back money from the purchase price in a fund to cover bad debts. An agreed percentage of the purchase price of each debt may be retained to cover bad debts and the balance paid to the client only after all debts have been paid from the fund or from the debtor.

#### Guarantee

The client may have to guarantee that all or some debtors will pay their debts, and if they do not, the client will have to pay.

#### Recourse

Normally the client will be liable to pay the factor if the debt is wholly or partly irrecoverable, whether it is for invalidity, set-off, or due to another reason.

#### Notification or non-notification

In some cases, the debtors are notified of the sale to the factor and the factor collects the debt directly. In other cases, the debtors are not notified, and pay the client who remits these receipts to the factor. Non-notification may be better for a client who does not want debtors to know how the client is raising funds.

## Debtor management

A type of factoring is debtor management, where the factor does not buy the debts, but simply collects them for the client.

### Pitfalls

Book debts fluctuate during the business cycle and contain some risks for all parties, but mainly for the financier as follows:

- ✦ A debtor may refuse to pay, claiming a set-off against the client;
- ✦ The client may factor fictitious debts;
- ✦ The client may attempt to factor the same debt with different financiers; or
- ✦ The debtor may pay the client who then fails to pay the factor.

### Advantages

This has advantages for businesses without computerised accounting and collection methods and will also give the client the benefit of the factor's knowledge of the credit rating of various debtors. Also:

- ✦ Factoring is a simple method of obtaining working capital finance. There are few complications in documentation, registration, and stamp duty.
- ✦ If debtor management is included, this may assist a small business in administering its finances, providing controls, etc.
- ✦ Cash is usually provided on delivery of invoices or at least within 7 days.
- ✦ Factoring does not distort the balance sheet.
- ✦ The factor may accept the full credit risk.

### Disadvantages

Most of the disadvantages fall against the factor and therefore this arrangement is usually more expensive than other forms of short-term funding.

## Promissory notes

A promissory note involves a borrower making a written promise to pay the bearer of the promissory note the face value of the note on a certain date.

Unlike a bill of exchange, there are no third parties named on a promissory note. The credit stands or falls on the name of the maker, and is often referred to as one name paper.

For these reasons, only first class credit-rated companies should consider issuing promissory notes.

### Advantages

Promissory notes:

- ✦ Are short and simple;
- ✦ Are readily transferable, independent of any underlying transaction;
- ✦ Give the lender the advantage of providing money under a document which can be readily cashed or used as security to obtain cash; and
- ✦ Give the borrower the advantage of having more than one lender as a source of large-scale fundraising.

### Disadvantages

- ✦ Promissory notes lack flexibility in variations of term, floating interest rates, etc. On a long-term transaction, periodic 'roll-overs' would probably be required.
- ✦ For the borrower, the transfer independently of the underlying transaction is a disadvantage.

## See Us First

- ✦ To assist you in meeting the necessary legal or financial requirements.
- ✦ If you consider that any of the issues contained in this fact sheet may affect you.

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### Disclaimer

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