Trade Credit and Promissory Notes

by Sophia

WHAT'S COVERED

What does short term financing look like? What are the different ways that an organization can have short term financing? This tutorial will cover trade credit and promissory notes, discussing some unsecured short term financing options for organizations. Our discussion breaks down as follows:

1. Short Term Financing

Short term financing is a normal aspect of business, and it doesn't necessarily mean that a business is in distress. It could simply mean that a business needs the financing to get over a particular moment or problem within the business. Therefore, just because a business has a short term financing plan doesn't necessarily mean that they're in trouble—it's perfectly normal to have a type of short term financing available.

Short term financing is typically paid within a year of the time that the loan is made. It's also a lot easier to get than long term financing, which makes it an attractive option for smaller businesses, also.

Short term financing also doesn't necessarily require collateral, and therefore it's referred to as**unsecured financing**. This is a loan of funds based solely on an agreement between two parties that one will pay the other. No physical items are offered as collateral on the loan. Therefore, an unsecured short term loan is simply a promise—it's a loan backed only by a promise that the loan recipient will pay the money back.

Now, short term financing is typically easier for businesses to get because the short repayment period has been shown to be less risky to the lender—there's more of a guarantee they'll get the loaned money back. Also, the amount borrowed is typically smaller than with long term loans, so there is less worry about a big payback along the way.

Typically, there's a working relationship between the lender and the lendee. With unsecured short term bank loans, the bank will usually charge a **prime interest rate**, which is the interest rate banks charge to their best commercial customers. These customers are very creditworthy businesses, so they receive the best rate possible. Less creditworthy businesses, on the other hand, may have a prime interest rate plus a percentage.

DID YOU KNOW

It is important to note that annual percentage rate, or APR, is similar, but it affects consumers and is generally higher than the rate given to businesses. In fact, if you look at the back of your credit card statement, you may see prime interest rate or prime interest rate plus a certain percentage. That refers to your particular annual percentage rate, and how the credit card company sets that rate for your credit card.

TERMS TO KNOW

Unsecured Financing

A loan of funds based solely on an agreement between two parties that one will pay the other; no physical items are offered as collateral on the loan.

Prime Interest Rate

The interest rate banks charge to their best commercial customers.

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2. Types of Short Term Loans

There are several types of short term loans, including:

- Trade credit
- Promissory Note

2a. Trade Credit

The first type of short term loans is called a **trade credit**. This is credit which suppliers extend to their customers for a specific period of time—usually 30, 60, or 90 days.

Retailers will use these delayed payments to resolve merchandise issues or to buy inventory, as will startups. The trade credit can be used if they need to get through a specific short period of time—stocking their shelves, for instance—and they don't necessarily have the cash on hand to make the purchase. As mentioned, the term of credit is usually between 30 and 90 days, but sometimes it can be longer.

Now, the seller—the person who's giving the trade credit—is typically going to offer a discount to the buyer if they pay at the time of delivery, or the buyer can pay up to the full amount with no discount at a later date.

> ↱ EXAMPLE For example, if you pay a certain portion of the entire amount at the time the purchase is made, you get a discount off the price that you paid for it. However, if you pay at a later date, taking the full 30, 60, or 90 days to pay that bill, you don't get a discount.

Considering accounts payable, it is expected that any creditworthy business would take advantage of trade discounts when they can; therefore, if no trade discount is offered, being able to withhold that payment for 30 to 120 days without paying interest will improve the purchaser's cost of funds and provide greater control over that business's cash flow.

> ↱ EXAMPLE Suppose you purchase a large amount of shirts from a supplier and he offers you a discount for buying them at the time of delivery. Now, you may really want to use that discount, so you go ahead and pay that money upfront to get the discount. However, if the supplier *doesn't* offer the discount, then there's really no benefit for you to pay that bill early. In this case, you may hold that bill for 30, 60, 90, or 120 days—however long the trade credit lasts—in order to control and hold your money within your bank account a bit longer, which will be beneficial to you, the lendee.

TERM TO KNOW

Trade Credit

Credit which suppliers extend to their customers for a specific period of time, usually 30, 60 or 90 days.

2b. Promissory Note

The next type of short term loan to consider is a **promissory note**, which is an agreement to pay a specific amount of money at a certain time under certain conditions, serving as another short term financing option for businesses. In this case, the borrower signs a legal instrument promising to pay the lender a specific amount of money, by a specific amount of time. Typically, interest is charged and generally, the time period of a promissory note will be between 60 to 180 days.

A promissory note is a legal document that can be used in court. It can also be sold and negotiated. For example, a company can sell the note to a bank it does business with. Now, if the note is discounted, the value of the amount that the supplier would receive is a slightly less than the value they would receive if it was at maturity. This is because the bank will be taking a small cut along the way.

The benefit for the supplier, though, is that the supplier gets the money a lot quicker, and the bank makes money when the borrower pays on that maturity date. Therefore, it really is a win for everybody involved. The supplier gets their money faster and the money can be put to use faster by the borrower. The bank that holds the promissory note pays a bit less for it, so when the promissory note is paid back fully by the borrower, they make a slight profit.

TERM TO KNOW

Promissory Note
An agreement to pay a specific amount of money at a certain time or under certain circumstances.

SUMMARY

Today we learned about **short term financing** and the different **types of short term loans**: trade credits and promissory notes.

Good luck!

Source: adapted from sophia instructor james howard

TERMS TO KNOW

Prime Interest Rate
The interest rate banks charge to their best commercial customers.

Promissory Note
A signed legal agreement to pay a specific amount of money at a certain time or under certain circumstances.

Trade Credit
Credit which suppliers extend to their customers for a specific period of time, usually 30, 60 or 90 days.

Unsecured Financing

A loan of funds based solely on an agreement between two parties that one will pay the other; no physical items are offered as collateral on the loan.

