

CHAPTER 11

FINANCING! AN ALTERNATIVE TO CAPITAL INJECTION

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79 BOOKS OF ACCOUNTS - A QUICK RECAP

In Chapter 3, we talked about the Books of Accounts which are normally used by a Business. The following Books of Accounts are used for the purposes of Accounting for Financing:

- General ledger
- Cash & Bank Book

In this Chapter, wherever Accounting entries are required to be shown, we will use these Books of Accounts for illustration purposes.

80 WHAT ARE THE SOURCES OF BANK FINANCING?

Financing can be available from any of the following Institutions:

- Commercial Banks
- Investment Banks
- Leasing Companies
- Modarabas

Every Institution may have different financing policies, products and terms & conditions which may vary from one another. Also the terms of financing offered by an Institution to a Business may not necessarily be the same as that offered to another Business.

Typically, of the Institutions mentioned above, Commercial Banks and Leasing Companies are the most common source of financing for a Business. Leasing has already been separately discussed in Chapter 8. In subsequent sections, we shall focus on Financing from Commercial Banks.

81 WHAT TYPES OF FINANCING ARE AVAILABLE TO BUSINESSES?

Businesses can usually choose between two types of Financing:

- Fixed asset (or project financing)
- Working capital

Each type of Financing is briefly discussed below:

81.1 FIXED ASSET (OR PROJECT) FINANCING

Fixed asset (or project financing) refers to financing taken on to:

Set up a new Business, which can include:

- Construction of factory and office blocks.
- Purchase of machinery.

Increase capacity or size of a Business, which can include:

- Constructing additional factory or office space.
- Buying additional machinery.

Balancing, modernization and replacement, which can include:

- Replacement of old machines with new.
- Refurbishment and renovation of existing facilities.

This type of financing is also commonly known as “Long Term Financing”. Long term financing is normally used for the purposes mentioned above because the source of repayment of this financing will be over a period of time through increased productivity, higher profits and cash flows. Since these benefits are expected to be derived over a longer time period, Businesses should opt for long term financing in such cases. Accordingly, long term financing usually has tenures exceeding 12 months, and are typically for periods between 3 and 5 years.

EXAMPLE # 11.1

Fixed Asset / Project financing

As was explained in Chapter 8, Hussain Khaddar & Looms (Pvt) Limited arranged long term financing to finance: purchase of 30 more looms costing Rs. 2,000,000; purchase of 4 kanals of land costing Rs. 2,000,000; and expansion of factory building space at a cost of Rs. 1,600,000 i.e. total financing of Rs. 5,600,000. The Bank sanctioned financing on 15/1/06 against a security of hypothecation and mortgage on moveable and immovable assets. Terms & conditions of bank financing were:

Amount of financing:	Rs. 5,600,000
Tenure:	4 years
Repayment terms:	Equal payments of Rs. 800,000/- every six-monthly starting from 1/8/06
Mark up rate:	15%
Mark up payment terms:	6 monthly on 1st August & 1st February annually

Disbursement of Financing

Disbursement Dates	Purpose	Rs.
1/2/06	Advance for purchase of land	1,000,000
1/2/06	For purchase of 30 looms	2,000,000
1/3/06	Balance for land purchase	1,000,000
31/3/06	For factory expansion	1,600,000

81.2 WORKING CAPITAL FINANCING

After a Business has been set up, funds are required to run the Business. Without these funds, a Business will find it difficult to continue or to even start its operations!

Typically, if you consider a Business's working capital requirement, funds are required from the time that inventory is purchased to the time that cash is received from sale of that inventory. Also, within this time period, more funds are also required for:

- Purchase of spares, consumables, tools; AND
- Payments for salaries, utilities, manufacturing expenses.

Working capital financing is extended by Banks on a renewable 12 month basis or for shorter tenures as mutually agreed between Banks and Borrowers. Banks usually renew working capital facilities upon expiry of each 12 month period, unless the Business has not fulfilled Bank's pre-agreed conditions. During the period for which financing is availed, mark up is usually payable on a calendar quarter basis with the principal outstanding repaid on or before expiry of the 12 month period – practically, Banks usually renew the financing facilities for a further 12 month period prior to the expiry of previous 12 month expiry date which means that Businesses are not usually required to repay the principal amounts.

Working capital financing is flexible so that each type of financing can be structured to meet a Business's specific requirement. These specific requirements are mutually agreed between the Business and the Bank. The various types of financing products (within the purview of working capital financing) which Banks generally offer are:

- Running Finance, also known as overdraft.
- Export Refinance, also called Packing Credit.
- Import Financing, also called Trust Receipt Financing.
- Pledge Financing.
- Negotiation and discounting of export documents.

Similarly, other types of financing products may also be structured based on mutual consent.

EXAMPLE # 11.2

Working Capital Financing

Hanif Auto Engineering plans to purchase auto spare parts for the workshop. They have negotiated working capital financing facility (running finance) of Rs. 1,000,000 from a local bank for this purpose by pledging Hanif Ahmed's personal residence. The facility was sanctioned on 1/5/06 with an expiry date of 30/4/07. Mark up rate is 15% per annum with mark up payments at the end of every calendar quarter.

No Accounting entries are passed when a working capital facility is sanctioned. Accounting entries are made only when a Business utilizes funds from such a facility.

Utilization of working capital financing

Continuing from above example, Hanif Auto Engineering drew a cheque on the running finance account for Rs. 500,000/- on 15/5/06 to purchase various spare parts. These were purchased from the local market.

The Accounting entries will be as follows:

GENERAL LEDGER							
INVENTORY CONTROL ACCOUNT				GL-10			
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
15/5/06	GL-17	Running Finance Account	500,000				

GENERAL LEDGER							
RUNNING FINANCE ACCOUNT				GL-17			
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
				15/5/06	GL-10	Inventory Control Account	500,000

At the same time, the inventory ledger (account for every item of inventory purchased) will be updated with this purchase. We have, however, not shown these memorandum entries here.

82 HOW ARE PAYMENTS MADE TO THE FINANCING BANK?

Financial charges represent mark up cost, which is incurred by a Business whenever Financing is utilized from a Bank. Financial charges are computed by Banks on the basis of the actual outstanding, under each financing, on a daily basis – what that means is that if a financing facility is not utilized, no financial cost will be paid by a Business.

The following additional tips will be useful in getting a better understanding of mark up costs:

82.1 FINANCIAL CHARGES

82.1.1 PER DIEM

There are two generally accepted basis used by Banks to quote mark up rates:

- on a per diem basis i.e. 48 paisas per day per thousand; OR
- as a percentage i.e. 17.50% per annum.

Percentage per annum charges are more commonly used. Where mark up rate is quoted on the basis of per diem, these can also be converted into a percentage, as follows:

$$\text{Mark Up Rate (\%)} = \frac{\text{Per Diem} * 365}{1,000}$$

Thus, in case of above example, the per diem rate of 48 paisas per day per thousand translates into a mark up rate of 17.50% per annum.

82.1.2 BASIS PERIOD

Basis period is a very specific term used by Banks when carrying out transactions in different currencies. However, it has relevant practical implications for Businesses. Basis period determines whether 360 days or 365 days will be assumed in a year when mark up cost is calculated.

When a Bank quotes a mark up rate of 17.50% per annum, the rate on which mark up is actually calculated is:

$$\text{Actual Rate (\%)} = \frac{\text{Mark Up Rate} * 365}{\text{Basis Period}}$$

This actually works out to a mark up rate of 17.74% per annum as against a mark up rate of 17.50% per annum quoted by Banks.

The Basis Period is not the same for all currencies. In case of financing in foreign currencies, the basis period for US\$ is 360 days while the basis period for GBP is 365 days. Interestingly, this applies to situations where Banks have extended Financing. In case of return on deposits, the basis period is always 365 irrespective of the currency.

82.1.3 ACCRUAL FOR FINANCIAL CHARGES

Banks have a fixed date on which mark up payments are made by Businesses. Therefore, there will also be situations where payment dates for mark up may not necessarily match with the dates on which a Business will also make its accounts.

In such cases, where there are periods for which financing has been utilized but no mark up has been paid, the Business will need to make a provision for mark up payable. In such instances, since the amount of mark up has not been paid but is payable, Accounting entries are passed in the Books of Accounts to recognize that there is a liability to pay.

82.1.4 CALCULATION OF FINANCIAL CHARGES

Having understood how Banks quote mark up rates, we will now consider examples to show how mark up is actually calculated.

EXAMPLE # 11.3

Financial charges: Long Term Finance

We will take the disbursement dates and amounts from Example # 11.1 for Hussain Khaddar & Looms (Pvt) Limited to show how mark up is calculated on long term financing

Based on the financing terms given in Example # 11.1, the following schedule will be prepared by the Bank:

Start	End	No Of Days	Principal O/S opening Balance	Further Disbursement	Principal Repaid	Principal O/S closing	Mark Up Accrued	Mark up Due	Amount Repaid
1-Feb-06	1-Mar-06	28		3,000,000		3,000,000	35,000		
1-Mar-06	1-Mar-06	-	3,000,000	1,000,000		4,000,000	-		
1-Mar-06	31-Mar-06	30	4,000,000			4,000,000	50,000		
31-Mar-06	31-Mar-06	-	4,000,000	1,600,000		5,600,000	-		
31-Mar-06	30-Jun-06	91	5,600,000			5,600,000	212,333		
30-Jun-06	30-Jun-06	-	5,600,000			5,600,000	-		
30-Jun-06	1-Aug-06	32	5,600,000			5,600,000	74,667		
1-Aug-06	1-Aug-06	-	5,600,000		800,000	4,800,000	-	372,000	1,172,000
1-Aug-06	1-Feb-07	184	4,800,000			4,800,000	368,000		-
1-Feb-07	1-Feb-07	-	4,800,000		800,000	4,000,000	-	368,000	1,168,000
1-Feb-07	30-Jun-07	149	4,000,000			4,000,000	248,333		-
30-Jun-07	30-Jun-07	-	4,000,000			4,000,000	-		-
30-Jun-07	1-Aug-07	32	4,000,000			4,000,000	53,333		-
1-Aug-07	1-Aug-07	-	4,000,000		800,000	3,200,000	-	301,667	1,101,667
1-Aug-07	1-Feb-08	184	3,200,000			3,200,000	245,333		-
1-Feb-08	1-Feb-08	-	3,200,000		800,000	2,400,000	-	245,333	1,045,333
1-Feb-08	30-Jun-08	150	2,400,000			2,400,000	150,000		-
30-Jun-08	30-Jun-08	-	2,400,000			2,400,000	-		-
30-Jun-08	1-Aug-08	32	2,400,000			2,400,000	32,000		-
1-Aug-08	1-Aug-08	-	2,400,000		800,000	1,600,000	-	182,000	982,000
1-Aug-08	1-Feb-09	184	1,600,000			1,600,000	122,667		-
1-Feb-09	1-Feb-09	-	1,600,000		800,000	800,000	-	122,667	922,667
1-Feb-09	30-Jun-09	149	800,000			800,000	49,667		-
30-Jun-09	30-Jun-09	-	800,000			800,000	-		-
30-Jun-09	1-Aug-09	32	800,000			800,000	10,667		-
1-Aug-09	1-Aug-09	-	800,000		800,000	-	-	60,333	860,333

In this schedule you will note that the amount of mark up accrued has been worked out on the basis of applying the basis period of 360 days, i.e. against the quoted mark up rate of 15.0% per annum, the actual mark up rate is 15.21% per annum.

In our example, mark up is due for payment on a six-monthly basis i.e. on 1st August and 1st February annually. If we assume that Hussain Khaddar is making accounts till 30th June, the accounting entries will be as follows.

Interest expense accrued till 30th June from initial disbursements.

Since the mark up payment has not become due till 30th June, only an accrual (liability to pay) entry will be passed:

GENERAL LEDGER							
INTEREST EXPENSE ACCOUNT							GL-24
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
30/6/06	GL-31	Interest Accrued Account	297,333				

GENERAL LEDGER							
ACCRUED INTEREST PAYABLE ACCOUNT						GL-31	
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
				30/6/06	GL-24	Interest Expense Account	297,333

The above schedule highlights the date that the accounts are being prepared for, i.e. 30th June. The total amount accrued as of this date is Rs. 297,333.

On 1st August, mark up is paid:

GENERAL LEDGER							
INTEREST EXPENSE ACCOUNT				GL-24			
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
1/8/06	GL-20	Bank Account	372,000				

CASH & BANK BOOK							
BANK ACCOUNT				GL-20			
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
				1/8/06	GL-24	Interest Expense Account	372,000

You will note that the payment on 1/8/06 includes all mark up which has accrued since the disbursement dates. This means that mark up till 30/6/06 is also included in this payment. However, you will also appreciate that mark up accrued till 30/6/06 has already been charged as an expense in the Accounts and against which a liability has also been booked. What this means is that if the mark up payment on 1/8/06 is also charged as an expense, mark up expense up to 30/6/06 will get charged twice. The solution is, therefore, that the liability (or accrual) for mark up payable should be "reversed" by crediting the expense account – this is explained in Chapter 12 where we explain the concept of Accruals and Prepayments in more detail.

Subsequently, on each payment date, similar entries will be recorded.

Calculation of mark up on working capital facilities is very similar to what we have shown above. The only difference is that, in the case of working capital facilities, the number of transactions is considerably higher. What this means is that a Business will have to calculate the actual outstanding on each working capital facility on a daily basis in order to work out the accrued mark up.

Mark up rate, after applying the basis period, will then be applied to balances outstanding to calculate mark up accrued (and / or payable). Here, it is important to discuss the "balances outstanding", it will be appreciated that a Business's General Ledger shows banking transactions on certain dates which may not match with the dates on which the Bank records those same transactions. The Bank will, however, charge or accrue mark up on the basis of daily outstanding balance in its own Books.

The following example with further explain this:

EXAMPLE # 11.4

Financial charges: Working Capital Finance

Continuing with Example # 11.2, Hanif Auto Engineering has utilized Rs. 500,000 of the Rs. 1,000,000 Running Finance Limit up to 15/5/06. Subsequently, further transactions were made on various dates and of amounts as are shown below in Hanif Auto's General Ledger.

Following is an extract from Hanif Auto's General Ledger for the Running Finance Account.

Transactions	Date	Dr.	Cr.	Amount O/S
Balance O/S	15/5/06	-	-	(500,000)
Payment made to Lahore party	16/5/06	-	50,000	(550,000)
Payment made to Sialkot party	18/5/06	-	50,000	(600,000)
Payment received from Lahore party	21/5/06	20,000	-	(580,000)
Payment made to Lahore party	22/5/06	-	40,000	(620,000)
Payment received from Sialkot party	23/5/06	60,000	-	(560,000)
Payment received from Multan party	24/5/06	100,000	-	(460,000)
Payment made to Multan party	25/5/06	-	50,000	(510,000)
Payment made to Lahore party	29/5/06	-	30,000	(540,000)
Payment made to Lahore party	31/5/06	-	40,000	(580,000)
Payment received from Lahore party	2/6/06	50,000	-	(530,000)

And, following is an extract from Hanif Auto's bank statement for the same transaction

Transactions	Date	Cr.	Dr.	Amount O/S
Balance O/S	15/5/06	-	-	500,000
Payment made to Lahore party	17/5/06	-	50,000	550,000
Payment made to Sialkot party	22/5/06	-	50,000	600,000
Payment received from Lahore party	22/5/06	20,000	-	580,000
Payment made to Lahore party	23/5/06	-	40,000	620,000
Payment received from Sialkot party	27/5/06	60,000	-	560,000
Payment received from Multan party	28/5/06	100,000	-	460,000
Payment made to Multan party	29/5/06	-	50,000	510,000
Payment made to Lahore party	31/5/06	-	30,000	540,000
Payment made to Lahore party	2/6/06	-	40,000	580,000
Payment received from Lahore party	3/6/06	50,000	-	530,000

If you compare the General ledger and the Bank Statement, you will find that the same transactions are recorded on different dates by the Business and by the Bank - some of the reasons for these differences are:

- Cheque payments are recorded by Businesses on the issue date but the Bank will make an entry against these cheques 2 to 7 days after they have been issued depending on whether these cheques are presented in clearing (same city) or on collection (different cities).

- Similarly, cheques deposited will have similar differences depending on whether these cheques are presented in clearing or sent on collection.
- Pay orders and drafts are entered by both the Business and the Bank on the same date.
- Likewise, there may also be differences in amounts between the Bank and the Business. For example, if a cheque for Rs. 100,000 is sent on collection, the amount actually credited by the Bank may be Rs. 98,250 – the difference being bank charges on collection which may not get entered in the Business's General Ledger until a copy of bank statement is received.

However, as explained before, the Bank will calculate mark up payable by the Business on the basis of the outstanding amounts on the bank statement.

The following schedule shows a typical calculation format.

Start	End	No Of Days	Principal O/S opening Balance	Dr.	Cr.	Principal O/S closing	Mark Up
15-May-06	17-May-06	2	500,000			500,000	417
17-May-06	17-May-06	-	500,000	50,000		550,000	-
17-May-06	22-May-06	5	550,000			550,000	1,146
22-May-06	22-May-06	-	550,000	50,000	20,000	580,000	-
22-May-06	23-May-06	1	580,000			580,000	242
23-May-06	23-May-06	-	580,000	40,000		620,000	-
23-May-06	27-May-06	4	620,000			620,000	1,033
27-May-06	27-May-06	-	620,000		60,000	560,000	-
27-May-06	28-May-06	1	560,000			560,000	233
28-May-06	28-May-06	-	560,000		100,000	460,000	-
28-May-06	29-May-06	1	460,000			460,000	192
29-May-06	29-May-06	-	460,000	50,000		510,000	-
29-May-06	31-May-06	2	510,000			510,000	425
31-May-06	31-May-06	-	510,000	30,000		540,000	-
31-May-06	2-Jun-06	2	540,000			540,000	450
2-Jun-06	2-Jun-06	-	540,000	40,000		580,000	-
2-Jun-06	3-Jun-06	1	580,000			580,000	242
3-Jun-06	3-Jun-06	-	580,000		50,000	530,000	-
3-Jun-06	30-Jun-06	27	530,000			530,000	5,963
							<u>10,342</u>

The accounting entries for mark up on working capital facilities will be similar to those for long term financing.

82.2 PRINCIPAL REPAYMENTS

Continuing from Example # 11.1 above, repayment of principal outstanding is in equal installments of Rs. 800,000, each falling due on a six-monthly basis, i.e. on 1st August and 1st February annually. Based on these terms, the repayment schedule will be as follows:

Principal O/S opening balance	Date	Principal Repaid	Principal O/S closing balance
5,600,000	30/6/06		5,600,000
5,600,000	1/8/06	800,000	4,800,000
4,800,000	1/2/07	800,000	4,000,000
4,000,000	1/8/07	800,000	3,200,000
3,200,000	1/2/08	800,000	2,400,000
2,400,000	1/8/08	800,000	1,600,000
1,600,000	1/2/09	800,000	800,000
800,000	1/8/09	800,000	-

We will consider the example of principal repayment of Rs. 800,000 on 1/8/06. The accounting entries will be as follows:

GENERAL LEDGER							
LONG TERM LOAN ACCOUNT				GL-32			
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
1/8/06	GL-20	Bank Account	800,000				

CASH & BANK BOOK							
BANK ACCOUNT				GL-20			
Debit				Credit			
Date	Folio	Description	Amount (Rs.)	Date	Folio	Description	Amount (Rs.)
				1/8/06	GL-32	Long Term Loan Account	800,000

Subsequently, on each payment date, similar entries will be recorded.

In case of working capital financing, there are no such principal repayments and,

practically, banks renew facilities prior to the expiry date. This means that Businesses do not have to make lump sum or (even) periodic repayments.

83 USING LONG TERM FINANCING TO YOUR ADVANTAGE

Long term financing is generally for periods between 3 to 5 years. However, from an accounting viewpoint, any amount owed by a Business after more than 12 months from the date of Balance Sheet is called a long term liability. Accounting rules require long term and short term liabilities (as well as long term and short term assets) to be shown separately from each other.

In case of long term financing in particular, the total of the outstanding amount can be split between:

- Those amounts which are payable in the next twelve months, (also called Current Portion of Long Term Financing).
- Those amounts which are payable after more than 12 months.

More importantly, when discussing financing, Banks are keen to see that the current ratio of a Business is also acceptable - while this ratio is explained in more detail in Chapter 15, it is calculated as follows:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Because the Current Portion of Long Term Financing is included as part of current liabilities, there is a popular misconception that Current Ratio, for the purposes of Prudential Regulations, is calculated using current liabilities inclusive of this amount which is not correct.

84 SOME FACTS TO KEEP IN MIND!

Businesses may find some of the following tips useful when discussing financing options with Banks.

84.1 NEGATIVE CIB CHECKING IS NOT A PROBLEM

Popular belief amongst Businesses is that State Bank of Pakistan prevents Banks from extending financing to Businesses whose CIB is “negative”, i.e., where that same Business is in default of an obligation towards any other Bank. This is not true!

We have given a relevant extract from State Bank of Pakistan’s Prudential Regulations # 8 section 1, which reads:

“Banks / DFIs may take exposure on defaulters keeping in view their risk management policies and criteria, provided they properly record reasons and justifications in the

approval form.”

Clearly, State Bank of Pakistan does not prevent Banks from extending financing to such Businesses. However, it is indeed a fact that Banks are more reluctant when it comes to financing Businesses whose CIB is or has been negative in the past.

84.2 REDUCE YOUR BUSINESS'S MARK UP COST

Since mark up is charged on actual outstanding amounts under various financings, it is important for Businesses to ensure that surplus cash balances are not kept in separate accounts – needless to say, carrying cash balances (in current accounts or savings accounts) and having outstanding financing (incurring cost) does not make financial sense – mark up charged on financing will always be higher than mark up received on surplus cash!

This is called “cash pooling”, - under which all cash resources of a Business are pooled together to have minimum outstanding financing.

84.3 KNOW HOW MUCH YOUR BUSINESS NEEDS

This is a question which Banks will also ask Businesses. In fact, every Business should have an answer for this question - so, how do you know what your working capital requirements are? The answer lies in the asset conversion cycle!

Asset conversion cycle is the time taken (can also be expressed in money terms) by a Business from procurement of inventory to the time that cash is received from sale of these inventory items. In this time period, funds are required for overheads, consumables etc. Clearly, if a Business has sufficient funds available for this time period, that Business will never be out of funds! When asset conversion cycle is expressed in monetary terms, it becomes the working capital requirement for the Business.

84.4 HOW DO YOU MAKE LONG TERM FINANCING CHEAPER?

Long term financing normally carries a higher mark up rate than that on working capital financing. Unlike working capital financing, Businesses are not allowed to utilize their short term surplus cash balances to reduce outstanding under long term financing.

In such a situation, it is important that Businesses get disbursements of long term financing at appropriate times, i.e., at times when funds are actually required for the purposes they were intended for.

CHAPTER HIGHLIGHTS

What have we covered?

1. Long term financing is normally for periods between 3 to 5 years. Working capital financing is offered on 12-month renewable basis.
2. Long term financing is normally available to finance fixed assets while working capital financing is used to finance current assets (inventory, receivables, payables etc.).
3. Financing is a liability which normally carries a "Credit" balance.
4. Mark up rates can be expressed as a %age of as per diem. Both ways conversion is also possible.
5. Every currency has a basis period which is either 365 or 360 days.
6. Mark up is calculated on the basis of the actual outstanding on daily basis.
7. Current ratio is a useful financial indicator which Banks also use.
8. Negative CIB does not mean that Banks can not extend financing.
9. Asset conversion cycle is the time taken to convert inventory into cash.
10. Some techniques to reduce the overall financial costs are: cash pooling and staggered disbursements.