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FINANCIAL MANAGEMENT-II
M.Com (Accountancy) Semester-II
Paper III

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FOREWORD

Since its establishment in 1976, Acharya Nagarjuna University has been forging ahead in the path of progress and dynamism, offering a variety of courses and research contributions. I am extremely happy that by gaining 'A' grade from the NAAC in the year 2016, Acharya Nagarjuna University is offering educational opportunities at the UG, PG levels apart from research degrees to students from over 443 affiliated colleges spread over the two districts of Guntur and Prakasam.

The University has also started the Centre for Distance Education in 2003-04 with the aim of taking higher education to the door step of all the sectors of the society. The centre will be a great help to those who cannot join in colleges, those who cannot afford the exorbitant fees as regular students, and even to housewives desirous of pursuing higher studies. Acharya Nagarjuna University has started offering B.A., and B.Com courses at the Degree level and M.A., M.Com., M.Sc., M.B.A., and L.L.M., courses at the PG level from the academic year 2003-2004 onwards.

To facilitate easier understanding by students studying through the distance mode, these self-instruction materials have been prepared by eminent and experienced teachers. The lessons have been drafted with great care and expertise in the stipulated time by these teachers. Constructive ideas and scholarly suggestions are welcome from students and teachers involved respectively. Such ideas will be incorporated for the greater efficacy of this distance mode of education. For clarification of doubts and feedback, weekly classes and contact classes will be arranged at the UG and PG levels respectively.

It is my aim that students getting higher education through the Centre for Distance Education should improve their qualification, have better employment opportunities and in turn be part of country's progress. It is my fond desire that in the years to come, the Centre for Distance Education will go from strength to strength in the form of new courses and by catering to larger number of people. My congratulations to all the Directors, Academic Coordinators, Editors and Lesson- writers of the Centre who have helped in these endeavours.

Prof. P. Raja Sekhar
Vice-Chancellor
Acharya Nagarjuna University

FINANCIAL MANAGEMENT – II

Unit –I: Business Finance– Definition, Features and concept of business finance – Objectives, Scope , Nature and Importance of Business Finance - Finance Functions of Business Finance - - Types of Business Finance - Sources of Business Finance

Unit-1I: Environment of Business Finance & Valuation of the Firm: Forms of Business Organisation – Financial Intermediaries- Financial Markets: Money market, capital market; Valuation of the Firm**:** Concept of value – Book value- Market value –Valuation of Bonds or Debentures – Valuation of Preference Shares – Valuation of Equity Shares

Unit-III: Financial Management & Financial Decisions: Definition and Meaning of Financial Management- Financial goal and firms goal- Organization of Finance function – Role of Financial manager; Financial Decisions: Investment decision—Financing decision—Dividend decision—Liquidity decision

Unit-IV: Dividend decision: Dividend Policy - Determinants of Dividend policy - Dividend Theories – Traditional Position -Walter's Model – Gordon's Model – MM Hypothesis

Unit – V: Working Capital Management: Working Capital Policies – Working capital control and Banking policy – Estimating Working Capital Needs - Assessing Global Liquidity of Working Capital

REFERENCE BOOKS

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Model Question Paper

M.Com (Accountancy) DEGREE EXAMINATION,
Second Semester
Paper III --FINANCIAL MANAGEMENT-II

Time : Three hours Maximum : 70 marks

SECTION A-- (5X3 = 15 marks)
Answer any FIVE of the following

1. (a) Business finance

(b) Importance of Business Finance

(c) Financial Markets

(d) Book value

(e) Financial goal

(f) Financing decision

(g) Dividend policy

(h) Walter's Model

(i) Working Capital

(j) Liquidity

SECTION B-- (5X8 = 40 marks)
Answer the following questions

2. (a) Define Business Finance ? What is the Importance of Business Finance?
Or
(b) Explain the Functions of Business Finance in an Organization

3. (a) Discuss various Forms of Business Organisation.
Or
(b) What is the Value of the Firm? How can you determine the valuation of the Bonds?

4. (a) What is Financial Management? How can you organizing the Finance Function?
Or
(b) Discuss various financial decisions of a firm.

5. (a) What is dividend? Explain the factors of dividend policy.
Or
(b) Explain the relevant theories of dividend.

6. (a) What is working capital? What are the factors influencing working capital?
Or
(b) What is liquidity? How can you Assessing Global Liquidity of Working Capital ?

SECTION C-- (1X15 = 15 marks)

(Compulsory)

41

The following information is obtainable in respect of a firm:

Capitalisation Rate (Ke) = 10%

Earning Per Share (E) = Rs. 8

Compute the market price of share under Walter's Model by assuming Rate of Return

(i) 15% (ii) 10% (iii) 5% and

Dividend Payout Ratio

(i) 0% (ii) 25% (iii) 50% (iv) 75% (v) 100%

FINANCIAL MANAGEMENT-II

LESSON-1
BUSINESS FINANCE: OBJECTIVES, NATURE, SCOPE & IMPORTANCE

Aims and Objectives

After studying this lesson you should be able to:

- Know the meaning and features of Business Finance
- Understand the Scope, Nature and Importance of Business Finance
- Explain the concept of Business Finance

Structure

1.1 INTRODUCTION

Business finance refers to funds availed by business owners to meet their needs that may include commencing a business, obtaining top-up funds to finance business operations, obtaining finance to purchase capital assets for the business, or to deal with a sudden cash crunch faced by the business. Business finance, also known as corporate finance in the business world, is responsible for allocating resources, creating economic forecasts, reviewing opportunities for equity and debt financing, and other functions within your organization.

It is also called working capital financing. Trade credit, working capital loans, invoice discounting, factoring, and business line of credit comes under short term finance. Advantages of short term finance are less interest, disbursed quickly and less documentation. Both consumers and businesses benefit from financing programs, because financing gives customers more buying power and flexibility, and it helps businesses boost sales and improve cash flow.

Business finance, the raising and managing of funds by business organizations. Planning, analysis, and control operations are responsibilities of the financial manager, who is usually close to the top of the organizational structure of a firm.

1.2. BUSINESS FINANCE DEFINITION

Business finance define as an area of finance that focuses particularly on the way in which large companies have the ability to create and sustain a certain value by making efficient use of all resources; They are strongly linked to disciplines such as economics and accounting. The main objective possessing business finance is to maximizing the value corresponding to the shareholders of the company or to the owners of it.

Here is some of the top list of definition of business finance by different authors. You can consider this for your reference as a part of additional knowledge. Below is the list which you can check it out!

i) ."Business finance is concerned aided with the sources of funds available to enterprises of all sizes and the proper use of money or credit obtained from such sources." – Professor Gloss and Baker

ii) "Business finance is to planning, controlling, coordinating and implementing financial activities of the business institution." – E.W Walker

iii) "An activity that satisfies the needs and desires regarding the community financial and arranged a company to engage in such tasks." – Musselman and Jackson

iv) "Financial management is concerned with financing, acquisition and management of assets with some overall goal in mind," – James C Van Horne

v) "Business is an institution which produces goods and solutions demanded by people". – Brown and Petrello

vi) "Business is an organization that provides items or services in an effort to earn profit". – Griffin and Ebert (1996)

vii) . "Business is all those activities taking part in supplying the items and services needed or desired by people." – Stenford

1.3. FEATURES (OR) CHARACTERISTICS OF BUSINESS FINANCE:

Helps us to differentiate with other branches related to finance : Business finance have some features that helps us to differentiate with other branches related to finance; for example, business finance generally tend to value both the time and money spent by a company, what you mean when an investor expects a profitable return, it is exposed to run very high risks. Anyway we must say that most investors are usually used to face this kind of risk, but still, of course, will always seek ways to reduce the risk you run.

Offering long-term investments: Moreover, business finance are characterized by offering long-term investments to be carried out simple and similar, because the bottom line here is that all investments in company project arises with sufficient finance. Opportunity costs are also part of the characteristic factors relating to business finance, and in this case we must say that this is the highest performance that finance will not be able to win in the event that funds are invested in particular project. The opportunity costs are usually associated with the losses

that an investor is willing to take when an option that is best to use the corresponding money is not chosen.

Often provide some dilemmas for investors: Business finance often provide some dilemmas for investors, for example, one of the most common is the one between liquidity and the need to invest, and this rethinking because every company prefers own money, but despite that, they often choose to sacrifice this liquidity in order to generate more utilities. Another of the dilemmas posed by business finance is one that is centred between risk and profit. As we said earlier in this article, the investor whenever you execute an investment is taking a risk of loss that can be either very large or very small depending on the type of investment and the economic impact, whether positive or negative than the same present.

A key feature of finance: Here are some of the important features of finance present for your understanding. Investment Opportunities: A key feature of finance is to look forward for investment opportunities. ...

a) Allocation and Utilization of Funds: ...
b) Diversify your Investment: ...
c) Financial Decision Making: ...
d) Financial Management:

1.4. MEANING OF BUSINESS FINANCE

According to B.O. Wheeler Meaning of Business Finance includes those business activities that are concerned with the acquisition and conservation of capital funds in meeting the financial needs and overall objectives of a business enterprise." Business is identified with the generation and circulation of products and services for fulfilling of needs of society. For successfully doing any operation, business requires money which is known as business finance. Therefore, funds are known as the lifeblood of any business. A business would not function unless there is adequate money accessible for use.

The capital contributed by the businessman to establish the business isn't adequate to meet the financial needs of the business. Consequently, the businessman needs to search for an option to generate funds. A research of the financial needs and options to fulfill those needs must be done with a specific end goal to arrive at effective financial management to maintain the business. The fundamental necessities of business would be to buy a plant or apparatus, or it could be to buy raw materials, development of a business that prompts more enrollments, paying wages and so on. The money related necessities of a business can be classified as follows:

i) Fixed Capital Requirement: In order to begin a business, money is required to buy fixed assets like land, building, plant and machinery. This is called the Fixed Capital Requirement.

ii) Working Capital Requirement: A business needs funds for its day to day activities. This is known as Working Capital Requirements. Working capital is required for the purchase of raw materials, paid salaries, wages, rent, and taxes.

iii) Diversification: A company needs more funds to diversify its activities to become a multi-product company e.g. ITC.

iv)Technology upgrading: Finances are needed to adopt the latest technology for example use of particular software and the latest computers in business.

1.5. OBJECTIVES OF BUSINESS FINANCE

Goals and objectives of business finance create discipline at workplace is one of the main financial objectives of a firm. Countless objectives exist, but prioritizing several will paint a picture that is obvious of immediate priorities. How to measure financial objectives of a business? Make the objective of business finance is the key to build a process to achieve goals. Startups, The financial business objectives of most firms include raising revenue, expanding profit margins, retrenchment during times of economic crisis, and receiving a return on investment. The following are the objectivities of business finance viz.,

i) Revenue Generation
Increasing income is the most basic and fundamental goal that is financial of business. Revenue growth comes from an emphasis on sales and marketing activities, and it is solely concerned with increasing earnings that are top-line earnings before expenses. Companies usually set revenue goals in regards to percentage increases rather than aiming for certain amounts. For Example: An objectives of business finance for company of increasing revenue by 15% each year for the first five years that is newly operated. Driving revenue and profitability that is consistent a major objective for any business. Creating revenue consistently is really a good indication for the business life-cycle. Income targets being an indicator of growth rate. Financial objectives examples for marketing plan: a sales team with a revenue target represents the growth rate in percentage on the same quarter when compared with last year.

ii) Profit Margin
Profits is a key objectives of business finance which are more sophisticated than revenue generation. Any money left over from sales revenue after all expenses have been paid is recognized as profit. Profit, or bottom-line profits, can be used in a number of ways, including investing it back into the business for expansion and distributing it among employees Profit objectives are concerned very first with revenue, then with costs. Maintaining expenses low by finding and building relationships with dependable suppliers, creating operations with an eye fixed toward lean efficiency and advantage that is using of scale, to call a few methods, can make you with additional money after paying all of your bills.

iii) Managing Operational Activities
Operations are one of the important objectives of business finance to keep business running. Important goals include human resources processes, accounting objectives to create payroll and payment statements on-time and daily tasks for every job role. Without sound operational objectives being met, achieving revenue goals become harder.

iv) Productivity and Efficiency Maximizing employee performance and productivity drives revenue. Establishing objectives each quarter, year, month or week is just a start that is good. Including incentive for fulfilling objectives will increase performance and also productivity.

v) Sustainability
At certain times, businesses or brands could be primarily concerned with basic survival that is financial. Retrenching is a marketing technique, predicating an objectives of business finance

that tries to keep a brand name alive and keep current revenue and profit levels from falling any further during the decline stage regarding the life cycle that is product/brand. Companies can be concerned with monetary sustainability during periods of economic turmoil, as well. Common monetary objectives for survival include gathering on all outstanding debts on time plus in complete, de-leveraging by paying off debt and income that is keeping consistent.

vi) Customer Satisfaction

The client is top priority and delivering satisfaction is a main objectives of business finance. Take the customers survey and make an objective to always look for an improvement approaches. Happy customers leave reviews that are positive, spread word that is positive of and are far more likely to repeat business.

vii) Return on Capital Investment

Return on Investment (ROI) is a ratio can be applied to two situations that are basic. First, ROI is concerned utilizing the profits generated from investments as a primary objective of business finance. Business owners want to make sure the buildings, machinery, equipment and other furniture they purchase generates revenue that is enough revenue to justify the purchase cost.

Secondly, ROI applies to assets in stocks, bonds and other investment instruments. The principle that is same to these investments, but there is generally no productive physical asset used to generate a return. Instead, ROI for investment items is determined by comparing the interest, dividends and capital gains realized from investments by the expense of the investment and the opportunity cost of forgoing investments which can be alternative.

viii) Employee Benefits

Performance and production are very important, at the same time employee health is really a major objective of business finance. Fair compensation and benefits are objectives every continuing business should make an effort to meet. Happy employees and healthy employees are more productive.

ix) Emergency / Contingency Plans

Unexpected occasions can break a continuing business without a proper contingency plans. A contingency is one thing a continuing company cannot prevent. For example: employees strike, natural disaster, halts manufacturing, the economy crisis. How will your business survive? create a series of contingency objectives to prepare for the worst situation.

x) Leadership and Management

Hiring and developing effective supervisors and business leaders is a goal that is key. Leadership upholds the core values and drives the continuing business to success. Organizations focused on developing the greatest possible leadership as a primary objectives of business finance are on a track that is positive.

1.6. NATURE OF BUSINESS FINANCE

Nature of business finance has carved out a situation that is key factors which no-one can challenge it. The need and requirements of finance begin with the birth and remain till the end for the business / company. Corporate finance / business finance is the area of finance that works with financial decisions within a corporate world. Let us understand the nature of business finance in points mentioned below:

In the entire journey of a company. It really is born, it grows and dies. At each and every stage it needs finance. But finance that is mere the disposal of the supervisor will perhaps not solve the situational problems, one got to know the nature of business finance, that is, the way the finance has to be utilized.

Business finance is available easily from different sources but the cost / interest / repayment terms involved in the nature of business finance varies. The conditions to be considered with reference to the various factors and then just will likely be ascertained the nature of business finance and choice has to be taken whether it's going to be wise to acquire business finance from some of the available sources. Interest on the finance is the price for its features or benefits.

Nature of business finance also denotes the outlook of the lender to which the borrower might perhaps not feel safe. A short-term or a long term finance additionally determining factor of nature of finance for a business. Financial management is always to think concerning the purpose for which finance is necessary; it may for very long time investment or investment that is short period of time for current assets or fixed assets. Here also is the relevant question of nature of finance.

Nature of Business Finance in Points

i) Boost the value of the corporate : The principal objective of finance is to make sure to boost the value of the corporate. What this means is, that business finance assesses risks to figure out the best finance gains. A lot of thought goes into the nature of business finance, meaning, there are several aspects of study that need anyone to examine all facets of finance before making a choice that is obvious.

ii) Business shall spend money on others: As an example, investment relates to equity and just how to consider debt versus having to pay dividends or offering more shares. Current assets, cash, liabilities, inventories, and business financing, all have part in what choices that are economic made. A business shall spend money on others, even in the stock exchange to greatly help increase their holdings. Some businesses use investors to obtain an investment capital, to be able to cultivate and get ahead.

iii) Allocate finance to other departments: The role of finance manager / finance department is to allocate finance to other departments, and also advice for proper utilization of business finance. The nature of business finance management has under-gone changes which are profound of various facets. For example: policies of different governments or new policies is one of these.

iv) Consumers are part of the equation: Competition is another area that is imperative to decisions that are financial. Your competition determines, whether a continuing business is ahead or behind. To have ahead, it has a savvy individual to keep equilibrium between too much debt and growth that is just enough. Consumers are part of the equation that is financial but revenue produced from customers is minimal in some organizations. Finance is also about debt and exactly how to get around financial obligation dilemmas. Budgeting, accounting, plus much more are all involved in business finance.

v) Simple rising of finance: Financial management assumes the nature that produces that it is therefore by the market that is financial. For example, availability of business finance has

increased sufficient for this noticeable change, has changed the way nature of finance management. Simple raising of finance and its utilization that is now the nature of financial management.

To summarize, financial management is now to control the nature of business finance. An advisor in regards to finance to any business / company that is whole the prime duty of the finance manager in today's world. A budget has to be made, to ensure the company knows exactly what it can and cannot handle regarding growth, revenue and quantity of financial position, each year and every quarter.

1.7. SCOPE OF THE BUSINESS FINANCE

Scope means the sphere of research or research that is covered by the subject. The scope of Business Finance is hence the scope that is broad by this topic. A business, person or a company do need to run various number of programs to attain their goals. These programs require resources such as human resource, natural resources or financial resource. Effectiveness in the management of financial resource is a key to optimize making use of natural resource and scope of business finance. Business Finance studies, analyses and examines, allocates funds and many other fields covered under scope of business finance functions. Let us see some of them are:

i) Analysis and Research of Financial Statement:

Analysis of financial statements an another scope of business. However, it analyses the situations which can be financial problems that arises in the advertising of the business firm. This financial statements cons the aspect related branding new business, administrative difficulties when it comes to expansion, necessary adjustments for the rehabilitation of the company in difficulties.

ii) Financial Planning and Controlling:

Any business or company must manage and make their analysis that is good financially. The financial manager should have knowledge about the present financial situation of the firm to make these financial planning and management accordingly. On the basis of these financial information, one should make appropriate plans for fu e financial situation associated with the company as well. Financial budget is a key area to control over financial plans. The firms on such basis as budget, finds out the deviation between the plan while the performance and tries to improve them. Hence, the scope of business finance is composed of financial planning and controlling.

iii) ***Capi Structure Management:***

Making financial decision related to long-term assets is known as long-ter investment decision or capital budgeting. This scope of business finance notes is related to an inve ent proposal out of the many related alternatives offered to the company. Here, e capital structure management technique measures the worth of this investment proposal, analysis the uncertainty and risk, as the returns from the investment proposal extends into the future

iv) Raising Capital:

Making capital opportunities is probably one of the most important and critical scope of business finance. The business finance has to raise money from the company with the assistance of sources like stocks, debentures, banks, monetary organizations, creditors etc.., a

business might also choose to sell shares to equity while raising long-term funds for company expansion to enhance the finance. Balancing business financing is a act that is delicate.

Investing Capital:

There are two main kinds of corporate finance, working capital and fixed capital. As the name suggests working capital is generally used to purchase raw material and manage day to day fixed expenses like salaries, overheads etc. Whereas fixed capital can be used to purchase fixed assets like land, building, machinery, property, etc. while Financing and investing decisions are like two edges of a same coin.

vi) ***Managing / Monitoring Finances and Risks:***

Monitoring finance is a technology, there is certainly a solution to it, it's not a simple job at all. It requires many tools and techniques. Corporate finance has to control and manage the finance of the business, they should minimize the risk of investment and at the same time guarantee maximum returns in the capital that is spent.

vii) ***Finance Management:***

Managing financing is just one more crucial area in the scope of business finance. The management of finance is worried with the mix of assets or structure associated with assets of the firm. The firm should mix the ratio correctly of equity capital and debt finance while investment. As capital structure is the ratio of equity and debt capital. Now, the capital structure comprising the ratio that is proper of and equity is recognized as optimum capital structure.

viii) ***Working Capital Management:***

Making financial decision with reference to present assets or short-term assets is well known as working capital management. Short-term success is a necessity of long term success and also this could be an important scope of business finance. Hence, the efficiency in the management of working money ensures the balance between profitability and liquidity.

ix) ***Dividend Management:***

Business finance also analyses the policies concerning the dividend, book and depreciation. every dividend choice is made on the basis of financing decision of the firm. The company should determine, how much of revenue should be distributed among shareholders as dividend and how much should be retained as earnings. Here, the monetary supervisor should develop a dividend policy that is sound.

1.8. SIGNIFICANCE / IMPORTANCE OF BUSINESS FINANCE

There is a significance of business finance or you can say as importance of business finance which gives companies, the money that is needed to expand, begin operations and hire professionals, etc. When a continuing business has an idea for the new product / product or service that fills a need in a community, this individual might move to business financing to bring the idea to reality. There are specific loans that are designed based on small businesses, mid-size company or a large company.

Importance of business finance is inescapable part of any company and efficient financial decisions are essential for success and growth since it involves the management of financial activities and financial resources of the company. Mostly team of accounting and finance professionals or the finance department generally handles it. You can go through out financial

courses to gain an understanding also to keep up to date with changing trends, technologies and legal challenges.

When businesses increase and hire a greater number of individuals, it benefits a grouped community and plays a vital role in the economy of the country as well. An increase in the number of businesses also lead to increase in government revenues through direct taxes or indirect taxes. The speed at which funding and investments are applied to company is one of the indication of the success of the business. Subsequently, the significance of business finance can be proven in the fact economic policymakers / financial investors in an area think about this activity when making decisions that affect the region that is entire.

i) Initial Investment / Capital

It really is popularly said that money is needed for earning profits. To begin the activities of the continuing business, capital investment is foremost required and every company knew the significance of business finance. For suggestions to materialize and become products services being/ groundwork for sales, product testing, marketing, etc. seed money is essential. Businesses have a make some hardcore decisions to choice that is determining debt and equity funding.

ii) ***Debt Ratios***

Importance of business finance are more significance than money in your hand. Many businesses have some level of debt, mostly in the startup stages. Excessively debt contrasted with revenues / profits and assets can leave you into much bigger problems than making your loan repayments. Vendors and suppliers usually run credit checks and may restrict what you can buy on credit or keep payment that is tight. Debt ratios can affect your capability to attract investors including venture capital firms and to acquire or rent area that is commercial.

iii) Managing Operation Expenses

For the short-term, businesses require finance in the type of working capital to meet operational costs such as for instance remunerative payments, raw materials, inventory, interest repayments, etc. An importance of business finance is to make proper short-term financial planning decisions as good finance flow is vital to keep the operations consistently ongoing. Though maintain money that is adequate is always important, it's especially important in the starting stages since profits takes some time to match the cash outflows.

iv) ***Asset Creation***

In the long-term, finance is required for buying assets like machinery, land, equipment, etc. to expand the production scale. Scaling up production will create assets, help the business grow and penetrate areas that are current. The business must have capital that is enough doing so and cannot be determined by short-term finances because of this. Either they must have savings or should know the importance of business finance and able to raise and infuse capital investment through equity or debt financing.

v) New Products and Opportunities in the Markets

There is significance of business finance and appropriate financial management that is also important to an established company will maybe not manage to explore more opportunities in the markets or develop and test newer solutions / items without finance. Finance has a great importance in business as it is required for research and testing purposes as well in terms of advertising and marketing purposes.

vi) ***Business Cycles***

No matter how well your business is doing, you need certainly to get ready for rainy days as well as storms. Business and cycles that are economic dark clouds you can't predict. Business cycles of growth, boom, recession, depression and renewal caused by changes in the economy and other factors that are outside a real possibility. And regardless of how well it is doing, the continuing company is bound to bear such consequences and should be ready to face these cycles. That's why businesses which are smart economic plans for downturns. Cash savings, good credit, smart investments, and favorable supply and property plans will help a business stay afloat or even maintain momentum when the business growth are unfavorable due to economic crisis.

1.9. KEY CONCEPT OF BUSINESS FINANCE

The concept of Business financing is just like what it appears: the activity of funding the many aspects of a continuing business, whether the funding be for beginning a business, running it, or expanding it. Aside from the size or form of business, you can find fundamental questions financing that is involving must certainly be addressed.

Most organizations buy number of products, for example: buildings, equipment, or workplace furniture and equipment, that are meant to be useful for a time that is very long. Such things are called investments that are long-term. Any business making investments that are long-term carefully think about what those investments will be, just how much they will cost, and how much they will hold their value over time. Just as important is the relevant concern of where you'll get the amount of money needed to pay for them.

In the meaning of Business Finance it indicates that each time a business is simply starting, it typically borrows money from banks or other non-banking financial institutions, or it brings in additional individuals or investors to fairly share ownership in the business in order to procure the first money it needs to protect the costs to build a business that is brand new. Capital is the expression given to the money or other things of worth that are needed to create products or solutions. Money can take the proper execution of human resources, goods and products by way of financial trade. Examples of capital are factories, workplace, skilled labors, tools, machinery, money, etc.

When businesses are up and running and handling the everyday operations being monetary it may likewise turn to banks and investors for financing, however it typically relies on its customers for producing the money needed seriously to finance business. If the company is profitable plus the company saves a number of the cash it generates from commercial activity, it may use that money to make investments being new will further expand its business. There are numerous practices that are very different usage to obtain the financing they need to fund large projects and to boost their profitability.

1.9.1.Primary concept of business finance is categorized into four different groups.
They are:
i) Investment Decisions
First we have the investment decisions, which usually always taken based on the study that the company makes on the assets which will make the investment.

ii) ***Dividends Decisions***

The second group of decisions on dividends, and in this particular case it is important to note that you must balance all the crucial aspects of the company. In a way, this implies remuneration in terms of equity of it and moreover it is limited to the organization of financial resources which you can use.

iii) Financing Decisions

The third group is that of financing decisions, where the different ways to obtain the funds required so that the company can own assets in which you want to invest are studied.

iv) ***Managerial Decisions***

The fourth and last group corresponding to business finance is of managerial decisions, which are directly relationships with operational and financial decisions that are made every day.

1.10. SUMMARY

This lesson has provided you an overview of Business Finance in a business entity. It reveals the meaning and features of Business Finance The Scope, Nature and Importance of Business Finance is covered in this lesson It explain the concept of Business Finance The management of company's financial resources is one of the areas of business competence that incorporates the management of one's own personal finances. A objectives of business finance such as borrowing, investing, lending, and saving are all part of the process of managing one's financial resources.

So to conclude, finance could be the bloodline of any continuing business, it is required in most kinds of small or big setups, development, expansion and diversification of a business. It is required across all phases in the company life-cycle, to initiate, build stability, survival, and also in the development phase. These are some of the key features and various scope of business Finance functions. Though this key list of scope of Business Finance is limited. Some of other scope of business finance notes are also related to research of regulation and control, revenue management, study of financial assistance.

Here we have learned importance of business finance in businesses. You should read more courses for significance of business finance professionals, courses for business at our online financial tutorial courses which will assist you to understand and get skills in financing management, forecasting and financial planning.

The profitability and risk of a company's operations are both influenced by financial decisions made by the company. The use of extra debt can also increase a company's profitability, but greater debt entails a higher level of uncertainty. The aim and definition of business finance by different authors is to strike a balance between risk and profitability that will ensure that the long-term value of a company's securities is maintained.

1.11.TECHNICAL TERMS :

Business : Business is the activity of making one's living or making money by producing or buying and selling products (such as goods and services).

Finance : Finance is a broad term that describes activities associated with banking, leverage or debt, credit, capital markets, funds, and investments. Basically, finance represents the getting, the spending, and the management of money.

Investment : An investment can refer to any mechanism used for generating future income. This includes the purchase of bonds, stocks, or real estate property, among other ...

Initial Investment : An initial investment is the starting amount of money that it takes to either open an account or establish a buy-in relationship.

Business Cycles : A business cycle is the periodic growth and decline of a nation's economy, measured mainly by its GDP.

Dividend : A dividend is a distribution of profits by a corporation to its shareholders. When a corporation earns a profit or surplus, it is able to pay a proportion of the profit as a dividend to shareholders. Any amount not distributed is taken to be re-invested in the business (called retained earnings).

1.12.SELF ASSESSMENT QUESTIONS :

1) Define Business Finance ?
2) What is the Meaning of Business Finance
3) Explain the Characteristics of Business Finance.
4) What is the nature Business Finance.
5) What is the scope of Business Finance ?
6) What is the Importance of Business Finance?
7) What is the primary concept of Business Finance?

1.13.SUGGESTED READINGS

I.M. Panday: "Financial Management " Vikas Publishing House (P) Ltd

Chandra, Prasanna "Financial Management " Tata Publishing House Ltd, New Delhi

S.N. Maheswari : "Principles of Financial Management " Sultan Chand, New Delhi

Sheeba Kapil : "Financial Management " Pearson, 2011

P.V. Kulakarni: "Financial Management " Himalaya Publishing House Bombay

Khan & Jain : Cases in "Financial Management " Tata Publishing House Ltd, New Delhi

LESSON-2
BUSINESS FINANCE: TYPES, SOURCES, FUNCTIONS & PRINCIPLES

Aims and Objectives

After studying this lesson you should be able to:

- Know the Finance Functions of Business Finance
- Discuss various Objectives of Business Finance
- Understand the various types of Business Finance
- Explain the sources of Business Finance

Structure

2.1 INTRODUCTION

Entrepreneurs or fast developing firm must set financial management goals and business finance objectives in order to succeed in their venture. A wide range of objectives, including monetary targets, are set by business owners in order to develop a strong plan for moving their organization in the direction of long-term success. Business Finance is responsible for allocating resources, creating forecasts, reviewing opportunities for equity and debt financing, and other concepts and functions of business finance. The growth and success of your business is greatest whenever there are principles and procedures to followed. As a whole, functions of business finance notes represents backbone of your organization. Functions of business finance is that task that will be concerned with the acquisition and conservation of capital funds in fulfilling the financial requirements while the objective that is general of business enterprise.

For entrepreneurs to create a successful company, it is vital that they have well defined business goals, vision statements, and mission statements. For the uninitiated, it is the result that the firm hopes to achieve in the short and long term. It is necessary for business owners to identify a variety of corporate objectives, and one of the most significant is financial business objectives that are consistent with a strong long-term plan. An organization's financial objectives might include a variety of objectives. Setting goals and goals is vital for any growing company. Companies set various types of goals, including objective of business

finance, to give them a plan that is solid transferring the way of long-term success. Let's understand financial objectives of a business organization in detail below:
Every successful business needs finance to expand their business to international level. Business need finance to pay for operational expenses, salaries, equipment, marketing and many more areas for business expansion. It is extremely important for a businessman to have knowledge on different types of business loan available in the market and which is best suitable for his business at current situation. The health of the company is decided by the type of business finance opted by the owner of the company. Let us see here various different types of business financing that can assist you in keeping your business in good health.

For a businessperson or entrepreneurs, to find the sources of business finance is the most important aspect when starting a business or a new venture. It needs the maximum effort and dedication. The sources of business finance are categorized based on ownership, time, period, and control, etc., evaluate, and used in different situations. Business finance is the funds required to establish, operate business activities, and expand in the future. Funds are specifically required various purchase type of tangible assets such as furniture, machinery, buildings, offices, factories, or intangible assets like patents, technical expertise, and trademarks, etc. Apart from the assets mentioned above, other things that require funding are the day-to-day operational activities of a business. This activity includes purchasing raw materials, paying salaries, bills, collecting money from clients, etc. It is essential to have sufficient amount of money to survive and grow the business.

2.2. TYPES OF BUSINESS FINANCE

What are the types of business finance? Are you looking for types of business funding or types of business financing or business finance types, then let me tell you all this different types of business finance are similar. Here we are going to discuss about business finance types in detail let's check it out. The Types of Business Finance are as follows: 1. Debt Finance 2. Asset-Based Lending 3. Equity Finance 4. Mezzanine Finance 5. Capital Raising Funds 6. Relatives and Friends 7. Angels Investor 8. Personal Equity Placements

i) Debt Finance

Debt financing does perhaps not give the financial institution ownership or control, nevertheless the principal must be paid back with interest. Security and other terms rely upon for what the loan is being used. For example the banks normally uses credit scoring techniques that assist with these type of business financing applications. The determining criteria include credit rating, the applicant's track record in operation, past bank account management and willingness to invest their very own money in the commercial, and proof of repayment ability based for a business plan. What types of debt are available to finance a business? Mainly there are 2 types of Debt Financing, they are:

A) Short-term: These types of business finance loans for (30-180 days) short periods usually built to cover short-term or seasonal needs for inventory or personnel. These are common for established businesses, but can be hard for a business that is new obtain. The key to getting financing that is short-term to will have an identified primary and secondary way to obtain payment. A loan that is short-term most likely be either a time loan or a line of credit, both with maturities of one year or less. These kind of loans often possess the characteristics that are following

B) Medium to Long term: These type of business financing have tenure for loans may be repaid over 1 to 5 years or sometime also decades depending on the type of business finance. The source of repayment is the cashflow associated with the company. Typical uses are for equipment, fixed assets, etc. Most loans to start a company that is small be of this type. Also known as term loans or loans that are installment these usually cost more than short-term credit. The most common uses for long-term loans are to provide capital that is to buy building or build land or purchase equipment's.

ii) Asset-Based Lending

Asset-Based Lenders are one of the type of business funding which provide a variety of financial services to small, medium-size, and large organizations through: loans for machinery and gear, property, leasing, secured lending against the assets of an organization, import-export financing, acquisitions, etc. Today's business that is small must understand all forms of financing, whatever they can do, why one technique may be better than another type of business finance, and where enough funds could be discovered. Given the credit that is highly managed faced by banking institutions it only is reasonable to maximize knowledge of lending options for your needs. Businesses which are small familiar with bank lending will find an asset-based lender capable of structuring similar loans and lending agreements with a willingness to take slightly more risk. Virtually any type of loan a bank can make could have a corresponding lending option that is asset-based.

iii) Equity Finance

In its many form that is basic equity financing outcomes in the repayment of principal and/or return only if the venture produces sufficient funds for that function; thus the term risk capital is involved in these types of business finance. Because of the risk(s), the business finance that can be done could be anybody, anywhere, anytime according to the amount, purpose, and phase of business at problem. Equity financing will always require consideration of profit, ownership, advantage sharing, management and operation control, valuation, and exit methods as crucial problems become carefully examined. Although equity financing can cover an array that is wide of supply types of business financing, there are, in general, several overall groups. The summaries that are following help you in the equity search.

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iv) Mezzanine Finance

Mezzanine finance is just a hybrid type of business finance solution of equity and debt financing that is typically used to finance the expansion of existing companies. Mezzanine financing is basically debt capital that provides the lender the rights to convert to an ownership or equity interest in the ongoing company if the loan amount isn't repaid in give amount of time. It really is generally speaking subordinated to debt provided by senior lenders such as banks and venture money companies.

v) Capital Raising Funds

This type of business funding for Venture Capital is provided by wealthy individuals of the country, investment banks along with other institutions that are financial as Finance Wales. This kind of funding is generally in the kind of equity. VC's (Venture Capital) are going to be requiring returns that are significant their investment and an exit path normally in just a period of 5 years. Roughly 500+ financial institutional firms represent sources of equity

financing involving investment approaches which are typically characterized by specific, often demanding investment criteria for their funding interest, outcome in significant due diligence investigations, and can require ownership sharing that is significant. The majority of this capital source is focused to more developed enterprises with few start-up or stage that is early. Of the equity that is whole for small businesses, venture capital funds represent less than 5 per cent.

vi) Relatives and Friends

For most start-up situations or stage that is early, capital is typically generated by friends or loved ones. Although needing less in the real type of business financing of written company materials and perhaps more available, there are substantial risks beyond economic factors which should be seriously assessed, maybe not the least of which may be disrupted relationships if the company not perform needlessly to say. Expert help group, and significant due diligence investigations are not characteristic of this type of business finance since the funding primarily results from the personal relationships included, complete business plans. Ownership sharing might or may not be needed. Many family members will come into an understanding through the use of a simple note that is promissory.

vii) Angels Investor

Angels represent a financial market of specific investors and company entrepreneurs or individuals whom may or may not constant the business investment area that is very small. Access of these type of business finance may be through any continuing company contact, but is usually the consequence of expert sourcing through a financing consultant, lawyer, accountant, and/or other form of business adviser. A solid company plan with professional support is usually needed to achieve an investor convenience zone which also usually includes diligence review that is due. Danger assessment and pricing are usually the issue that is major as opposed to ownership sharing.

viii) Personal Equity Placements

This type of business finance is susceptible to several regulatory and demands that are legal. Accordingly, direct support and continuing the help of a professional team of financial, legal, and accounting adviser's is needed to assemble the necessary written materials and establish an effective marketing plan that is financial. A company that is complete is important and homework should be expected. Ownership sharing and valuation may be issues that are significant. This type of business financing is extremely effective and quite efficient. It can take place in a variety that is wide of and will even involve direct competitors in teaming arrangements. Sourcing is generally with expert business financing and business advisers needing a good professional help team, and business planning that is solid. The following are the Sources of Business Finance revealed in this lesson such as:

2.3. SOURCES OF BUSINESS FINANCE

Key important and primary sources of business finance is the fact that associated with the owners of business. Hence, for almost any continuing business owners, there are two main sources of business finance, that is, funds contributed by owners, and funds available from loans and credits. She/he might also borrow funds on her/his security that is personal or security of assets. Likewise, the capital of a partnership firm consists partly of funds

contributed by the partners and partly of borrowed funds. If necessary, they may also decide to reinvest their own shares of revenue.

On these sources of business finance notes, we've come up with a list of Top 10 – Best Sources of Business Finance for small business start-ups as well as source of business finance for entrepreneurs to simply help you to make that right decision for your business: Best Sources of Business Finance for Small Business / Startups: The following are the Sources of Business Finance revealed in this lesson such as: 1. Corporate / Business Credit Cards: 2. Institutional Finance: 3. Business Funding via Personal Assets: 4. Merchant / Business Cash Advances: 5. Crowd funding: 6. Bank Loans: 7. Invoice Factoring: 8. Issue of Shares: 9. Issue of Debentures: 10. Retained Profits:

i) Corporate / Business Credit Cards:

A small business credit card is a very convenient sources of business finance in effort to finance some company expenses. because of its convenience; its physicality can leave your business susceptible to fraud or theft. It can be a source of business funding that is risky for your business sometime. Firstly, credit cards are expensive as interest is usually high and can accumulate quickly if the balance are not repaid within specific time. Credit cards is also generally better ideal for small funding for your business. A credit card is a reasonably quick and way that is convenient of funding when you need it on urgent basis. It's not particularly hard to apply for credit cards plus it's unsecured so none of your assets will soon be at risk.

ii) Institutional Finance:

Institutional finance is also known as institutional sources of business finance to company or business, other than commercial banks. These non-banking financial institutions / companies act as a third party between business owners and investors, but are distinct from commercial bunks. These financial institutions offer finance and financial solutions in areas which are outside the traditional source of business finance that is mmercial banking. This kind of source of business funding can be obtained by Public Financial Institutions (PFIs), Non-Banking Financial Companies (NBFCs), Investment Trusts and Mutual Funds (ITMF).

iii) Business Funding via Personal Assets:

Using your personal funds is a way that is direct finance your business. This can be done by using your cost savings toward company expenses, taking out a line of credit on your own house, cashing out retirement accounts and money that is borrowing friends or family. The Small Business Administration highlights that most companies that are new personally financed. If it is an option which you have significantly more control of the repayment options for you, the upside to funding your own personal company is. This is one of the common sources of business finance for small business startups you will mostly observe it. For instance, having to pay a back that is general be negotiated, whereas when you obtain cash from a lender you are bound to its payment terms.

iv) Merchant / Business Cash Advances:

A Business Cash Advance is just another source of business financing that is short-term that's designed especially for businesses who take card repayments. Those seasonal businesses who encounter highs and lows throughout the year or those who need short term business funding

that's simple to repay. As opposed to making repayments as being a fixed cost that is month-to-month you'll pay back as an agreed percentage of your customer card takings, meaning you'll only pay to supplier only when your customers pay you.

v) Crowd funding:

Crowd funding has grown to be a sources of business finance for small business startups that is ever more popular businesses to improve finance for brand new projects and ideas. You can subscribe to a crowdfunding website, tell your story and what you would like to quickly attain, and then set a target money objective how it works is simple. It's then up for your requirements to effectively promote your campaign to encourage donations. This kind of source of business funding is readily useful for existing businesses with exciting task plans or start-up businesses with big ideas and projects. Perhaps there's no guarantee you're going to improve all of the funds you're seeking. And you'll need to purchase telling your story, as unless your campaign goes viral, acquiring those funds is likely to be always a process that is slow.

vi) Bank Loans:

A bank loan is the most form that is traditional of finance. Essentially, a bank will loan a business money based on its value, company plan and the observed power to pay the loan back. A bank loan is just a reliable, trusted and best sources of business finance for entrepreneurs as well for small business. Banking institutions can lend out high sums of money over longer terms with reasonable interest rates. These source of business funding can be used in making purchases, or expanding a company and more. The challenging part is their terms and conditions offer are frequently rigid, and the loans by themselves can be difficult to obtain with no significant track record or security that is valuable.

vii) Invoice Factoring:

Invoice factoring is really a sort of debtor finance where a business sells its open invoices up to a factoring company for an amount that is reduced can be obtained immediately. Basically, you'll be advanced funds whenever your company issues invoices which can be new sources of business finance the factoring company will get payment of that invoice. This kind of source of business funding is suitable for those businesses who have actually issued invoices and in are need of funding for everyday expenses to steady keep income. Invoice factoring is a borrowing solution that is flexible. The quantity that the continuing business can borrow increases as sales increase. In addition, the mortgage is unsecured, meaning your home won't be at risk ever, like it may be with a bank loan. Perhaps factoring can be risky. The factors legally own your financial situation, meaning that the invoices you raise count as their assets.

viii) Issue of Shares:

The total amount of money decided to be raised from members associated with the public is divided into units of equal value. These units are known as shares therefore the value that is aggregate of is known as share value of the company / business. Those who subscribe to the share capital become members associated with ongoing company and are known as shareholders. They are the best component owners of the company. Hence, stocks will also be described as ownership securities. These sources of business finance for entrepreneurs are

of two types may be released by an ongoing company to raise capital they are called equity shares and preference shares.

ix) Issue of Debentures:

Debentures are source of business finance for raising term debt capital that is long. Whenever a business decides to increase loans from the public, the quantity of loan raised from the issue that is specific of is divided into units of similar value. A debenture certificate issued by the ongoing business to acknowledge its financial obligation to repay the debts. Those who invest cash in debentures are known as debenture holders. These are typically creditors associated with company. Debentures are, therefore, called creditor-ship securities.

x) Retained Profits:

The total amount that is total of capital of a company could be dependent on adding the share capital and accumulated reserves. Businesses may convert reserves and surplus into share money by issuing bonus shares. From the ongoing company viewpoint, bonus shares are issued without any cost plus don't result in almost any outflow of money. Investors too are benefited by issuing shares for free of cost.
These kind of sources of business finance notes is useful in certain industries such as pharmaceuticals research and development tasks are of vital value. Constant innovation and products that are new essential for survival. Funds for these purposes are available away from retained earnings. This source of business funding is helpful to finance for new projects and expansion plans are essential areas for the long term. Retained profits prove useful times that are such. Since profits participate in the shareholders, retained profit is considered to be an ownership investment. It serves the purpose of medium and term finance that is long.

2.4. FUNCTIONS OF BUSINESS FINANCE IN AN ORGANIZATION

In general, some small businesses may well not have a finance department, but nevertheless big event does perhaps not exist in-house, you might rely on advi from outside sources for appropriate decisions describe the function of business finance. People gain knowledge of monetary concepts as kids. When parents ask their children to complete some different things in return for an allowance, this transaction that is financial transaction. Fast forward 20 years, and you've traded different things for your own business. Now, you're relying on another kind or kind of fiscal entity: business finance. While business finance still takes care of your allowance, they serve many other functions that are crucial can assist business recognize growth.

The following are the functions of business finance such as : 1. Financial Goals 2. Financial Planning 3. Managerial Functions 4. Business Finance Formula's 5. Forecasting 6. Budgeting 7. Misconceptions and Considerations 8. Initiate Reality Check 9.Manages Payable and Receivables 10. Manage Accounting.

i) Financial Goals

Every business has a bottom-line because every business has objectives. Functions of Business finance helps companies define their objectives by setting financial goals, a business will know if they're remaining stagnant whether they've reached the threshold of profitability. The reason is that without well financial plans which are strategic organizations

might possibly not have that knowledge on how to achieve profitability. Because strategies and techniques are the backbone to the ongoing company's goals, finance is tasked with the obligation to meeting the bottom-line goal of business finance.

ii) Financial Planning

Financial planning is a key functions of business finance that could be the procedure of determining how much reserves the company should keep for a rainy day, how much money is required for a business to operate on, how a company will receive the money (loans, income) and exactly how that money should be spent and allocated through the organization. Budgeting is really a type that is popular of planning tool. Business finance creates budgets through forecasting efforts. Budgets are ready on spreadsheets containing line items, which represent buck values for how much money will undoubtedly be budgeted for that expense that is particular. They're especially helpful for keeping task that is financial track, as well as gauging a company's spending and saving practices.

iii) Managerial Functions

There are some of the essential concepts and functions of business finance in an organization decisions of a finance manager. Financing Decision: the next function of the business financial manager is to determine about the allocation of dividend among its stakeholders. In this full case, retained earnings may also be considered. Long-term Capital Investment: Capital budgeting can be involved for investing in term project where the next things are thought: general assets and cost, expected the return that is future the risk of expected return, cost of money. Short-term Capital Investment: in this instance investment is manufactured in current assets for one or lower than one. Investment decision: Investment decision is taken by valuing projects that are different expected the return and danger are considered. Investment project or assets could be divided into two categories:

iv) Business Finance Formula's

Generally, business formulas offer certain information pertaining to investments made for growth opportunities and business operations. Each formula can help you compare the cost that is total of decisions that can impact your organization financially in terms of profits or losses. Formulas are commonly used in various functions of business finance to determine specific things like net present value, return on investment, payback period and more. This formula is important to assist you ensure the viability that is long-term of organization.

v) Forecasting

Forecasting is a type of forecast that determines exactly what a company's future financials will look like. For example: company's product sales volumes will be and what forms of capital expenses they could have. Stakeholders and investors are particularly interested in financial forecasts as this data will inform them of whether company will likely be profitable or not. If forecasts do maybe not seem financially promising, financial risk is elevated and stakeholders could withdraw their investments if the return on investment isn't in their favour. Company professionals may then use forecasts to develop brand new strategies that might help the business understand more growth that is future.

vi) Budgeting

Financial planning leads to the functions of business finance, which is budgeting. Budgeting is a popular planning that is financial that comes from forecasting efforts. Generally, you prepare budgets with numerous line items that represent the rupee value of how much money is allocated for the cost that is particular. Most organizations find that creating and adhering to a spending plan is useful in maintaining task that is financial track. Exactly like in individual finances, a budget will gauge spending and saving practices that may help or hinder objectives that are economic.

vii) Misconceptions and Considerations

As a whole, you should not count solely on formulas when you require to create business decisions such as assessing growth that is brand new. A qualitative analysis can round out the decision-making process by including expertise and individual experience for some companies. You can use survey results or any other type of non-measurable information. With qualitative analysis, you apply subjective information that cannot be quantified when determining an opportunity. Rather, an additional analysis tool might provide you with a greater amount of comfort once you come towards final decision.

viii) Initiate Reality Check

The thing that is great business finance is that mathematical or statistical formulas can create factual economic results associated with business information. Internal business formulas are typically based on ways to eliminate waste and maximize production output in operations. For external company finance formulas, you examine potential opportunities that are connected with goals and objectives. You can even establish facts based on present conditions that are economic whether the marketplace is ready for the product or plan.

ix) Manages Payable and Receivables

Using business finance to manage payable and receivables is a component that is natural of your organization. Generally, you will have a finance department to manage cash inflows and outflows. Creditors, vendors and employees expect prompt repayments. You need the quantity that is right of to keep operations running smoothly.

x) Manage Accounting

Depending on the complexity and size of your organization, the bookkeeping process is quick or long. One of the important functions of business finance is that you can have a process that is simple chronicle financial transactions that occur, or you might have a complicated system to record, evaluate and interpret day-to-day deals.

2.5. PRINCIPLES OF BUSINESS FINANCE

Business finance is a term that means a variety that is wide of and disciplines revolving across the management of money as well as other valuable assets. Business finance programs in universities familiarize students with accounting methodologies, investing strategies and debt management that is effective. Business owners need to understanding that is solid of principles of finance to keep their businesses profitable. When you are starting a business, it is important to manage business finance and personal finance. Money must be kept separate so that it is easier to track that personal funds are not used in business expenses.

i) Take Separate Accounts:

Business finance and personal finance to maintain the home and the family must be managed discretely. This confusion arises when making payments of taxes and other legal responsibilities, helps to account for the money that belongs to the business are avoided, and helps you keep track of how and where the money is spent. Carrying separate accounts also shields personal appeals against debts and business expenses, if it fails to succeed.

ii) Ways of keeping Accounts Separate:

It is good to have a separate bank account for the business. It is easier to control business costs if managed from a single account, and a clear idea about the income. Keep the money in a safe place. Ask other business owners to do the same. Open an account with banks having great savings plans. Adopt a good accounting system that permits control of your expenses. Talk to owners of prosperous businesses and ask about the accounting systems that provide them with good results.

iii) Pay a Salary and consider it as a Business Expense:

Decide in advance how much you want to invest personal savings in the business. Set a static limit that will help you determine whether or not it is worth investing money in that business.

iv) Do not misuse of Business Funds:

As a business proprietor, you might be interested to consider all gains it as personal income, but even if you know who manages the money, you should not treat it as your own, and that doing so could results in other risks. For example, if you start borrowing as collateral to the business then you cannot afford it; the company would be at risk, as well as investments of other people will be also at risk. Here are the precautions you should undertake when utilizing business funds. This will help you as a guide in how to manage small business finances.

v) Precaution Measures – Manage Small Business Finances:

If you need to borrow money for business, use the money only for the cost of this. Make clear that if the business throws more money than expected over a period of time, that money must be saved or reinvested. You and the other employees have fixed salaries and that should not change until there is a new financial business analysis.

vi) Advantage and Benefits of Personal Finance:

To open a business, then it offers some advantages offered to have personal resources in order. You know in advance how to spend with attention and maintain a detailed audit of revenue and expenditure. It is likely to ensure a strong credit history and a good reputation because it has managed money dutifully, which can help you get support for business. If you ever need a loan, and have a record of your finances; present your finances in order before a bank will help you increase your chances to be eligible for a loan. It will be easier to set aside money from their savings to support family while starting the business or generate savings from business finance.

2.6. ELEMENTS OF A COMPANY'S FINANCIAL REPORT

The six main elements of a company's financial report give a good summary of the company's financial health and its performance over the most recent reporting period. Companies prepare financial reports to inform their owners, shareholders, board members, management and regulatory authorities about their financial position, and to highlight financial difficulties the company may be experiencing. The financial report tells them whether the company is viable and how profitable it is.

i) Assets

The section of a company's financial report on assets lists items that the company owns and controls that have a future value. Assets include physical property such as factories, office buildings and equipment as well as financial assets such as accounts receivable. Assets may also include intangibles that have value, such as trademarks, brands and patents.

ii) Liabilities

Another major element of a financial report lists liabilities, which are company obligations toward other organizations or individuals. The list of liabilities consists of items that will cost the company money in the future. It includes short-term obligations such as accounts payable, rent that is due and hasn't been paid, back taxes and payrolls that haven't been paid out yet but for which the work has been done. Long-term obligations can include environmental costs, pensions and debt.

iii) Equity

Equity is the amount that would be left over if a company sold all its assets and used the proceeds to pay all of its obligations. This money belongs to the shareholders or owners of the company. It is made up of the money invested by the owners or shareholders plus all the profits and losses that the company has earned or lost on behalf of its owners or shareholders.

iv) Revenue

The financial report section on revenue lists cash inflows from operations. The company produces goods and services and sells them to customers, and the proceeds from these operations are revenue. Revenue excludes proceeds from the sale of assets when such a sale is not part of normal operations selling to customers. Proceeds from the sales of assets are listed as gains in equity.

v) Expenses

Expenses are cash outflows resulting from operations and overhead. Companies have expenses that they attribute directly to the generation of revenue, but they also have expenses independent of operations. Typical operating expenses are salaries for production workers, materials used in production and shipping. Overhead expenses are costs such as rent and management salaries, which generate cash outflows even in the absence of any operations.

vi) Profit or Loss

A key element summarizing company performance is the statement of profit or loss. Revenue minus expenses represents the company profit or loss for the reporting period. Profits can increase equity after adjustments for increasing assets by investing some of the profits or decreasing liabilities by paying off debt or accounts payable. Losses decrease equity by increasing liabilities if the company borrows to cover the loss. Profits or losses over several years affect the value of the company by increasing or decreasing total owner or shareholder equity.

2.7. SUMMARY

This lesson has provided you an overview of Business Finance-II in a business entity. It reveals the Objectives of Business Finance The following are the objectivities of business finance viz.,1. Revenue Generation 2. Profit Margin 3. Managing Operational Activities 4. Productivity and Efficiency 5. Sustainability 6. Customer Satisfaction 7. Return on Capital Investment 8. Employee Benefits 9. Emergency / Contingency Plans 10. Leadership and Management. The Functions of Business Finance is covered in this lesson. The following are the functions of business finance such as : 1. Financial Goals 2. Financial Planning 3. Managerial Functions 4. Business Finance Formula's 5. Forecasting 6. Budgeting 7. Misconceptions and Considerations 8. Initiate Reality Check 9.Manages Payable and Receivables 10. Manage Accounting. The Types of Business Finance are as follows: 1. Debt Finance 2. Asset-Based Lending 3. Equity Finance 4. Mezzanine Finance 5. Capital Raising Funds 6. Relatives and Friends 7. Angels Investor 8. Personal Equity Placements. The following are the Sources of Business Finance revealed in this lesson such as: 1. Corporate / Business Credit Cards: 2. Institutional Finance: 3. Business Funding via Personal Assets: 4. Merchant / Business Cash Advances: 5. Crowd funding: 6. Bank Loans: 7. Invoice Factoring: 8. Issue of Shares: 9. Issue of Debentures: 10. Retained Profits: It also explained the Elements of a Company's Financial Report.

2.8. TECHNICAL TERMS:

Profit Margin : Profit margin gauges the degree to which a company or a business activity makes money, essentially by dividing income by revenues. Expressed as a percentage, profit margin indicates how many cents of profit has been generated for each dollar of sale.

Sustainability : Sustainability refers to the ability to maintain or support a process Continuously over time. In business and policy contexts, sustainability seeks to prevent the depletion of natural or physical resources, so that they will remain available for the long term.

Forecasting : Forecasting is a technique that uses historical data as inputs to make informed estimates that are predictive in determining the direction of future trends. Businesses utilize forecasting to determine how to allocate their budgets or plan for anticipated expenses for an upcoming period of time.

Budgeting : Budgeting is the process of creating a plan to spend your money. This spending plan is called a budget. Creating this spending plan allows you to determine in advance whether you will have enough money to do the things you need to do or would like to do.

Budgeting is simply balancing your expenses with your income.

Mezzanine Finance : Mezzanine financing is a hybrid system of financing, which incorporates the features of equity and debt, both. It gives the lender a right to convert their debt into equity shares, in case of a default. Mezzanine debt is subordinated debt, and close to being the last to be paid off. It is senior only to equity shares.

Institutional Finance : Institutional finance means finance raised from financial institutions other than commercial banks. These financial institutions act as an intermediary or link between savers and investors. They provide finance and financial services in areas which are outside the purview of traditional commercial banking.

Crowd funding : Crowdfunding is a way of raising money to finance projects and businesses. It enables fundraisers to collect money from a large number of people via online platforms. Crowdfunding is most often used by startup companies or growing businesses as a way of accessing alternative funds.

2.9. SELF ASSESSMENT QUESTIONS

1) Define objective? Explain the Objectives of Business Finance
2) What is function? Discuss various Functions of Business Finance
3) What is Business Finance? Explain different Types of Business Finance
4) Discuss the Sources of Business Finance and also reveal the most useful source of finance in MSM organizations.
5) What is Financial Report? Explain the Elements of a Company's Financial Report.

2.10. SUGGESTED READINGS

I.M. Panday: "Financial Management " Vikas Publishing House (P) Ltd

Chandra, Prasanna "Financial Management " Tata Publishing House Ltd, New Delhi

S.N. Maheswari : "Principles of Financial Management " Sultan Chand, New Delhi

Sheeba Kapil : "Financial Management " Pearson, 2011

P.V. Kulakarni: "Financial Management " Himalaya Publishing House Bombay

Khan & Jain : Cases in "Financial Management " Tata Publishing House Ltd, New Delhi

LESSON - 3
ENVIRONMENT OF BUSINESS FINANCE

Aims and Objectives

After studying this lesson you should be able to:

- Know the Financial environment
- Understand the Forms of Business Organization

Structure

3.1. INTRODUCTION:

This lesson is divided into eight parts. The first part of it is revealed some aspects such as: financial system, public finance, Finance interrelated areas, Business Environment, Financial environment. It is introduced different forms of business organizations viz., Sole proprietorships, Partnerships, joint-stock company, Cooperatives, Corporations, Limited Liability Company in the second part of this lesson. Regarding Sole proprietorships and its merit and demerits is presented in the third part of this lesson. Advantages and Disadvantages of Partnerships, joint-stock company, Cooperatives, Corporations, Limited Liability Company is mentioned in the parts of fourth, fifth, sixth, seventh, and eighth respectively in this lesson.

a. Financial system:

The financial system plays a critical role in the economy. It enables the financial intermediation process which facilitates the flow of funds between savers and borrowers, thus ensuring that financial resources are allocated efficiently towards promoting economic growth and development. Finance is majorly divided into three segments: Personal Finance, Corporate Finance, and Public Finance. Basic financial management includes managing the day-to-day operations of a business and keeping within budget. It also includes making long-term investments in equipment and obtaining the financing for your operations. Best Banks for Small Businesses in 2022.

b. Public financing:

Public financing is very important, but it is just as important to realise that public support alone cannot be the only solution – it needs to play a catalytic role to attract private financing and to crowd-in private investors. Moreover, public financial support cannot remove the risk associated with innovation activity at the firm level – and it should not attempt to do so; however, public financing can be used to make the innovation phase more attractive to private investors. Innovation takes place in markets, and the market participants know best where the needs are and where technological developments are leading. Firms need finance to: start up a business, eg pay for premises, new equipment and advertising. run the business, eg having enough cash to pay staff wages and suppliers on time. expand the business, eg having funds to pay for a new branch in a different city or country.

c. Finance interrelated areas:

Finance consists of three interrelated areas: (1) money and credit markets, which deals with the securities markets and financial institutions; (2) investments, which focuses on the decisions made by both individuals and institutional investors; and (3) financial management, which involves decisions made within the firm regarding the acquisition and use of funds. Career opportunities in finance include positions in retail bank management, commercial lending, securities analysis, securities brokerage, commercial credit, consumer credit, and corporate financial management. Detailed information about these and other career opportunities in finance can be found on a CD-ROM entitled "Discovering Your Finance Career," which is available in the department office. Finance positions require not only knowledge of the three areas of finance, but also good analytical, quantitative, computer, communication and collaborative work skills. Departmental and finance concentration goals seek to enhance these skills.

d. Business Environment:

Business Environment is sum or collection of all internal and external factors such as employees, customers needs and expectations, supply and demand, management, clients, suppliers, owners, activities by government, innovation in technology, social trends, market trends, economic changes, etc. Six Major Components of Business Environment (i) Economical Environment: (ii) Social Environment: (iii) Political Environment: (iv) Legal Environment: (v) Technological Environment: (vi) Financial Environment

e. Financial environment:

The complete system of financial environment comprises of four important components. These include (1) financial managers (2) investors (3) financial markets and 4) Financial instruments. This chapter has provided depth insight on each of these components in detail and illustrates how they are integrated. A financial environment is a part of an economy with the major players being firms, investors, and markets. Essentially, this sector can represent a large part of a well-developed economy as individuals who retain private property have the ability to grow their capital. Firms are any business that offer goods or services to consumers. Investors are individuals or businesses that place capital into businesses for financial returns. Markets represent the financial environment that makes this all possible.

Historically, firms were very small or even nonexistent in economies or financial markets. Though a few firms have always been in existence, the ability for a large number of firms was not possible until markets became more mature. Mature markets allow for more access to resources necessary to produce goods and services. As firms begin to grow, expand, and multiply, higher capital needs to persist in order for firms to succeed. Capital sources include money from outside parties, such as investors.

Many times investors are individuals who have more capital than is necessary to provide a sufficient living standard. Any excess capital can actually make individuals more money if they invest the funds into a firm that offers a financial return. This symbiotic relationship in the financial environment allows both parties to increase their capital. Many different factors play a role for individuals making investments. A few of these may include risk, current market conditions, and competition, among others.

The last player in the financial environment is the market. Markets represent any place where sellers and buyers can meet together and exchange items. In most cases, the exchange is capital for goods or services. Markets may be local, regional, or international, depending on the economy. Free markets tend to have fewer government regulations, allowing for an increased exchange of goods due to lower transaction costs.

A financial environment can exist anywhere so long as the major players exist in the economy. Newer markets tend to have fewer resources and lower levels of economic activity due to their lack of resources. The financial environment is also subject to the business cycle, which dictates the stages of growth and decline in the economy. For example, when a new financial market or environment receives an influx of resources, it has the ability to grow and expand as the players see fit. Decline occurs when the market is saturated with goods and services due to a lack of demand.

3.2. FORMS OF BUSINESS ORGANISATION:

It is revealed different forms of business organizations viz., Sole proprietorships, partnerships, joint-stock company, Cooperatives, Corporations, Limited Liability Company. One of the first decisions that you'll have to make as business owners is how your business should be structured. You need to know the advantages and disadvantages of each of the different forms of business organization to make sure you're making the right decision for your new business. All businesses must adopt some legal configuration that defines the rights and liabilities of participants in the business's ownership, control, personal liability, lifespan and financial structure. The form of business determines which income tax return form to file and the company's and owners legal liabilities.

This is a big decision that has long-term implications, so if you're unsure of which form of business is best for your company, you'll want to consult a professional. Luckily, there are several business counselors and centers across Missouri offering free assistance in forming a business that are knowledgeable and ready to help.

3.2.1. When you're forming your new business, you will want to take into account the following: Your (practical) vision regarding the size and nature of your business.

i) The level of control you wish to have
ii) The level of "structure" you are willing to deal with.

iii) The business's vulnerability to lawsuits
iv) Tax implications of the different organizational structures
v) Expected profit (or loss) of the business.
vi) Now let's dig into the different forms of business organization.

3.3. SOLE PROPRIETORSHIP

A sole proprietorship is a business that can be owned and controlled by an individual, a company or a limited liability partnership. There are no partners in the business. The legal status of a sole proprietorship can be defined as follows: It is not a separate legal entity from the business owner. The vast majority of small businesses start out as sole proprietorships. These businesses are owned by one person, usually, the individual who has day-to-day responsibility for running the business. Sole proprietors can be independent contractors, freelancers or home-based businesses.

Sole proprietorships are available for individual owners (or married couples). Owners may want to consider other entity types for tax advantages. Some owners may prefer their simpler tax filing requirements with this business type. As well as the convenience of having less documentation requirements. Many owners may prefer complete control over their company. An owner should consider another entity type if they don't have enough wealth to start the company and do not want to take on the extra debt necessary to fund it. Owners should keep in mind that their personal assets are vulnerable to the risks involved in their company.

3.3.1. The following are the characteristics of a sole proprietorship:

i) Sole owner of the business.

Sole Owner. Any Holder (or Holders, provided they act in unanimity) holding 100% of the then outstanding Certificates (excluding the Class R and Class LR Certificates), or an assignment of the Voting Rights thereof.

ii) Unlimited liability.:

Sole proprietors and partners have unlimited liability. The unlimited liability means that if you're unable to repay the debts of the business, your creditors can go after whatever you own. So you could lose any of your possessions that would allow them to recover the amount.

iii) ***No legal entity***:

Since a sole proprietorship does not create a separate legal entity, the business owner faces unlimited personal liability for all debts incurred by the entity

iv) Sole decision maker:

Sole decision-making in a divorce case which involves a child means that only one parent has the legal right to make decisions with regards to how a child lives and is raised. It pertains to major matters such as education, health care, extra-curricular activities, religion, etc..
v) Can wrap up the business anytime.

3.3.2. Sole Proprietorship Advantages

i) Owner receives all the profits
ii) Profits are taxed only once
iii) Owner makes all decisions and is in complete control of the company (could also be a disadvantage)
iv) Easiest and least expensive form of ownership to organize

3.3.3. Sole Proprietorship Disadvantages

i) Unlimited liability if anything happens in the business. Your personal assets are at risk (including your home in Missouri)
ii) Limited in raising funds and may have to acquire consumer loans
iii) No separate legal status

Tip: When looking at setting up a sole proprietorship, assess what type of liability you have. If you're selling advice or services, you may need an errors and omissions insurance policy to cover yourself against claims for negligence. Determine what you have to lose. Do you own a home or savings account? Your personal assets could be at risk in the case of a lawsuit.

3.4. PARTNERSHIP FIRM

A partnership is a kind of business where a formal agreement between two or more people is made who agree to be the co-owners, distribute responsibilities for running an organization and shares the income or losses that the business generates.
In India, all the aspects and functions of the partnership are administered under 'The Indian Partnership Act 1932'. This specific law explains that partnership is an association between two or more individuals or parties who have accepted to share the profits generated from the business under the supervision of all the members or behalf of other members.

3.4.1. Features of Partnership:

Following are the few features of a partnership Such as: a) Agreement between Partners: b). Two or More Persons, c). Sharing of Profit, d) . Business Motive, e). Mutual Business, f). Unlimited Liability

a) Agreement between Partners:

It is an association of two or more individuals, and a partnership arises from an agreement or a contract. The agreement (accord) becomes the basis of the association between the partners. Such an agreement is in the written form. An oral agreement is evenhandedly legitimate. In order to avoid controversies, it is always good, if the partners have a copy of the written agreement.

b). Two or More Persons:

In order to manifest a partnership, there should be at least two (2) persons possessing a common goal. To put it in other words, the minimal number of partners in an enterprise can be two (2). However, there is a constraint on their maximum number of people.

c). Sharing of Profit:

Another significant component of the partnership is, the accord between partners has to share gains and losses of a trading concern. However, the definition held in the Partnership Act elucidates – partnership as an association between people who have consented to share the gains of a business, the sharing of loss is implicit. Hence, sharing of gains and losses is vital.

d) . Business Motive:
It is important for a firm to carry some kind of business and should have a profit gaining motive.

e). Mutual Business:

The partners are the owners as well as the agent of their firm. Any act performed by one partner can affect other partners and the firm. It can be concluded that this point acts as a test of partnership for all the partners.
f). Unlimited Liability: Every partner in a partnership has unlimited liability.
Also, Explore: Dissolution of Partnership Dissolution of Partnership Firm

3.4.2. Indian Partnership Act 1932

Most of the businesses in India adopt a partnership business, so to monitor and govern such partnership The Indian Partnership Act was established on the 1st October 1932. Under this partnership act, an agreement is made between two or more persons who agrees to operate the business together and distribute the profits they gain from this business. In a Partnership, two or more people share ownership of a single business. Like proprietorships, the law does not distinguish between the business and its owners. The partners should have a legal agreement that sets forth how decisions will be made, profits will be shared, disputes will be resolved, how future partners will be admitted to the partnership, how partners can be bought out or what steps will be taken to dissolve the partnership when needed A partnership is a formal arrangement by two or more parties to manage and operate a business and share its profits. There are several types of partnership arrangements. In particular, in a partnership business, all partners share liabilities and profits equally, while in others, partners may have limited liability.

3.4.3.Types of Partnerships

A partnership is divided into different types depending on the state and where the business operates. Here are some general aspects of the three most common types of partnerships.

a). General Partnership

A general partnership comprises two or more owners to run a business. In this partnership, each partner represents the firm with equal right. All partners can participate in management activities, decision making, and have the right to control the business. Similarly, profits, debts, and liabilities are equally shared and divided equally.
In other words, the general partnership definition can be stated as those partnerships where rights and responsibilities are shared equally in terms of management and decision making. Each partner should take full responsibility for the debts and liability incurred by the other partner. If one partner is sued, all the other partners are considered accountable. The creditor

or court will hold the partner's personal assets. Therefore, most of the partners do not opt for this partnership.

b). Limited Partnership

In this partnership, includes both the general and limited partners. The general partner has unlimited liability, manages the business and the other limited partners. Limited partners have limited control over the business (limited to his investment). They are not associated with the everyday operations of the firm. In most of the cases, the limited partners only invest and take a profit share. They do not have any interest in participating in management or decision making. This non-involvement means they do not have the right to compensate the partnership losses from their income tax return. You might also want to know: Different modes of reconstitution of Partnership Firm

c) .Limited Liability Partnership

In Limited Liability Partnership (LLP), all the partners have limited liability. Each partner is guarded against other partners legal and financial mistakes. A limited liability partnership is almost similar to a Limited Liability Company (LLC) but different from a limited partnership or a general partnership.

d) .Partnership at Will

Partnership at Will can be defined as when there is no clause mentioned about the expiration of a partnership firm. Under section 7 of the Indian Partnership Act 1932, the two conditions that have to be fulfilled by a firm to become a Partnership at Will are: The partnership agreement should have not any fixed expiration date. No particular determination of the partnership should be mentioned. Therefore, if the duration and determination are mentioned in the agreement, then it is not a partnership at will. Also, initially, if the firm had a fixed expiration date, but the operation of the firm continues beyond the mentioned date that it will be considered as a partnership at will.

3.4. 4.Advantages of Partnership Firm:

i) Easy Formation – An agreement can be made oral or printed as an agreement to enter as a partner and establish a firm. Easy to establish (with the exception of developing a partnership agreement) Separate legal status to give liability protection

ii) Large Resources – Unlike sole proprietor where every contribution is made by one person, in partnership, partners of the firm can contribute more capital and other resources as required.

iii) Flexibility – The partners can initiate any changes if they think it is required to meet the desired result or change circumstances. Profits taxed only once

iv) Sharing Risk – All loss incurred by the firm is equally distributed amongst each partner.

v) Combination of different skills – The partnership firm has the advantage of knowledge, skill, experience and talents of different partners. Partners may have complementary skills.

3.4.5. Partnership Disadvantages

i) Partners are jointly and individually liable for the actions of the other partners
ii) Profits must be shared with the partners
iii) Divided decision making
iv) Business can suffer if the detailed partnership agreement is not in place

3.5. JOINT-STOCK COMPANY

The modern corporation has its origins in the joint-stock company. A joint-stock company is a business owned by its investors, with each investor owning a share based on the amount of stock purchased. Joint-stock companies are created in order to finance endeavors that are too expensive for an individual or even a government to fund. The owners of a joint-stock company expect to share in its profits. A joint-stock company is a business owned collectively by its shareholders. Historically, a joint-stock company was not incorporated and thus its shareholders could bear unlimited liability for debts owed by the company. In the U.S., the process of incorporation limits shareholder liability to the face value of their shares.

3.5.1. Understanding Joint-Stock Companies:

Unless the company is incorporated, the shareholders of a joint-stock company have unlimited liability for company debts. The legal process of incorporation, in the U.S., reduces that liability to the face value of stock owned by the shareholder. In Great Britain, the term "limited" has a similar meaning. The shares of a joint-stock company are transferable. If the joint-stock company is public, its shares are traded on registered stock exchanges. Shares of private joint-stock company stock are transferable between parties, but the transfer process is often limited by agreement, to family members, for example. Historically, investors in joint-stock companies could have unlimited liability, meaning that a shareholder's personal property could be seized to pay off debts in the event of a company collapse. Historically, investors in joint-stock companies could have unlimited liability, meaning that a shareholder's personal property could be seized to pay off company debts.

3.5.2. Definition of Joint Stock Company

The simplest way to describe a joint stock company is that it is a business organisation that is owned jointly by all its shareholders. All the shareholders own a certain amount of stock in the company, which is represented by their shares.
Professor Haney defines it as “a voluntary association of persons for profit, having the capital divided into some transferable shares, and the ownership of such shares is the condition of membership of the company.” Studying the features of a joint stock company will clarify its structure.

3.5.3. Features of a Joint Stock Company

1) Artificial Legal Person: A company is a legal entity that has been created by the statues of law. Like a natural person, it can do certain things, like own property in its name, enter into a contract, borrow and lend money, sue or be sued, etc. It has also been granted certain rights by the law which it enjoys through its board of directors. However, not all laws/rights/duties apply to a company. It exists only in the law and not in any physical form. So we call it an artificial legal person.

2) Separate Legal Entity: Unlike a proprietorship or partnership, the legal identity of a company and its members are separate. As soon as the joint stock company is incorporated it has its own distinct legal identity. So a member of the company is not liable for the company. And similarly, the company will not depend on any of its members for any business activities.

3) Incorporation: For a company to be recognized as a separate legal entity and for it to come into existence, it has to be incorporated. Not registering a joint stock company is not an option. Without incorporation, a company simply does not exist.

4) Perpetual Succession: The joint stock company is born out of the law, so the only way for the company to end is by the functioning of law. So the life of a company is in no way related to the life of its members. Members or shareholders of a company keep changing, but this does not affect the company's life.

5) Limited Liability: This is one of the major points of difference between a company and a sole proprietorship and partnership. The liability of the shareholders of a company is limited. The personal assets of a member cannot be liquidated to repay the debts of a company. A shareholders liability is limited to the amount of unpaid share capital. If his shares are fully paid then he has no liability. The amount of debt has no bearing on this. Only the companies assets can be sold off to repay its own debt. The members cannot be made to pay up.

6) Common Seal: A company is an artificial person. So its day-to-day functions are conducted by the board of directors. So when a company enters any contract or signs an agreement, the approval is indicated via a common seal. A common seal is engraved seal with the company's name on it. So no document is legally binding on the company until and unless it has a common seal along with the signatures of the directors.

7) Transferability of Shares: In a joint stock company, the ownership is divided into transferable units known as shares. In case of a public company the shares can be transferred freely, there are almost no restrictions. And in a public company, there are some restrictions, but the transfer cannot be prohibited.

3.5.4. Advantages of a Joint Stock Company

i) Limited liability: One of the biggest drawing factors of a joint stock company is the limited liability of its members. their liability is only limited up to the unpaid amount on their shares. Since their personal wealth is safe, they are encouraged to invest in joint stock companies

ii) Transferable: The shares of a company are transferable. Also, in the case of a listed public company they can also be sold in the market and be converted to cash. This ease of ownership is an added benefit.

iii) Perpetual succession:Perpetual succession is another advantage of a joint stock company. The death/retirement/insanity/etc does affect the life of a company. The only liquidation under the Companies Act will shut down a company.

iv) Effective and efficient management: A company hires a board of directors to run all the activities. Very proficient, talented people are elected to the board and this results in effective

and efficient management. Also, a company usually has large resources and this allows them to hire the best talent and professionals.

3.5.5. Disadvantages of a Joint Stock Company

i) Complex and lengthy procedure: One disadvantage of a joint stock company is the complex and lengthy procedure for its formation. This can take up to several weeks and is a costly affair as well.

ii) Lack of secrecy for the company: According to the Companies Act, 2013 all public companies have to provide their financial records and other related documents to the registrar. These documents are then public documents, which any member of the public can access. This leads to a complete lack of secrecy for the company.

iii) Reduces the freedom of a company: And even during its day to day functioning a company has to follow a numerous number of laws, regulations, notifications, etc. It not only takes up time but also reduces the freedom of a company

iv) Often leads to a conflict of interest: A company has many stakeholders like the shareholders, the promoters, the board of directors, the employees. the debenture holders etc. All these stakeholders look out for their benefit and it often leads to a conflict of interest.

3.5.6. Joint-Stock Company Versus Public Company

The term joint-stock company is virtually synonymous with a corporation, public company, or just plain company, except for a historical association with unlimited liability. That is, a modern corporation is a joint-stock company that has been incorporated in order to limit shareholder liability. Each country has its own laws regarding a joint-stock company. These generally include a process to limit liability.

3.6. COOPERATIVE SOCIETY

A business organization can take many forms. One such form is that of a cooperative society. Such societies have unique features of joint ownership and democratic leadership. Let us take a brief look at their features and some types of societies.

A cooperative is an association of persons (organization) that is owned and controlled by the people to meet their common economic, social, and/or cultural needs and aspirations through a jointly-owned and democratically controlled business (enterprise). The people of the cooperative are those who use its products, supplies, and/or services. Profits are also often returned back to the members of the cooperative, however, cooperatives are often more focused on services for members than for investments. Cooperatives can be created for a number of different reasons or to fulfill a number of different needs: jointly process goods, split costs, split control over work, purchasing power (bulk buys), shared employees, shared wages, etc.

A cooperative society is not a new concept. It prevails in all the countries, this is almost a universal concept. The cooperative society is active in all countries worldwide and is represented in all the sectors including agriculture, food, finance, healthcare, etc.

3.6.1. Features of a Cooperative Society

i) Protect the interest of weaker sections: To protect the interest of weaker sections, the co-operative society is formed. It is a voluntary association of persons, whose motive is the welfare of the members.

ii) Voluntary association : As it is a voluntary association, the membership is also voluntary. A person is free to join a cooperative society, and can also leave anytime as per his desire. Irrespective of their religion, gender & caste, membership is open to all.

iii) Separate legal identity: It is compulsory for the co-operative society to get registration. The co-operative society is a separate legal identity to the society. It does not get affected by the entry or exit of its members.

iv) Limited liability: There is limited liability of the members of co-operative society. Liability is limited to the extent of the amount contributed by members as capital.

v) Right to vote: An elected managing committee has the powers to take decisions. Members have the right to vote, by which they elect the members who will constitute the managing committee.

vi) Principle of mutual help & welfare: The cooperative society works on the principle of mutual help & welfare. Hence, the principal of service dominates it's working. If any surplus is generated, it is distributed amongst the members as a dividend in conformity with the bye-laws of the society.

3.6.2. Types of Cooperative Society

Producer Cooperative

To protect the interest of small producers, these societies are set up. The co-operative society members may be farmers, landowners, owners of the fishing operations. To increase the marketing possibilities and production efficiency, producers decide to work together or as separate entities. They perform several activities like processing, marketing & distributing their own products. This helps in lower costs and strains in each area with a mutual benefit to each producer.

a) ***Consumer Coperative***

These businesses are owned and governed by consumers of a particular area for their mutual benefit. Their view is to provide daily necessary commodities at an optimum price. Rather than earning a pecuniary profit, their aim is towards providing service to the consumers

b) ***Credit Unions***

Credit unions are generally member-owned financial cooperatives. Their principle is of people helping people. They provide credit and financial services to the members at competitive prices. Each and every depositor has the right to become a member. Members attend the annual meeting and are given rights to elect a board of directors.

c) Marketing Cooperative Society

With an aim of helping small producers in selling their products, these societies are established. The producers who wish to obtain reasonable prices for their output are the members of this society. For securing a favourable market for the products they eliminate the middlemen and improve the competitive position of its members. It collects the output of individual members. Various marketing functions like transportation, packaging, warehousing, etc are performed by the cooperative societies to sell the product at the best possible price.

d) Housing Cooperative Society

To help people with limited income to construct houses at reasonable costs, these societies are established. Their aim is to solve the housing problems of the members. A member of this society aims to procure the residential house at lower cost. They construct the houses and give the option to members to pay in installments to purchase the house. They construct flats or provide plots to members on which the members themselves can construct the houses as per their choice.

3.6.3. Principles of a Cooperative

***a) Voluntary and Open Membership*:** Cooperatives are voluntary organizations, open to all persons able to use their services and willing to accept the responsibilities and meet the requirements of membership, without gender, social, racial, political or religious discrimination. Members have control over setting policies for the co-op and making decisions for the cooperative.

b) Democratic Member Control: Cooperatives are democratic organizations controlled by their members, who actively participate in setting their policies and making decisions.

c*) Member Economic Participation*: Members contribute equitably to, and democratically control, the capital of their cooperative.

d) Autonomy and Independence: Cooperatives are autonomous, self-help organizations controlled by their members.

e) Education, Training, and Information: Cooperatives provide education and training for their members, elected representatives, managers, and employees so they can contribute to the development of their cooperatives. They inform the general public about the nature and benefits of cooperatives.

f) Cooperation among Cooperatives: Cooperatives serve their members most effectively and strengthen the cooperative movement by working together through local, national, regional, and international structures.

g) Concern for Community: Cooperatives work for the sustainable development of their communities through policies approved by their members.

3.6.4. Advantages of Cooperative Society

The cooperative form of organization offers the following advantages:

a) Easy to Form- A cooperative society is a voluntary association and may be formed with a minimum of ten adult members. Its registration is very simple and can be done without much legal formalities.

b) Open Membership- Membership in a cooperative organisation is open to all people having a common interest. A person can become a member at any time he likes and can leave the society at any time by returning his shares, without affecting its continuity.

c) Democratic Management- A cooperative society is managed in a democratic manner. It is based on the principle of 'one man one vote'. All members have equal rights and can have a voice in its management.

d) Limited Liability- The liability of the members of a co-operative society is limited to the extent of capital contributed by them. They do not have to bear personal liability for the debts of the society.

e) ***Stability-*** A co-operative society has a separate legal existence. It is not affected by the death, insolvency, lunacy or permanent incapacity of any of its members. It has a fairly stable life and continues to exist for a long period.

f) Economical Operations- The operation of a cooperative society is quite economical due to elimination of middlemen and the voluntary services provided by its members.

g) Government Patronage- Government gives all kinds of help to co-operatives, such as loans at lower rates of interest and relief in taxation.

h) Low Management Cost- Some of the expenses of the management are saved by the voluntary services rendered by the members. They take active interest in the working of the society. So, the society is not required to spend large amount on managerial personnel.

i) ***Mutual Co-Operation-*** Cooperative societies promote the spirit of mutual understanding, self-help and self-government. They save weaker sections of the society from exploitation by the rich. The underlying principle of co-operation is "self-help through mutual help."

j) No Speculation- The share is always open to new members. The shares of co-operative society are not sold at the rates higher than their par values. Hence, it is free from evils of speculation in share values.

k) Economic Advantages- Cooperative societies provide loans for productive purposes and financial assistance to farmers and other lower income earning people.

l) Other Benefits- Cooperative societies are exempted from paying registration fees and stamp duties in some states. These societies have priority over other creditors in realising its dues from the debtors and their shares cannot be decreed for the realisation of debts.

3.6.5. Disadvantages of co-operatives:

As against the advantages of co-operatives, the following limitations and drawbacks of this form of organization must also be noted:

a) ***Limited Capital-*** Cooperatives are usually at a disadvantage in raising capital because of the low rate of return on capital invested by the members.

b) Inefficient Management- The management of a co-operative society is generally inefficient because the managing committee consists of part-time and inexperienced people. Qualified managers are not attracted towards a cooperative on account of its limited capacity to pay adequate remuneration.

c) Absence of Motivation- A cooperative society is formed for mutual benefit and the interest of individual members is not fully satisfied. There is no direct link between effort and reward. Hence, members are not inclined to put their best efforts in a co-operative society.

d) Differences and Factionalism among Members- Once the initial enthusiasm about the co-operative ideal is exhausted, differences and group conflicts arise among members. Then, it becomes difficult to get full co-operation from the members. The selfish motives of members begin to dominate and service motive is sometimes forgotten.

e) Rigid Rules and Regulations- Excessive Government regulation and control over co-operatives affect their functioning. For example, a co-operative society is required to get its accounts audited by the auditors of the co-operative department and to submit its accounts regularly to the Registrar. These regulations and control may adversely affect the flexibility of operations and the efficiency of management in a co-operative society

.

f) Lack of Competition- Cooperatives, generally, do not face any stiff competition. Markets for their goods and services are more or less ready and assured. Hence, there is possibility of slackening of efforts.

g) Cash Trading- The members of the societies are generally from poor sections of the society. These persons need credit facilities. On the other hand, private traders extend credit facilities to the consumers. Though the societies sell goods at lower prices but absence of credit facilities compel them to go to private traders for meeting their requirements.

h) Lack of Secrecy- The affairs of a co-operative society are openly discussed in the meetings of the members. Every member is free to inspect the books and records of the society. Therefore, it becomes difficult to keep the secrets of business.

i) Weightage to Personal Gains- Mutual co-operation erodes away over a period of time and the members start giving weightage to their personal gains.

j) Lack of Incentive and Initiative- In a cooperative society form of organisation everybody is the owner of the society and over a period of time it becomes lifeless due to a lack of incentive and initiative as everybody is the owner, but business does not belong to any one of them.

k) Corruption- It is the worst demerit from which co-operative societies suffer, it is the biggest hindrance in the development and growth of business.

3.7. CORPORATIONS

A corporation is considered by law to be a unique entity, separate from those who own it. A corporation can be taxed, sued and enter into contractual agreements. The corporation has a life of its own and does not dissolve when ownership changes.There are three types of corporations: C-corporation, S-corporation and Limited Liability Company.

3.7.1. C-corporation: A C-corporation is a corporation that is taxed separately from its owners. It gives the owners limited liability encouraging more risk-taking and potential investment.

3.7.1.a). C-Corporation Advantages

i) Limited liability
ii) Transfer of ownership, shareholders can sell their shares
iii) Capital is easier to raise through the sale of stock
iv) Company paid fringe benefits
v) Tax benefits

3.7.1. b). C-Corporation Disadvantages

i) Double taxation (corporation and shareholder earnings taxed)
ii) Can be costly to form
iii) More administrative duties - required by law to have annual meetings, notify stockholders of the meeting, must keep minutes of meetings and turn in
iv) Pay corporate taxes at a different time than other forms of business

3.7.2. S-Corporation: An s corporation also known as subchapter S-corporation offers limited liability to the owners. S-corporations do not pay income taxes rather the earnings and profits are treated as distributions. The shareholders must report their income on their individual income tax returns.

3.7.2.a). S-Corporation Advantages

i) Limited liability
ii) Avoids double taxation
iii) Profits taxed only once
iv) Capital is easier to raise through the sale of stock
v) Transfer of ownership

3.7.2.b). S-Corporation Disadvantages

i) Can be costly to form
ii) Stockholders limited to individuals, estates or trustees
iii) Required administrative duties
iv) Cannot provide company paid fringe benefits
v) Stockholders are limited to citizens or resident aliens of the United States

3.8. LIMITED LIABILITY COMPANY

A limited liability company or LLC is a hybrid business structure that provides the limited legal liability of a corporation and the operational flexibility of a partnership or sole proprietorship. However, the formation is more complex and formal than that of a general partnership.

Tip: Forming an LLC requires the business owner to file legal paperwork. You may want to consult an attorney to assist you with the process. Here is a list of service providers in Missouri that provide legal assistance.

3.8.a) Limited Liability Company Advantages

i) Most common business structure and specifically created for small businesses
ii) Must have insurance in case of a suit
iii) Separate legal entity
iv) Usually taxed as a sole proprietorship
v) Unlimited number of owners
vi)

3.8. b) Limited Liability Company Disadvantages

i) Can be costly to form
ii) Yearly administrative costs
iii) Personal tax liability
iv) Legal and accounting assistance is recommended

3.9. SUMMARY:

This lesson is divided into eight parts. The first part of it is revealed some aspects such as: financial system, public finance, Finance interrelated areas, Business Environment, Financial environment. It is introduced different forms of business organizations viz., Sole proprietorships, Partnerships, joint-stock company, Cooperatives, Corporations, Limited Liability Company in the second part of this lesson. Regarding Sole proprietorships and its merit and demerits is presented in the third part of this lesson. Advantages and Disadvantages of Partnerships, joint-stock company, Cooperatives, Corporations, Limited Liability Company is mentioned in the parts of fourth, fifth, sixth, seventh, and eighth respectively in this lesson.

3.10. TECHNICAL TERMS:

Sole proprietorship : A sole proprietorship is an unincorporated business with only one owner who pays personal income tax on profits earned.

Partnership : A relationship between individuals or groups that is haracterized by mutual cooperation and responsibility, as for the achievement of a specified goal. A relationship between individuals or groups that is characterized by mutual cooperation and responsibility, as for the achievement of a specified goal.

Joint-stock company : Joint-stock companies are created in order to finance endeavors that are too expensive for an individual or even a government to fund. The owners of a joint-stock company expect to share in its profits.

Cooperatives : A cooperative (also known as co-operative, co-op, or coop) is "an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly-owned enterprise".

LimitedLiabilityCompany: An LLC is a business entity with all the protection of a corporation plus the ability to pass through any business profits and losses to your personal income tax re. An LLC is a hybrid type of business structure where the owners of the LLC are called "members," and all enjoy the advantages that an LLC has to offer.

Corporations : A corporation is a legal entity that is separate and distinct from Its owners. Under the law, corporations possess many of the same rights and responsibilities as individuals. They can enter contracts, loan and borrow money, sue and be sued, hire employees, own assets, and pay taxes.

3.11. SELF ASSESSMENT QUESTIONS:

1) Explain the importance of financial environment.
2) Define Sole proprietorshi Explain the merits and demerits of Sole proprietorship.
3) Define nership firm? Explain the merits and demerits of Partnership firm.
4) Define Joint-stock company ? Explain the merits and demerits of Joint-stock company .
5) Define Cooperatives ? Exp in the merits and demerits of Cooperatives .
6) Define Limited Liability Company? Explain the merits and demerits of Limited Liability Company.
7) Define Corporations ? Explain the merits and demerits of Corporations.

3.12. SUGGESTED READINGS:

I.M. Panday: "Financial Management " Vikas Publishing House (P) Ltd

Chandra, Prasanna "Financial Management " Tata Publishing House Ltd, New Delhi

S.N. Maheswari : "Principles of Financial Management " Sultan Chand, New Delhi

Sheeba Kapil : "Financial Management " Pearson, 2011

P.V. Kulakarni: "Financial Management " Himalaya Publishing House Bombay

Khan & Jain : Cases in "Financial Management " Tata Publishing House Ltd, New Delh

LESSON - 4
INDIAN FINANCIAL SYSTEM

Aims and Objectives

After studying this lesson you should be able to:

- Know the Indian Financial system
- Understand the Financial Markets: Money market & Capital market

Structure

4.1. INTRODUCTION

A developing country – India is the 5th largest economy in the world in terms of its nominal GDP. The Indian Financial System refers to all institutions, structures, and services that provide pecuniary facilities to the public. It makes possible trade and transfers of funds in a secure manner. India, being a democracy has independent pillars of the financial system especially in the areas of banking, capital and stock markets, insurance, liabilities, claims, transactions, and investments. It is important for wealth creation and the economic development of the country.

A *financial system* may be defined as a set of institutions, instruments, and markets which promote savings and channels them to their most efficient use. It consists of individuals (savers), intermediaries, markets and users of savings (investors)

According to Prasanna Chandra, "financial system consists of a variety of institutions, markets, and instruments related in a systematic manner and provide the principal means by which savings are transfor medinto investments".

According to Van Horne, "financial system allocates savings efficiently in an economy to ultimate users either for investment in real assets or for consumption".

4.1.1. *What is a Financial System?*

A financial system is a set of institutions, such as banks, insurance companies, and stock exchanges, that permit the exchange of funds. Financial systems exist on firm, regional, and global levels. Borrowers, lenders, and investors exchange current funds to finance projects, either for consumption or productive investments, and to pursue a return on their financial assets. The financial system also includes sets of rules and practices that borrowers and lenders use to decide which projects get financed, who finances projects, and terms of financial deals.

Financial markets involve borrowers, lenders, and investors negotiating loans and other transactions. In these markets, the economic good traded on both sides is usually some form of money: current money (cash), claims on future money (credit), or claims on the future income potential or value of real assets (equity). These also include derivative instruments. Derivative instruments, such as commodity futures or stock options, are financial instruments that are dependent on an underlying real or financial asset's performance. In financial markets, these are all traded among borrowers, lenders, and investors according to the normal laws of supply and demand.

In a centrally planned financial system (e.g., a single firm or a command economy), the financing of consumption and investment plans is not decided by counterparties in a transaction but directly by a manager or central planner. Which projects receive funds, whose projects receive funds, and who funds them is determined by the planner, whether that means a business manager or a party boss.

Most financial systems contain elements of both give-and-take markets and top-down central planning. For example, a business firm is a centrally planned financial system with respect to its internal financial decisions; however, it typically operates within a broader market interacting with external lenders and investors to carry out its long term plans.

At the same time, all modern financial markets operate within some kind of government regulatory framework that sets limits on what types of transactions are allowed. Financial systems are often strictly regulated because they directly influence decisions over real assets, economic performance, and consumer protection.

4.1.2. Financial Market Components

Multiple components make up the financial system at different levels. The firm's financial system is the set of implemented procedures that track the financial activities of the company. Within a firm, the financial system encompasses all aspects of finances, including accounting measures, revenue and expense schedules, wages, and balance sheet verification.

On a regional scale, the financial system is the system that enables lenders and borrowers to exchange funds. Regional financial systems include banks and other institutions, such as securities exchanges and financial clearinghouses.

The global financial system is basically a broader regional system that encompasses all financial institutions, borrowers, and lenders within the global economy. In a global view, financial systems include the International Monetary Fund, central banks, government treasuries and monetary authorities, the World Bank, and major private international banks.

4.1.3. The Complete Introduction to Economics

Learning the basics of economics is easier than you think, especially when courses are taught by instructors from all over the world. With Udemy, you'll be able to understand what economics is all about and the difference between microeconomics and macroeconomics. You'll also be able to take courses that span over 65 languages and have a 30-day money-back guarantee. Learn more about Udemy and get started today.

4.2. FUNCTIONS OF THE INDIAN FINANCIAL SYSTEM

A financial system is the set of global, regional, or firm-specific institutions and practices used to facilitate the exchange of funds. Financial systems can be organized using market principles, central planning, or a hybrid of both. Institutions within a financial system include everything from banks to stock exchanges and government treasuries. Understanding the Financial System Like any other industry, the financial system can be organized using markets, central planning, or some mix of both.

i) Issuing and gathering of deposits.
ii) Supply of loans from the collected pool of money.
iii) The undertaking of financial transactions.
iv) Boosting the growth of stock markets and other financial markets.
v) Setting up the legal commercial substructure.
vi) Provision of monetary and consultative services.
vii) Permits portfolio adaptation for existing assets.

viii) Allotment of chance and risk.
ix) It forges a connection between depositors and investors.

x) Boosts depth and breadth of finances by increasing its horizon.
xi) It is responsible for capital creation.
xii) Adds time value to assets and money.

xiii) To set up an entire payment structure and system.
xiv) Allocate and dissipate the economic resources.
xv) To maintain the economic stability in the country and the markets.
xvi) To create markets that can judge the investment performance.Top of Form

4.2.1. Functions of the Financial System in India

***i) Liquidity Function*:** The most important function of a financial system is to provide money and monetary assets for the production of goods and services. Monetary assets are those assets that can be converted into cash or money easily without loss of value. All activities in a financial system are related to the liquidity-either provision of liquidity or trading in liquidity.

ii) Payment Function

The financial system offers a very convenient mode of payment for goods and services. The cheque system and credit card system are the easiest methods of payment in the economy. The cost and time of transactions are considerably reduced.

iii)SavingFunction

An important function of a financial system is to mobilize savings and channelize them into productive activities. It is through the financial system the savings are transformed into investments.

RiskFunction

The financial markets provide protection against life, health, and income risks. These guarantees are accomplished through the sale of life, health insurance, and property insurance policies.

v) Transfer Function

A financial system provides a mechanism for the transfer of resources across geographic boundaries.

vi) Reformatory Functions

A financial system undertaking the functions of developing, introducing innovative financial assets/instruments services and practices and restructuring the existing assets, services, etc, to cater to the emerging needs of borrowers and investors.bjectives of Fin

vii)FacilitatePayment

The financial system facilitates payment through banks and any other financial institution. Anything we buy or sale requires the transection of money. That is done by the financial system

viii) It Link Between Saver and Investor

The financial system provides a place where saver and investor meets. Saver saves money and investors invest it in different types of stocks to get profit on it.

ix) Helps in Capital Formation

For capital formation, there should be a good financial system that provides the finance timely and in an appropriate amount.

x) To Ensure Safety on Investment

The financial system has different institutions for the proper supervision of the financial market that controls the market. So, the safety of the investment can be done.

xi) Helps in the Growth of the Economy

Proper mobilization of funds and proper control in the financial market helps the business to grow and motivate investors to invest. That helps in the growth of the economy.

4.3. COMPONENTS OF THE INDIAN FINANCIAL SYSTEM:

4.3.1. Financial Institution

Their role is to mediate between the lender and the borrower. The lender's savings are gathered through various commercial markets. These can turn risky financings into safe investments. A liability that is for a short duration can be turned into an investment for a longer duration. These can make comparable large deposits and loans with small deposits and loans due to uniform denominations. These provide a balance between the loan taker and the amount depositor. Financial Institutions have 2 major types:

a. Banking Institutions or Depository Institutions: **i)** Their role is to acquire money from the public. ii) Interests are paid on these deposits made by the people.iii) The lent money is then provided as loans to those who need it. iv) Interests are charged on these loans given to those who require it. v) Examples include banks and other credit unions.

b. ***Non-banking Institutions or Non-depository Institutions*****: i)** Their role is to sell commercial and financial goods and products to those who visit them. ii) These are based on offering insurance, mutual funds, brokerage deals, etc. iii) Examples of these majorly include companies.

These further have 3 categories:

a. Regulatory**:** Those managements and institutions which regulate and overlook the commercial and financial market. Example – RBI, IRDA, SEBI, etc.

b. Intermediates: Those institutions which provide financial counseling and help by offering loans etc. Example – PNB, SBI, HDFC, BOB, Axis Bank.

c. Non – Intermediates**:** These institutions help corporate visitors with their finances. Examples – NABARD, SIDBI, etc.

4.3.2. Financial Assets

The objective of these is to provide convenient trade of securities in the commercial and financial market based on the requirements of those who seek credit. These are the goods or products which are sold in the financial market.

i) Call Money**:** Without any assurance, this is a loan lent for just a day which is repaid the next day.

ii) Notice Money: Without any assurance, this is a loan rent for more than a day but less than a duration of 14 days.

iii) Term Money**:** When the duration of the maturity of a particular amount deposited is more than 14 days.

iv) Treasury Bills: With the duration of maturity of less than a year, these belong to the government in the bond or debt security format. These are bought in the form of government T– Bills which are taken as loans from the government.

v) Certificate of Deposit: This works on the format of electronic funds that remain deposited in a particular bank for a fixed period of time.

vi) Commercial Paper: Used by corporates, it is an instrument that is not secured even though for a short duration of debt.

4.3.3. Financial Services

The major objective of these is to provide counseling to their visitors regarding the purchase or selling of a property, permitting transactions, deals, lending, and investments. These make sure the effectiveness of the investment and arrangement of the fund source too. These are

usually taken up by asset and liability management companies. Financial services also include in them:

a) Banking Services: Functions performed by a bank such as the provision of loans, accepting debits, giving out credit or debit cards, account opening, granting checkbooks, etc are a part of these services.

b) Insurance Services: These include services of offering insurance, selling policies, brokerage deals, etc.

c) Investment Services: These services include overlooking and management of investment, assets, and deposits.

***d) Foreign Exchange Services*:** These include currency exchanges, foreign exchanges, and foreign fund transfers.

4.3.4. Financial Markets

Financial Markets include any place or system that provides buyers and sellers the means to trade financial instruments, including bonds, equities, the various international currencies, and derivatives. Financial markets facilitate the interaction between those who need capital with those who have capital to invest.

Financial markets, from the name itself, are a type of marketplace that provides an avenue for the sale and purchase of assets such as bonds, stocks, foreign exchange, and derivatives. Often, they are called by different names, including "Wall Street" and "capital market," but all of them still mean one and the same thing. Simply put, businesses and investors can go to financial markets to raise money to grow their business and to make more money, respectively.

To state it more clearly, let us imagine a bank where an individual maintains a savings account. The bank can use their money and the money of other depositors to loan to other individuals and organizations and charge an interest fee. The depositors themselves also earn and see their money grow through the interest that is paid to it. Therefore, the bank serves as a financial market that benefits both the depositors and the debtors. The markets where trade and exchange of bonds, shares, money, investments, and assets take place between buyers and purchasers are these.

4.3.5. Money

It is an important medium of exchange that can be used to purchase goods and services. It can also act as a store of value. It is uniformly accepted everywhere. It eases transactions especially impromptu daily purchases. It makes the goods and services easily exchangeable. It acts as a verifiable record in the socio-economic context.

4.4. TYPES OF FINANCIAL MARKETS

There Are So Many Financial Markets, And Every Country Is Home To At Least One, although they vary in size. some are small while some others are internationally known, such

as the New York Stock Exchange (NYSE) that trades trillions of dollars on a daily basis. Here are some types of financial markets.

i) Stock market The stock market trades shares of ownership of public companies. Each share comes with a price, and investors make money with the stocks when they perform well in the market. It is easy to buy stocks. The real challenge is in choosing the right stocks that will earn money for the investor. There are various indices that investors can use to monitor how the stock market is doing, such as the Dow Jones Industrial Average (DJIA) and the S&P 500. When stocks are bought at a cheaper price and are sold at a higher price, the investor earns from the sale.

ii) Bond market The bond market offers opportunities for companies and the government to secure money to finance a project or investment. In a bond market, investors buy bonds from a company, and the company returns the amount of the bonds within an agreed period, plus interest.

iii) Commodities market The commodities market is where traders and investors buy and sell natural resources or commodities such as corn, oil, meat, and gold. A specific market is created for such resources because their price is unpredictable. There is a commodities futures market wherein the price of items that are to be delivered at a given future time is already identified and sealed today.

iv) Derivatives market Such a market involves derivatives or contracts whose value is based on the market value of the asset being traded. The futures mentioned above in the commodities market is an example of a derivative.

v) Capital Market: These deal with trades and transactions which take place in the market. These take place for a period of 1 year. These are of 3 major types: Corporate Securities Market Government Securities Market, Long Term Loan Market

vi) Money Market: These are for short-duration investments. They are denominated by the government, banks, and other institutions. This market is based on wholesale debt having a low-risk factor with transparent instruments and formats used. It has 2 main types: Organized Money Market, Unorganized Money Market

vii),Foreign Exchange Market: A highly developed market dealing with several currencies. It is responsible for the foreign transfer of funds. This takes place on the basis of foreign currency rates.

viii) Credit Market: This involves both short-duration loans and long-duration loans. It can be given to both individuals and organizations. These are granted by several banks, financial institutions, non – financial institutions, etc.

4.4.1. . Financial Markets are the institutional arrangements by which savings generated in the economy are channelised into avenues of investment by industry, business and the government. It is a market for the creation and exchange of financial assets.

(A) Functions of the Financial Markets

The role of financial markets in the success and strength of an economy cannot be underestimated. Here are four important functions of financial markets:

i) Puts savings into more productive use: As mentioned in the example above, a savings account that has money in it should not just let that money sit in the vault. Thus, financial markets like banks open it up to individuals and companies that need a home loan, student loan, or business loan.

ii) ***Determines the price of securities*** Investors aim to make profits from their securities. However, unlike goods and services whose price is determined by the law of supply and demand, prices of securities are determined by financial markets.

iii) ***Makes financial assets liquid*** Buyers and sellers can decide to trade their securities anytime. They can use financial markets to sell their securities or make investments as they desire.

iv) Lowers the cost of transactions In financial markets, various types of information regarding securities can be acquired without the need to spend.

(B) Importance of Financial Markets

There are many things that financial markets make possible, including the following: Financial markets provide a place where participants like investors and debtors, regardless of their size, will receive fair and proper treatment. They provide individuals, companies, and government organizations with access to capital. Financial markets help lower the unemployment rate because of the many job opportunities it offers

i) Mobilization of savings and channelizing them into the most productive uses: Facilitates transfer of savings from the savers to the investors. Financial markets help people to invest their savings in various financial instruments and earn income and capital appreciation. Facilitate mobilization of savings of people and their channelisation into the most productive uses.

ii) Facilitate Price Discovery: Price of anything depends upon the demand and supply factors. Demand and supply of financial assets and securities in financial markets help in deciding the prices of various financial securities; where business firms represent the demand and the households represent the supply.

iii) Provide liquidity to financial assets: Financial markets provide liquidity to financial instruments by providing a ready market for the sale and purchase of financial assets. Whenever the investors want, they can invest their savings into long term investments and whenever they want, they can sell the investments/ instruments and convert them into cash.

iv) Reduce the cost of transactions: By providing valuable information to buyers and sellers of financial assets, it helps to saves time, effort and money that would have been spent by them to find each other. Also investors can buy/sell securities through brokers who charge a nominal commission for their services. This way financial markets facilitate transactions at a very low cost.

(C) Money Market Instruments: Market for financial securities with maturity period of less than one year. Mkt for low risk, unsecured and short term debt instruments that are highly liquid are traded everyday. No physical location bye conducted over the telephone and the internet. Helps to: raise short term funds Temporary deployment of funds . The main instruments of money market are as follows:

a) Treasure Bills: They are issued by the RBI on behalf of the Central Government to meet its short-term requirement of funds. They are issued at a price which is lower than their face value and arc repaid at par. They are available for a minimum amount of Rs.25000 and in multiples thereof. They are also known as Zero Coupon Bonds. They are negotiable instruments i.e. they are freely transferable.

***b) Commercial Paper*:** It is a short term unsecured promissory note issued by large credit worthy companies to raise short term funds at lower rates of interest than market rates. They are negotiable instruments transferable by endorsement and delivery with a fixed maturity period of 15 days to one year.

c) Call Money: It is short term finance repayable on demand, with a maturity period of one day to 15 days, used for interbank transactions. Call Money is a method by which banks borrow from each other to be able to maintain the cash reserve ratio as per RBI. The interest rate paid on call money loans is known as the call rate.

d) Certificate of Deposit: It is an unsecured instrument issued in bearer form by Commercial Banks & Financial Institutions. They can be issued to individuals. Corporations and companies for raising money for a short period ranging from 91 days to one year.

e) Commercial Bill: It is a bill of exchange used to finance the working capital requirements of business firms. A seller of the goods draws the bill on the buyer when goods are sold on credit. When the bill is accepted by the buyer it becomes marketable instrument and is called a trade bill. These bills can be discounted with a bank if the seller needs funds before the bill maturity.

(D) Capital Market: Facilities and institutional arrangements through which long term securities are raised and invested- both debt and equity. Important component of Financial markets

i) Two segments (primary and secondary)
ii) Two forms (organized and unorganized)
iii) long term securities
iv) Satisfies long term requirements of funds
v) Performs trade-off functions
vi) Creates dispersion in business ownership
vii) Helps in capital formation
viii) Creates liquidity

Features of Capital Market Instruments:

a. Provide long term funds
b. Lesser outlay required as unit value of instruments is low
c. Duration more than 1 year

d. Liquidity
e.Lowersafety
f. Higher expected returns as compared to short term securities

4.5. DIFFERENCE BETWEEN CAPITAL AND MONEY MARKET

Basis	Capital Market	Money Market
Participants	Its participants include commercial banks, NBFS, chit funds, Financial Institutions, Corporate Entities, foreign investors and individuals.	Its participants include commercial banks, NBFS, chit funds, RBI, Banks Institutions and finance companies.
Responsibility	The SEBI is responsible for its working.	The RBI is responsible for its working
Instruments traded	Associates with assets such as Equity shares, bonds, preferences, debentures, call money ,government securities. and etc.	Associates with assets like treasury bills, commercial paper, bills of exchange, certificate of deposits, Trade Bills etc.
Investment Outlay	Does not necessarily require a huge financial outlay.	Entails huge sum of money as the instruments are quite expensive.
Duration	Deals in medium and long term securities having a maturity period of one year.	Deals in short term funds having a maturity period upto one year.
Liquidity	Securities are less liquid as money market securities.	Money markets instruments are highly liquid
Expected	Involves dealing with long-term funds. and High return	Involves dealing with short-term funds and Low return
Safety	Capital Market Instruments are riskier both with respect to return and repayment.	Money market instruments are generally much safer with a minimum risk of default.

4.6. PRIMARY MARKET VS. SECONDARY MARKET

The capital market can be divided into two parts: 1. Primary Market 2. Secondary Market

A) Primary Market:

i) New issues markets,
ii) Transfers investible funds from savers to entrepreneurs.

iii) Funds used for setting up new projects, expansion, diversification, modernization of existing projects, mergers and take overs etc.

Methods of Floatation of New Issues in Primary Market

i) Offer through Prospectus: It involves inviting subscription from the public through issue of prospectus. A prospectus makes a direct appeal to investors to raise capital through an advertisement in newspapers and magazines.

ii) Offer for Sale: Under this method, securities are offered for sale through intermediaries like issuing houses or stock brokers. The company sells securities to intermediary/broker at an agreed price and the broker resells them to investors at a higher price.

***iii) Private Placements*:** It refers to the process in which securities are allotted to institutional investor and some selected individuals.

iv) Rights Issue: It refers to the issue in which new shares are offered to the existing shareholders in proportion to the number of shares they already possess.

v) e-IPOs: It is a method of issuing securities through an on-line system of stock exchange. A company proposing to issue capital to the public through the on-line system of the stock exchange has to enter into an agreement with the stock exchange. This is called an e-initial public offer. SEBI's registered brokers have to be appointed for the purpose of accepting applications and placing orders with the company.

B) Secondary Market

1.Refers to a market where existing securities are bought and sold.
2.The company is not involved in the transaction at all. It is between two investors.

Features of Secondary market are:

1) Creates liquidity
2) Fixed location
3) Comes after primary market
4) Encourages new investment

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4.6.B.1. Stock Exchange/Share Market

A Stock Exchange is an institution which provides a platform for buying and selling of existing securities. It facilitates the exchange of a security i.e. share, debenture etc. into money and vice versa.

8

i) Functions of a Stock Exchange:

a. Gives liquidity and marketability to existing securities
b. Pricing of securities(dd and ss)
c. Safety of transactions(membership = regulated + dealings well defined)

d. Contributes to economic growth (ensures that savings are channelized to most productive investment avenues)
e. Spreading of equity cult(ensures wider share ownership)
f. Provides scope for speculation (in a restricted and controlled environment)

ii) Securities and Exchange Board of India (SEBI)

SEBI was established by Government of India on 12 April 1988 as an interim administrative body to promote orderly and healthy growth of securities market and for investor protection. It was given a statutory status on 30 January1992 through an ordinance which was later replaced by an Act of Parliament known as the SEBI Act, 1992. It seeks to protect the interest of investors in new and second hand securities.

(a) Objectives of SEBI

i) To regulate stock exchange and the securities market to promote their orderly functioning.
ii) To protect the rights and interests of investors and to guide & educate them.
iii) To prevent trade mal practices such as internal trading.
iv) To regulate and develop a code of conduct and fair practices by intermediaries like brokers, merchant bankers etc.

(b) Functions of SEBI

i) Protective Functions :

a) Prohibit fraudulent & unfair trade practices in secondary market (e.g. Price rigging & misleading statement) .
b) Prohibit insider trading.
c) Educate investors Promote fair practice & code of conduct in securities market

ii) Development Functions :

a) Promotes training of intermediaries of the securities market .
b) Investor education
c) Promotion of fair practices code of conduct of all SRO‘s.
d) Conducting research & publish information useful to all market participants

iii) Regulation Functions :

a) Registration of brokers and sub brokers & other players in the mkt.
b)) Registration of collective investment schemes & mutual funds.
c) Regulation of stock bankers & portfolio exchanges & merchant bankers.

c) Trading Procedure on a Stock Exchange

i) Selection of Broker: in order to trade on a Stock Exchange first a broker is selected who should be a member of stock exchange as they can only trade on the stock exchange.

ii) Placing the order: After selecting a broker, the investors specify the type and number of securities they want to buy or sell.

iii) Executing the order: The broker will buy or sell the securities as per the instructions of the investor.

iv) Settlement: Transactions on a stock exchange may be carried out on either cash basis or carry over basis (i.e. badla). The time period for which the transactions are carried forward is referred to as accounts which vary from a fortnight to a month. All transactions made during one account are to be settled by payment for purchases and by delivery of share certificates, which is a proof of ownership of securities by an individual. Earlier trading on a stock exchange took place through a public outcry or auction system which is now replaced by an online screen based electronic trading system. Moreover, to eliminate, the problems of theft, forgery, transfer, delays etc. an electronic book entry from a holding and transferring securities has been introduced, which is called process of de materialisation of securities.

4.6.1.DIFFERENCE BETWEEN PRIMARY MARKET AND SECONDARY MARKET

Basis	Primary Market	Secondary Market
Securities	Only new securities are traded	Existing securities are traded
Price of Securities	Prices of securities are determined by the management of the company.	Prices are determined by the forces by the demand and supply of the securities.
Purchase	Securities are sold to investors directly by the company or through intermediary.	Investors exchange ownership of securities.
Market Place	There is no fixed geographical location.	Located at specified places.
Medium	Only buying of securities takes place.	Both buying and selling of securities can take place.

4.7. DEPOSITORY SERVICES AND DEMAT ACCOUNTS:

Keeping In The Mind The Difficulties To Transfer of shares in physical form, SEBI has developed a new system in which trading in shares is made compulsory in electronic form Depository services system and D-Mat Account are very basis of this system.

A) Depository Services: Just like a bank keeps money in safe custody for customers, a depository also is like a bank and keeps securities(e.g. shares, debentures, bonds, mutual funds etc.) in electronic form on behalf of the investor. In the depository a securities account can be opened, all shares can be deposited, they can be withdrawn/ sold at any time and

instruction to deliver or receive shares on behalf of the investor can be given. At present there are two depositories in India: NSDL. (National Securities Depository Ltd.) and CDSL (Central Depository Services Ltd.). which are known as "Depository Participants". (DPs)

4.7.1. Services provided by Depository

Dematerialization (usually known as demat) is converting physical certificates to electronic form. Rematerialization, known as remat, is reverse of demat, i.e getting physical certificates from the electronic securities.
Transfer of securities, change of beneficial ownership. Settlement of trades done on exchange connected to the Depository. Now a days on-line paper-less trading in shares of the company is compulsory in India. Depository services is the name of that mechanism. In this system transfer of ownership in shares take place by means of book entry without the physical delivery of shares. When an investor wants to deal in shares of any company he has to open a Demat account. There are four players who participate in this system.

B) Players in Depository services

i) ***The Depository:*** A depository is an institution which holds the shares of an investor in electronic form. There are two depository institutions in India these are NSDL and CDSL.

ii) ***The Depository Participant:*** He opens the account of Investor and maintains securities records.

iii) ***The Investor:*** He is a person who wants to deal in shares whose name is recorded

iv) ***The Issuing Company:*** That organization which issues the securities. This issuing company sends a list of the shareholders to the depositories.

C) Benefits of Depository Services

i) Sale and Purchase of shares and stocks of any company on any stock Exchange.
ii) Saves time.
iii) Lower transaction costs
iv) Ease in trading.
v) Transparency in transactions.
vi) No counterfeiting of security certificate
vii) Physical presence of investor is not required in stock exchange.
viii) Risk of mutilation and loss of security certificate is eliminated.

4.7.2. DEMAT ACCOUNT

Demat (Dematerialized) account refers to an account which an Indian citizen must open with the depository participant (banks, stockbrokers) to trade in listed securities in electronic form. The securities are held in the electronic form by a depository.

A), Opening of Demat Account

A Demat account is opened on the same lines as that of a bank account. Prescribed account opening forms available with the DP, need to be filled in. Standard agreement is to be signed by the client and the DP, which details the rights and obligation of both parties. Along with the form, the client is required to attach photograph, attested copies of residence proof and proof of identity need to be submitted.

B) Benefits of Demat Account

i) Reduces paper work.
ii) Elimination of problems on transfer of shares such as loss, theft and delay.
iii) Exemption of stamp duty when transfer of shares.
iv) The concept of odd lot stand abolished.
v) Increase liquidity through speedy settlement.
vi) Attract foreign investors and promoting foreign investment.
vii) A single demat account can hold investments in both equity and debt instruments.
viii) Traders can work from anywhere.
ix) Automatic credit into demat account for shares arising out of bonus/split/consolidation % merger.
x) Immediate transfers of securities.
xi) Change in address recorded with a DP gets registered with all companies in which investor holds securities eliminating the need to correspond with each of them.

4.8.SUMMAR

This lesson is presented into seven parts. In the first part is introduction about Indian financial system. Function of Indian Financial system is revealed in the second part. In the third part of this lesson is covered Components of Indian Financial system. Under the fourth explained regarding Types of markets. The fifth and sixth chapters are established distinguish between **primary market vs. secondary market & Capital market vs. Money market respectively. The last but not least is mentioned that** Depository services system and D-Mat Account.

4.9.TECHNICAL TERMS

Financial system : A financial system is a set of institutions, such as banks, insurance companies, and stock exchanges, that permit the exchange of funds. Financial systems exist on firm, regional and global levels.

Primary market : The primary market is where securities are created. It's in this market that firms sell (float) new stocks and bonds to the public for the first time. An initial public offering, or IPO, is an example of a primary market.

Secondary market : The secondary market is where investors buy and sell securities they already own. It is what most people typically think of as the "stock market," though stocks are also sold on the primary market when they are first issued.

Capital market : Capital market is a place where buyers and sellers indulge in trade (buying/selling) of financial securities like bonds, stocks etc. The trading is undertaken by participants such as individuals and institutions. Capital market trades mostly in long-term securities.

Money market : The money market is defined as dealing in debt of less than one year. It is primarily used by governments and corporations to keep their cash flow steady, and for investors to make a modest profit. The capital market is dedicated to the sale and purchase of long-term debt and equity instruments.

4.10. SELF ASSESSMENT QUESTIONS

1. Explain about financial system in India.
2. Discuss various types of markets.
3. What is primary market? Explain about primary market.
4. What is secondary market? Explain about secondary market.
5. What is capital market? Explain about capital market.
6. What is money market? Explain about money market.
7. Discuss various money market instruments.

4.11. SUGGESTED READINGS

1. I.M. Panday: "Financial Management " Vikas Publishing House (P) Ltd

2. Chandra, Prasanna "Financial Management " Tata Publishing House Ltd, New Delhi

3. S.N. Maheswari : "Principles of Financial Management " Sultan Chand, Delhi

4. Sheeba Kapil : "Financial Management " Pearson, 2011

5. P.V. Kulakarni: "Financial Management " Himalaya Publishing House Bombay

6. Khan & Jain : Cases in "Financial Management " Tata Publishing House Ltd, Delh

LESSON - 5
FINANCIAL INTERMEDIARIES
&
FINANCIAL INSTITUTIONS

Aims and Objectives

After studying this lesson you should be able to:

- Know the Financial intermediaries
- Understand the major categories of financial institutions

Structure

5.1. INTRODUCTION

Financial intermediaries move funds from parties with excess capital to parties needing funds. The process creates efficient markets and lowers the cost of conducting business. For example, a financial advisor connects with clients through purchasing insurance, stocks, bonds, real estate, and other assets. Banks connect borrowers and lenders by providing capital from other financial institutions and from the Federal Reserve. Insurance companies collect premiums for policies and provide policy benefits. A pension fund collects funds on behalf of members and distributes payments to pensioners.

Financial intermediaries have a central role to play in a market economy where efficient allocation of resources is the responsibility of the market mechanism. In these days of increased complexity of the financial system, banks and other financial intermediaries have to come up with new and innovative products and services to cater to the diverse needs of the borrowers and lenders. It is the right mix of financial products along with the need for reducing systemic risk that determines the efficacy of a financial intermediary.

The financial institutions provide the best way to invest the money and to earn good returns from that investment. It try to help our nation in building up economies. They provide a very unique and advanced way to keep the money safe. The customers should also understand that the institutions also carry some risk factors associated with their services. The customers should very carefully understand the policies of the institutions and should check the Non-performing Asset of the company before investing their money in the financial institutions.

The default in the case is a panic situation because the repayment can be very tough in that situation.

5.1.1. What is a Financial Intermediary?

A financial intermediary is an entity that acts as the middleman between two parties in a financial transaction, such as a commercial bank, investment bank, mutual fund, or pension fund. Financial intermediaries offer a number of benefits to the average consumer, including safety, liquidity, and economies of scale involved in banking and asset management. Although in certain areas, such as investing, advances in technology threaten to eliminate the financial intermediary, disintermediation is much less of a threat in other areas of finance, including banking and insurance.

Financial intermediaries serve as middlemen for financial transactions, generally between banks or funds. These intermediaries help create efficient markets and lower the cost of doing business. Intermediaries can provide leasing or factoring services, but do not accept deposits from the public. Financial intermediaries offer the benefit of pooling risk, reducing cost, and providing economies of scale, among others.

5.1.2. How a Financial Intermediary Works

A non-bank financial intermediary does not accept deposits from the general public. The intermediary may provide factoring, leasing, insurance plans, or other financial services. Many intermediaries take part in securities exchanges and utilize long-term plans for managing and growing their funds. The overall economic stability of a country may be shown through the activities of financial intermediaries and the growth of the financial services industry.

5.1.3. Example of a Financial Intermediary

In July 2016, the European Commission took on two new financial instruments for European Structural and Investment (ESI) fund investments. The goal was to create easier access to funding for startups and urban development project promoters.1 Loans, equity, guarantees, and other financial instruments attract greater public and private funding sources that may be reinvested over many cycles as compared to receiving grants. One of the instruments, a co-investment facility, was to provide funding for startups to develop their business models and attract additional financial support through a collective investment plan managed by one main financial intermediary. The European Commission projected the total public and private resource investment at approximately €15 million (approximately $17.75 million) per small- and medium-sized enterprise.1

5.1.4. Role of the Financial Intermediaries

The reason for the all-pervasive nature of the financial intermediaries like banks and insurance companies lies in their uniqueness. As outlined above, Banks often serve as the “intermediaries” between those who have the resources and those who want resources. Financial intermediaries like banks are asset based or fee based on the kind of service they provide along with the nature of the clientele they handle. Asset based financial intermediaries are institutions like banks and insurance companies whereas fee based financial intermediaries provide portfolio management and syndication services.

5.1.5. Need for regulation

The very nature of the complex financial system that we have at this point in time makes the need for regulation that much more necessary and urgent. As the sub-prime crisis has shown, any financial institution cannot be made to hold the financial system hostage to its questionable business practices. As the manifestations of the crisis are being felt and it is now apparent that the asset backed derivatives and other "exotic" instruments are amounting to trillions, the role of the central bank or the monetary authorities in reining in the rogue financial institutions is necessary to prevent systemic collapse. As capital becomes mobile and unfettered, it is the monetary authorities that have to step in and ensure that there are proper checks and balances in the system so as to prevent losses to investors and the economy in general.

5.1.6. Recent trends

Recent trends in the evolution of financial intermediaries, particularly in the developing world have shown that these institutions have a pivotal role to play in the elimination of poverty and other debt reduction programs. Some of the initiatives like micro-credit reaching out to the masses have increased the economic well being of hitherto neglected sectors of the population.

Further, the financial intermediaries like banks are now evolving into umbrella institutions that cater to the complete needs of investors and borrowers alike and are maturing into "financial hyper marts".

As we have seen, financial intermediaries have a key role to play in the world economy today. They are the "lubricants" that keep the economy going. Due to the increased complexity of financial transactions, it becomes imperative for the financial intermediaries to keep re-inventing themselves and cater to the diverse portfolios and needs of the investors. The financial intermediaries have a significant responsibility towards the borrowers as well as the lenders. The very term intermediary would suggest that these institutions are pivotal to the working of the economy and they along with the monetary authorities have to ensure that credit reaches to the needy without jeopardizing the interests of the investors. This is one of the main challenges before them.

5.1.7. Benefits of Financial Intermediaries

Through a financial intermediary, savers can pool their funds, enabling them to make large investments, which in turn benefits the entity in which they are investing. At the same time, financial intermediaries pool risk by spreading funds across a diverse range of investments and loans. Loans benefit households and countries by enabling them to spend more money than they have at the current time.

Financial intermediaries also provide the benefit of reducing costs on several fronts. For instance, they have access to economies of scale to expertly evaluate the credit profile of potential borrowers and keep records and profiles cost-effectively. Last, they reduce the costs of the many financial transactions an individual investor would otherwise have to make if the financial intermediary did not exist.

5.1.8. The Fundamentals of Corporate Finance and Accounting

Whatever your learning style, understanding corporate finance and accounting is easy when you can choose from 183,000 online video courses. With Udemy, you'll be able to learn accounting terminology and how to prepare financial statements and analyze business transactions. What's more, each course has new additions published every month and comes with a 30-day money-back guarantee. Learn more about Udemy and sign up today.

Financial intermediaries work in the savings/investment cycle of an economy by serving as conduits to finance between the borrowers and the lenders. In the financial system, intermediaries like banks and insurance companies have a huge role to play given that it has been estimated that a major proportion of every dollar financed externally has been done by the banks. Financial intermediaries are an important source of external funding for corporates. Unlike the capital markets where investors contract directly with the corporates creating marketable securities, financial intermediaries borrow from lenders or consumers and lend to the companies that need investment.

5.2. FINANCIAL INSTITUTION

Financial Institutions are referred to as a company that deals in all types of finance-related businesses. They are different from banks and play a very important part in broadening the financial services in the country. They provide a very attractive rate of returns to the customers in comparison to any government-centric banks. It deals in loans and advances and also specializes in some specified sectors like hire purchases and leasing etc.

The financial institution deals with finance-related services. These are gaining popularity day by day nowadays. The attractive rate of returns on the customer's investment is very demanding. It also provides specialized services like hire purchase and leasing, etc. The simple and organized procedure of the institutions is becoming very complementary. It provide a broad range of business opportunities. There are different types of financial institutions. The goal of all the institutions is different and they provide different services and have different levels of risk associated with it. All the financial institutions have unique features and it works in a specialized way. The financial institution is gaining immense popularity in broadening the finance-related services in the country.

Functions of a Financial Institution

5.2.1. There are multiple functions of financial institutions. They include:

a) Banking services **-** Financial institutions, specifically commercial banks, assist their customers by giving them banking services like deposit and saving services. These institutions also give out credit services that assist their clients in catering to their immediate needs. The credit services could include mortgages, personal or educational loans.

b) Capital formation - Financial institutions assist in the creation of capital by increasing capital stock. Financial institutions can increase the stocks by organizing savings that are not in current use by customers and giving them to investors.

c) Monetary supply regulation - Financial institutions control the supply of money in an economy. The main objective of this control is to ensure that there is stability in an economy and limited chances of inflation. The financial institution tasked with this responsibility is the

central bank, and it completes this task by transacting the government's securities to influence liquidity.

d) Pension fund services - Pension funds are made by financial institutions to assist people in preparation for their retirement. These pension funds are investment means that these institutions create to ensure individuals have money after their retirement, which could be issued on a monthly basis.

e) Ensure economic growth of a nation - Governments play a vital role in controlling financial institutions, and the main objective is to help in the growth of an economy. When there are issues in an economy, financial institutions are mandated to provide loans with low interest to assist in maintaining an economy.

5.3. FUNCTIONS OF FINANCIAL INSTITUTIONS

i) The financial institutions provide loans and advances to the customers.
ii) The rate of return is very high in case of investment made in this type of institution.
iii) It also gives a high rated consultancy to the customers for their beneficial investments.
iv) It also serve as a depository for their customers.
v) It can also make an effort to minimize the monitoring cost of the company.
vi) All the finance related work is done by the financial institution or on behalf of the customers.

5.4. ROLE OF FINANCIAL INSTITUTIONS

i) The financial institution provides varied kinds of financial services to the customers.
ii) The financial institution provides an attractive rate of return to the customers.
iii) Promotes the direct investment by the customers and making them understand the risk associated with that as well.
iv) It helps in forming the liquidity of the stock in case of an emergency in the financial markets.

5.5. FEATURES

i) It provides a high rate of return to the customers who have invested in the financial institution.
ii) It reduces the cost of financial services provided.
iii) It is considered very important for the development of financial services in the country.
iv) It also advises the customers on how to deal with the equity and the other securities bought and sold in the market.
v) It helps to improvise decision making because it follows a systematic approach to calculate all the risks and rewards.

5.6. ADVANTAGES OF FINANCIAL INSTITUTIONS

i) The financial institutions help in the upliftment of the economies of our country.

ii) It has been proved to be more successful in terms of return earned by the customers since the rate of return is higher compared to any other place.
iii) It is also a smart way to invest money and keep the money rotated in the finance market.
iv) It provides financial services to the customers.
v) The repayment facility is also very well managed in the financial institutions.
vi) It also provide underwriting facilities.

5.7. DISADVANTAGES OF FINANCIAL INSTITUTIONS

i) The process is very complex for some customers because they try to indulge in various businesses and end up making confusion for themselves.
ii) In case of default done by the management of the financial institutions, the customers will have to face major worse circumstances.
iii) The money which they have invested may not be recovered. Sometimes the principal amount is not assured to be recovered because the government in case of default announces a certain sum of money which will be repaid and most of the time the amount of government declare to be repaid is very less in comparison to the principal amount of the investment made.

5.8. THE MAJOR CATEGORIES OF FINANCIAL INSTITUTIONS

In today's financial services marketplace, a financial institution exists to provide a wide variety of deposit, lending, and investment products to individuals, businesses, or both. While some financial institutions focus on providing services and accounts for the general public, others are more likely to serve only certain consumers with more specialized offerings. To know which financial institution is most appropriate for serving a specific need, it is important to understand the difference between the types of institutions and the purposes they serve. There are major types of financial institutions that provide a variety of services from mortgage loans to investment vehicles. As financialization continues to permeate our lives, it is increasingly likely that you will have an account or product offered by several of these types. Nowadays, an increasing number of financial institutions operate online, which in some instances may reduce some of their services fees.

The major categories of financial institutions include central banks, retail and commercial banks, internet banks, credit unions, savings, and loans associations, investment banks, investment companies, brokerage firms, insurance companies, and mortgage companies. Regional rural banks (RRB), Cooperative banks/ societies., Development banks and All India finance institutions (IDBI, NABARD, SIDBI, NHB etc.) Pension/provident funds (NPS, EPFO etc.), India Infrastructure Finance Company Ltd (IIFCL), Export-Import Bank of India (EXIM Bank), Small Industries Development Bank of India(SIDBI), National Housing Bank (NHB), Acuite Ratings & Research Limited, Industrial Finance Corporation of India (IFCI). Here we take a look at these, from central banks to neighborhood banks and everything in between.

How does it work?

Financial institutions work like banks in some ways. They give loans and advances to the customers and also set a platform for the customers to do some investments. The customers get exciting offers and returns from them and therefore these institutions are gaining

popularity. It also provide consultancy services to the clients on their investments related to the financial markets where the huge amount of risk is involved. Moreover, the customers who are handing over their hard-earned monies to such institutions should check for the history and origin of this financial institution.

A) Central Banks

A central bank is a public institution that manages the currency of a country or group of countries and controls the money supply – literally, the amount of money in circulation. The main objective of many central banks is price stability.

A central bank is a financial institution given privileged control over the production distribution of money and credit for a nation or a group of nations. In modern economies, the central bank is usually responsible for the formulation of monetary policy and the regulation of member banks. Central banks are the financial institutions responsible for the oversight and management of all other banks. In the United States, the central bank is the Federal Reserve Bank, which is responsible for conducting monetary policy and supervision and regulation of financial institutions .Individual consumers do not have direct contact with a central bank; instead, large financial institutions work directly with the Federal Reserve Bank to provide products and services to the general public.

The functions of a central bank can be discussed as follows:

i) Currency regulator or bank of issue.
ii) Bank to the government.
iii) Custodian of Cash reserves.
iv) Custodian of International currency.
v) Lender of last resort.
vi) Clearing house for transfer and settlement.
vii) Controller of credit.
viii) Protecting depositors interests.

B) Retail and Commercial Banks

Traditionally, retail banks offered products to individual consumers while commercial banks worked directly with businesses. Currently, the majority of large banks offer deposit accounts, lending, and limited financial advice to both demographics. Products offered at retail and commercial banks include checking and savings accounts, certificates of deposit (CDs), personal and mortgage loans, credit cards, and business banking accounts.
Banking is a business like any other business. Banks and other financial institutions exist to make profits. A commercial bank is a fairly simple busi-ness concern. Its basic objective is to provide certain services for customers and in return receives pay-ment from them.

Such banks provide a full range of banking ser-vices, including savings and current accounts and loans for all commercial purposes. Commercial banks are designed primarily to finance the produc-tion, distribution, and sale of goods as well as pro-viding long-term or capital funds, (as the State Bank of India is doing with its capital market business).

The term full-service banking has been used in re-cent years as a more appropriate term because of the diversification of commercial banks into various operations other than

commercial lending, includ-ing consumer banking, mortgage banking, commer-cial sales financing, international banking and many other functions.

C) **Internet Banks**

Internet banking, also known as online banking, e-banking or virtual banking, is an electronic payment system that enables customers of a bank or other financial institution to conduct a range of financial transactions through the financial institution's website.

A newer entrant to the financial institution market is internet banks, which work similarly to retail banks. Internet banks offer the same products and services as conventional banks, but they do so through online platforms instead of brick-and-mortar locations. Under internet banks, there are two categories: digital banks and neo-banks. Digital banks are online-only platforms affiliated with traditional banks. However, neobanks are pure digital native banks with no affiliation to any bank but themselves.2

Best Online Banks of May 2022

i) Best Online Banks. ii) Quontic Bank. iii) Axos Bank., iv) Discover Bank.v) Ally Bank. vi) nbkc bank.vii) iGObanking.viii) Salem Five Direct

D) Credit Unions

A credit union, a type of financial institution similar to a commercial bank, is a member-owned nonprofit financial cooperative. It providing traditional banking services and is created, owned, and operated by its members. In the recent past credit unions used to serve a specific demographic per their field of membership, such as teachers or members of the military. Nowadays, however, they have loosened the restrictions on membership and are open to the general public. Credit unions are not publicly traded and only need to make enough money to continue daily operations. That's why they can afford to provide better rates to their customers than commercial banks. While members can access better rates, credit unions may provide fewer services than traditional banks and they have fewer brick-and-mortar locations than most banks, which can be a drawback for clients who like in-person service.

These are non-profit making cooperative soci-eties formed by individuals bound together by same common tie, such as a common employer or labour union. Typically credit union members hold mem-bers' savings accounts and enjoy access to pooled savings of all members.

Best Credit Unions

Credit Union	**Key features**
Alliant Credit Union	Best credit union for checking and savings.
Connexus Credit Union	Best credit union for checking APY.
First Tech Federal Credit Union	Best credit union for member experience.
Golden 1 Credit Union	Best credit union for teens and college students.
Consumers Credit Union	Best credit union for APY.
America First Credit Union	Free checking account that earns interest.
State Employees Credit Union	Strong share certificate rates.

Credit Union	Key features
Suncoast Credit Union	No monthly fees and decent APYs.

E) Savings and Loan Associations

The most important purpose of savings and loan associations is to make mortgage loans on residential property. Both savings and loans and commercial banks have been taxed heavily to pay for the Savings and Loan Crisis. At the end of the 1980s, Congress removed the walls that separated commercial banks and S&Ls, whereby much of the S&L industry today has been folded into the regular banking industry. However, S&Ls place a stronger emphasis on residential mortgages, whereas commercial banks tend to concentrate on working with large businesses and on unsecured credit services (such as credit cards). Commercial banks can be chartered at either the state or federal level. The same is true for S&Ls.

These are financial institutions, mostly mutual organisations having no capital stock, sometimes re-ferred to as savings associations, building and loan associations, normally found in western countries. Such associations pool the savings of a neighbourhood in order to provide funds for home purchases. Financial institutions that are mutually owned by their customers and provide no more than 20% of total lending to businesses fall under the category of savings and loan associations. They provide individual consumers with checking and accounts, personal loans, and home mortgages. Unlike commercial banks, most of these institutions are community-based and privately owned, although some may also be publicly traded. The members pay dues that are pooled together, which allows better rates on banking products.

F) Investment Banks

Investment banks are financial institutions that provide services and act as an intermediary in complex transactions, for instance, when a startup is preparing for an initial public offering (IPO), or in merges. They can also act as a broker or financial adviser for large institutional clients such as pension funds. Investment banks do not take deposits; instead, they help individuals, businesses and governments raise capital through the issuance of securities. Such banks are engaged in banking activities associated with securities underwriting, making a market in securities, and arranging mergers, acqui-sitions and restructuring regulated by the Securities and Exchange Board of India (SEBI).

Investment companies, traditionally known as mutual fund companies, pool funds from individuals and institutional investors to provide them access to the broader securities market. Global investment banks include JPMorgan Chase, Goldman Sachs, Morgan Stanley, Citigroup, Bank of America, Credit Suisse, and Deutsche Bank. Robo-advisors are the new breed of such companies, enabled by mobile technology to support investment services more cost-effectively and provide broader access to investing by the public.

Top 10 Indian Investment Banking Companies : Over 300 investment banking firms operate in India today. A few of the leading contenders in the field are listed below.

i) AXIS Capital

An important part of Axis Bank is Axis Capital Limited (ACL). Axis Capital Limited, formerly Enam Securities Private Limited, is a subsidiary of Axis Bank. It is one of India's

biggest investment banking firms, specializing in boutique and mid-market services. The company's authorized capital is Rs 17500.0 lakhs, and its paid-up capital is Rs 7350.0 lakhs or 42.0 percent.

ii) Avendus Capital

As an Indian-based investment bank, Avendus Capital specializes in asset management, investment banking, wealth management, and private placement services. An annual revenue of INR 15,137.41 lakhs was recorded in the company's 2018-19 Annual Report, according to the report.

iii) Edelweiss Financial Services Limited

This company was formed by Rashesh Shah and is a part of a group of companies called the Edelweiss Group. As a result, the group serves a large and diverse clientele. Many services are offered, including debt capital transactions and asset management. In the fiscal year 2020, the company expects to earn INR 9602.63 Cr.

iv) J Financial Institutions Securities

JM Financial Institutions Securities has a comprehensive view of banking, handling topics including mortgage lending to wealth management and troubled credit to brokerage services and asset reconstruction. They are very well known in the industry for providing private equity services. Big corporations, high-net-worth individuals, and retail investors are all clients of the firm. Their entire income for FY 2020 is INR 3453.33 Cr.

v) IDBI Capital

IDBI Capital is a venture capital firm based in India. IDBI Capital is an investment bank that provides a holistic range of services and products to its clients. It is a completely subsidiary of IDBI Bank that provides support in investment banking, underwriting, debt placement, capital market products, corporate consultancy, and a variety of other areas. It has a net worth of roughly INR 3 billion and engages more than 200 employees in 15 locations across India. In FY 2018, they made a total revenue of INR 95.57 crore.

vi) O3 Capital Global Advisory Services

O3 Capital Global Advisory Services is a company that provides global advisory services.
O3 Capital Global Advisory Services is a full-service mid-market investment bank serving individual, institutional, and corporate clients. Corporate finance and wealth management are two of their areas of expertise. Healthcare, life sciences, industrials, and financial services are among the companies that the firm concentrates on. The company has a Rs 125.0 lakh authorized capital and a Rs 120.38 lakh paid-up capital of 96.30096 percent. Their operating income ranges between INR1 crore and INR100 crore.

vii) ICICI Securities Limited is a financial services company based in India (I-Sec)

I-Sec is an ICICI Bank Ltd subsidiary that specializes in integrated securities. Financial institutions, companies, and retail investors all benefit from the firm's consulting services. Some of the services provided by the business include private wealth management, retail

broking, institutional broking, and the placement of initial public offerings. In FY 2020, their total revenue increased from INR 418.22 crore FY 2019 to INR 680.46 crore. The annual income for FY 2020 is INR 1724.94 Cr.

viii) Veda Corporate Advisors

Veda Corporate Advisors is a consulting firm that helps customers with mergers and acquisitions, private equity, buyouts, venture capital, and joint ventures. The company's authorized share capital is Rs. 250,000, with a paid-up capital of Rs. 134,420.

ix) Unitus Capital

Investment banking firm Unitus-Capital is the first impact-based investment banking firm in India. It helps with initial venture finance and subsequent public offerings (IPOs).

x) Spark Capital

Spark Capital is among India's leading mid-market investment banking firms. The firm works with a variety of industries, including commerce, fintech, markets, and media.

G) Brokerage Firms

Brokerage firms act as a liaison between their clients and the stock exchange. Their primary function is to buy and sell financial products, including stocks, on behalf of their clients. Brokers pool resources to help their clients negotiate how things work in the stock market. Brokerage firms assist individuals and institutions in buying and selling securities among available investors. Customers of brokerage firms can place trades of stocks, bonds, mutual funds, exchange-traded funds (ETFs), and some alternative investments. As nouns the difference between brokerage and broker is that brokerage is a business, firm, or company whose business is to act as a broker (eg, stockbroker) while broker is a mediator between a buyer and seller.

A brokerage company primarily acts as a middleman to connect buyers and sellers to facilitate a transaction. Brokerage companies typically receive one of two types of commission: a flat fee or a percentage of the transaction amount. Examples of a full-service broker might include offerings from a company such as Morgan Stanley, Goldman Sachs, or even Bank of America Merrill Lynch. The larger brokerage firms tend to carry an inventory of shares available to their customers for sale.

A brokerage firm buys and sells stocks, bonds, options and other financial products on behalf of clients. Many brokerages hire individual brokers as a way to pool resources and offer the best service. In addition, many financial services companies also have brokerage houses as part of their broader services.

Eight Best Discount Brokers in India – Stock brokers List 2022
i) Zerodha.,ii) Angel One (Previously Angel Broking),iii) Upstox. iv) 5Paisa, v) Kotak Securities (Trade FREE Plan), vi) Groww.,vii) Paytm Money., viii) Trade Smart.

H) Insurance Companies

Term insurance is the most basic and cost-effective form of life insurance availed for a predefined period of time.The objective of term insurance is to provide financial coverage to the policyholder (you) and/or beneficiary in case of unfortunate events in return for paying regular premiums. When you get term insurance, you can be assured that your family and dependents will be financially secure in your absence.This helps your family fulfil their future needs like higher education. Financial institutions that help individuals transfer the risk of loss are known as insurance companies. Individuals and businesses use insurance companies to protect against financial loss due to death, disability, accidents, property damage, and other misfortunes.

In this type of investment, the insurance company takes ownership of all the policy and plan matters and manages the strategies themselves. Having understood the basic difference between passive and active strategies, you must now have a much deeper understanding of active vs. passive investment.

How does claim settlement work in case you have more than one term insurance policy? Does term insurance provide cover outside India? What if I suffer from some major illness or start smoking after buying a term insurance policy? How easy is it to get a claim from a private insurance company as compared to the state-owned Life Insurance Corporation of India (LIC)? I am sure you must be concerned about all these questions if you have a term insurance policy or planning to buy one.

Today, I will answer some of the most asked questions, which an individual has in his mind, about term insurance. These questions if left unanswered would not only lead to fear, but may also delay one from taking the right decision. Please note: The following questions and answers are only for term insurance policy and are generally true for any company's term plan. However, very rarely these questions and answers may differ across insurers.

i) Do Term Insurance pay in case of Accidental Death?

Yes, term insurance pays in case of an accidental death. The sum assured or cover taken under the term plan will pay the claim if the death has occurred due to any reason, be it natural or accidental death, or death due to some illness. There are certain riders (additional benefits) such as accidental death benefit, permanent disability rider and critical illness rider. By buying/adding these riders to the policy, a policyholder can ensure that his nominee will get an amount over and above the basic sum assured (due to any of the rider-related incidents).

ii) Does Life Insurance covers death outside India?

Yes, term plans cover death outside India provided the policyholder has updated this fact with the insurance company. He needs to mention that he now lives outside India. Just like change of phone number, address or nominee, there is a facility in the policy service form where the policyholder has to mention that he is going abroad. However, if he is going to a country that is marked as unsafe like Pakistan, Burma, Somalia etc., then the company will decline this facility. Otherwise, this cover will be valid in other countries like US or UK.

iii) To what extent Pvt Insurance companies investigates death compared to LIC?

There is a difference between early claim and normal claim. If a claim arises within the first two years of buying the policy (This period varies from company to company), the company investigates extensively before settling the claim. You can very well understand if someone has a cover of Rs.50 lakh by paying Rs.7,000 annually (And he has taken this policy on monthly basis, i.e. paying around Rs.600 monthly), then the company is at a great risk. Hence, the company will doubly check everything to settle the claim. In normal claim, premiums are paid regularly and the policy is in force for a long period, say 12 to 15 years. In these cases, there are not much issues in getting a claim, be it LIC or any private company.

iv) If I buy a term insurance policy today, can its premium change in the future?

Unless and otherwise it's mentioned in the policy document. Premium of a term insurance remains the same throughout the term of the policy provided everything remains the same with the policyholder. That is, the policyholder has not developed any illness or any smoking/drinking habit. On declaring any such thing, company might apply loading and thus the premium amount changes.

v) What if a person becomes a smoker after some years of taking the policies?

If the policyholder has developed any habit, like drinking or smoking, after buying the policy, he generally does not have to disclose this fact to the company at all, unless it's clearly mentioned in the policy document

vi) What if a person was a smoker long back but not at the time of taking the policy?

Depends on the policy, but just for example, the Kotak Life Insurance proposal form mentions that the client has to declare whether he was a smoker or drinker earlier also even if he has left that habit long ago. Please see page 4, question 10.3 of this document . However, I am not sure about other companies. Also, it depends on the company whom they consider as a non-smoker at the time of issuing a policy.For example: Max New York Life Insurance, for its Platinum Protect (term insurance), considers people, who have left smoking more than three years ago, as non-smokers. So please check the company's rule

vii) What kind of deaths are not covered in term insurance?

Some important facts, which most of the people are unaware of, are that most companies exclude "Death due to Terrorist Attack". Although such claims are settled on humanitarian grounds later on when the nominee approaches Insurance Regulatory and Development Authority (IRDA) but such exclusion is there in most companies. Other important fact, which public at large is unaware of, is that insurance companies do not cover death due to war or natural disaster like earthquake/tsunami. Because in these cases, death toll is high and the claim to be settled runs in crores of rupees which is difficult to settle by the company all of a sudden. Therefore, these facts should also be kept in mind while buying a term insurance.

viii) How to take care of claim settlement in case of more than two policies?

The very first thing, in these cases, is to declare in the proposal form that you already have a policy from an XYZ company. (There is a column in every company's proposal form, which

a client has to fill if he has an insurance policy from the same company or any other company). Once such information is provided, then at the time of claim, the usual practice is to submit the Death Certificate to the insurance company with whom the policy is running for the longest period. Other companies are then informed of the procedure due and an acknowledgment from the FIRST Company is provided to them which are accepted by other companies. Moreover, of late, it has been reported that generally insurance companies do not ask for an original death certificate to settle the claims, even a photocopy of the certificate will do. So be alert while filling the form and provide all the information about your previous policies to prevent even a minor problem later on.

ix) Can NRI's buy Term Insurance?

They can, but there is a catch. As a general rule, a person has to be resident in India to take up insurance policy from an Indian Company, reason being the documents required by the company like Address proof/age proof are to be for some place in India. Moreover, if the Sum assured required is more than 50 lakhs or so, customer is required to submit his financial papers such as last 3 years ITR or Form-16 which again should be done in India only. Last thing, medical tests would be done at some medical center affiliated to the insurance company near the address of the client which again should be in India. So these are reason why insurance might have been declined to some NRI. So one way which might work is this , If a NRI wants to take Insurance, then on his/her next visit to India he should submit his proof of residence, age, last 3 years ITR etc. and get his medical done at his Indian address. This way he can get his policy issued very easily. However, there is no need to complicate it and in-case you are out in some country and plan to be there for next couple of years, the best thing would be to take term insurance from your country of residence and later when you come back to India, you can buy term insurance that time.

I) Mortgage Companies

A mortgage company is a specialized financial firm engaged in the business of originating and/or funding mortgages for residential or commercial property. A mortgage company is often just the originator of a loan; it markets itself to potential borrowers and seeks funding from one of several client financial institutions that provide the capital for the mortgage itself. That, in part, is why many mortgage companies went bankrupt during the subprime mortgage crisis of 20008-09. Because they weren't funding most of the loans, they had few assets of their own, and when the housing markets dried up, their cash flows quickly evaporated. Financial institutions specialized in originating or funding mortgage loans are mortgage companies. While most mortgage companies serve the individual consumer market, some specialize in lending options for commercial real estate only. Mortgage companies focus exclusively on originating loans and seek funding from financial institutions that provide the capital for the mortgages. Many mortgage companies today operate online or have limited branch locations, which allows for lower mortgage costs and fees.

What is the Main

i) A mortgage company is a lender specializing in originating home loans.

ii) Some mortgage lenders offer creative and out-of-the-box loan offerings, such as no origination fees or offering loans to those with less than stellar credit.

iii) The factors that differentiate one mortgage company from another include relationships with funding banks, products offered, and internal underwriting standards.

iv) It is possible today to complete a mortgage application entirely online, although some customers prefer face-to-face meetings with a loan offer at a bank.

v) Understanding Mortgage Companies

vi) A mortgage company is a financial firm that underwrites and issues (originates) its own mortgages to homebuyers, using their own capital to issue the loans. Also known as a direct lender, a mortgage company typically only specializes in mortgage products and does not offer other banking services such as checking, investments, or loans for other purposes.

vii) Moreover, they will usually offer their own products and will not offer loans or products from other companies.

Many mortgage companies today operate online or have limited branch locations, which may reduce face-to-face interaction, but could, at the same time, lower the costs of doing business. While a mortgage company will originate loans, they may not service your loan, or keep it on their balance sheet for long. Indeed, many times, a mortgage lender will sell the loan (individually or bundled together with others) to a third-party mortgage servicing institution such as an investment bank, hedge fund, or agency like Fannie Mae or Freddie Mac. While this typically has no bearing on an individual borrower, this practice has been criticized for creating an abundance of subprime debts that ultimately led to the 2008-09 financial crisis. Mortgage companies often offer a portfolio of mortgage products to potential homebuyers including fixed-rate, adjustable-rate (ARM), FHA, VA, military, jumbos, refinance, and home equity lines of credit (HELOCs).

Special Considerations

The Equal Credit Opportunity Act prohibits credit discrimination based on age, race, color, religion, national origin, gender, marital status, or because you get public assistance. It's also illegal for lenders to discourage you from applying or to impose different terms or conditions because of these factors. Finally, it prohibits lenders from denying mortgages to retirees if all standard criteria are met—things like your credit score, the size of your down payment, your liquid assets, and your debt-to-income ratio. Although it is unclear how long the trend will continue, positive economic data indicates that for the immediate future homebuyers can continue to benefit from low mortgage interest rates.

J) Merchant Banks:

The term merchant bank refers to a financial institution that conducts underwriting, loan services, financial advising, and fundraising services for large corporations and high-net-worth individuals (HWNIs). Merchant banks are experts in international trade, which makes them specialists in dealing with multinational corporations. Unlike retail or commercial banks, merchant banks do not provide financial services to the general public. Some of the largest merchant banks in the world include J.P. Morgan Chase, Goldman Sachs, and Citigroup.

Merchant banks are financial institutions and companies that deal with international finance for multinational corporations. These banks differ from other types of financial institutions. As such, they don't deal with the general public. They don't provide everyday financial services such as checking accounts, bill payments, or basic investments and don't take deposits or make withdrawals for their customers.

Although they don't deal with the general public, some of the biggest merchant banks also have retail and commercial banking operations. Instead, merchant banks traditionally perform international financing and underwriting including real estate, trade finance, and foreign investment. They may be involved in issuing letters of credit (LOCs) and in the transfer of funds. They may also consult on trades and trading technology. Merchant banks use more creative forms of financing. They typically work with companies that may not be large enough to raise funds from the public through an initial public offering (IPO). Merchant banks help corporations issue securities through private placement, which require less regulatory disclosure and are sold to sophisticated investors.

Merchant banks may also be involved in arranging other international transactions. Let's say Company ABC–based in the United States—wants to buy Company XYZ in Germany, it would hire a merchant bank to facilitate the process. That bank would advise Company ABC how to structure the transaction. It may also help ABC in the financing and underwriting process. The term merchant bank is used to describe investment banks in the United Kingdom but has a more narrow focus in the United States. Merchant banks may act like investment banks in the U.S. but tend to focus on services tailored to multinational corporations and high net worth individuals who do business in more than one country.

Special Considerations

If a multinational corporation operates in many different countries, a merchant bank can finance business operations in all those countries and manage the currency exchanges as funds are transferred and provide the funds to make the purchase using a letter of credit. Using the example above, the sellers in Germany receive a LOC issued by the merchant bank hired by Company ABC as payment for the purchase. The merchant can also help the Company ABC work through the legal and regulatory issues required to do business in Germany.

Merchant Banks vs. Investment Banks

There's a very fine line between merchant and investment banks. Investment banks underwrite and sell securities to the general public through IPOs. The bank's clients are large corporations that are willing to invest the time and money necessary to register securities for sale to the public. Investment banks also provide advisory services to companies about mergers and acquisitions (M&A) and provide investment research to clients. While merchant banks are fee-based, investment banks have a two-fold income structure. They may collect fees based on the advisory services they provide to their clients, but may also be fund-based, meaning they can earn income from interest and other leases.

Regardless of how a company sells securities, there are some minimum disclosure requirements to inform investors. Both IPOs and private placements require a company audit by an external certified public accountant (CPA) firm, which provides an opinion on the

financial statements. Audited financial statements must include several years of financial data along with disclosures. Potential investors can use this information about the risks and potential rewards of buying the securities.

K) Mutual Funds:

A mutual fund is a type of investment vehicle consisting of a portfolio of stocks, bonds, or other securities, which is overseen by a professional money ... These are investment companies that issue and sell redeemable securities that present an undivided interest in the assets held by the funds, sometimes classified as management companies or unit invest-ment trust; pooled resources of many investors that provide diversification and professional management. Most mutual funds fall into one of four main categories – money market funds, bond funds, stock funds, and target date funds. Each type has different features, risks, and rewards. Mutual funds are a safe investment if you understand them. Investors should not be worried about the short-term fluctuation in returns while investing in equity funds. You should choose the right mutual fund, which is in sync with your investment goals and invest with a long-term horizon.

5 Simple Steps to Invest in Mutual Funds Online

i) Understand your risk capacity and risk tolerance. ...
ii) The next step is asset allocation. ...
iii) Then you should identify the funds that invest in each asset class. ...
iv) Decide on the mutual fund schemes you will be investing in and make the application online or offline.

L) Mutual Savings Banks:

A mutual savings bank is a financial institution chartered by a central or regional government, without capital stock, owned by its members who subscribe to a common fund. From this fund, claims, loans, etc., are paid. Profits after deductions are shared among the members. These were originally set up to serve very small savers. These banks can use their deposits for a wide variety of purposes, including investment in bonds and blue chip-stocks. Today, it's quite common for both institutions to offer the same services. The primary difference is in how they're operated: MSBs are depositor-owned, while commercial banks are shareholder-owned.

A mutual savings bank is owned by its depositors while a public bank is owned by shareholders. A traditional bank is owned by shareholders, which means a regular bank is more concerned with pleasing them, not you. Mutual savings banks more closely resemble credit unions and savings and loans than traditional banks, because they are owned by members. Earn long-term rewards by opening a savings account today Mutual banks have a different corporate structure than commercial banks. They do not have shareholders, but rather are owned mutually by their depositors. They cannot be bought and answer only to their customers. We're safe. Under Australian law, credit unions, mutual banks and retail banks are referred to as Australian Authorised Deposit-Taking Institutions and all are regulated by the Australian Prudential Regulation Authority (APRA). Mutuals are just as safe as a bigger retail bank.

What is a mutual bank?

Unlike a retail bank, which is usually owned by large institutional investors and other shareholders, a mutual bank is owned by its members. That means everything done by a mutual bank is for the benefit of its members.

10 reasons why it's better banking with a mutual

i) You own the place. Every member has an equal share in the mutual, and an equal vote. So, you can bank where you matter.

ii) Profits are reinvested, rather than siphoned off to shareholders. By reinvesting profits back into systems and products, mutuals are able to provide members with the better services, products and value.

iii)A human touch. Most mutuals are far smaller than the retail banks, which means when you deal with a mutual you often deal with a financial institution that knows you by name and not by a number.

iv) Our size also means we're able to offer more support and help to members. We have the time and care to work with members on finding the best possible solution for them, rather than a one-size-fits-all approach.

v) We're safe. Under Australian law, credit unions, mutual banks and retail banks are referred to as Australian Authorized Deposit-Taking Institutions and all are regulated by the Australian Prudential Regulation Authority (APRA). Mutuals are just as safe as a bigger retail bank.

vi) We care. At the heart of every mutual is a member-focussed ethos that always looks to act in the best interest of members. We like to think of it as banking with heart.

vii) You'll be satisfied. When it comes to customer satisfaction, mutuals far outrank their retail bank counterparts. According to the recent Roy Morgan customer satisfaction survey, on average mutual banks scored an impressive 90.0 per cent satisfaction rating, compared to the average rate of 78 per cent for the Big 4.

viii) Great range of products. Mutual banks generally offer standard consumer banking services such as home loans, online savings accounts, insurance, etc. It's a one-stop-banking-shop.

ix) We keep the market competitive. By banking with a mutual, you are helping maintain market competition in the banking industry. Which ultimately translates into a fairer playing field and better options for consumers.

x) Banking on the go. In today's fast-paced world, online and mobile banking are important. Most mutual banks can offer the same digital features as bigger banks, including online banking facilities and apps.

5.8. SUMMARY

This lesson is entitled that "Financial intermediaries & Financial Institutions" Its planned to reveal the entire lesson is divided into six aspects such as: 1. Introduction 2.Financial intermediaries & Financial Institutions, 3. Functions of financial institutions, 4. Features & Role of Financial Institutions, 5. Advantages & Disadvantages of financial institutions, and 6. Types of financial institutions

5.9.TECHNICALTERMS

Financial intermediaries: A financial intermediary is an entity that acts as the middleman between two parties in a financial transaction, such as a commercial bank, investment bank, mutual fund, or pension fund.

Financial Institutions : A financial institution (FI) is a company engaged in the business of dealing with financial and monetary transactions such as deposits, loans, investments, and currency exchange.

Mutual bank : The basic idea behind mutual banks is they are not controlled by stockholders or other direct owners. Rather, their customers – the depositors that bank with them – are considered mutual owners.

Mutual fund : A mutual fund is a type of financial vehicle made up of a pool of money collected from many investors to invest in securities like stocks, bonds, money market instruments, and other assets.

Merchant Banks : Merchant banking is a professional service provided by the merchant banks to their customers considering their financial needs, for adequate consideration in the form of fee. Merchant banks are banks that conduct fundraising, financial advising and loan services to large corporations

Investment Banks : Essentially, investment banks serve as middlemen between a company and investors when the company wants to issue stock or bonds. The investment bank assists with pricing financial instruments to maximize revenue and with navigating regulatory requirements.

5.10. SELF ASSESSMENT QUESTIONS

1) What is Financial Intermediary? Discuss about Financial intermediaries .
2) What is Financial Institution? Explain regarding Financial Institution.
3) Discuss any three types of financial institutions.
4) What is Merchant Bank? Discuss about Merchant Banks.
5) What is Investment Bank? Explain regarding Investment Bank.

5.11. SUGGESTED READINGS

1. I.M. Panday: "Financial Management " Vikas Publishing House (P) Ltd

2. Chandra, Prasanna "Financial Management " Tata Publishing House Ltd, New Delhi

3. S.N. Maheswari : "Principles of Financial Management " Sultan Chand, Delhi

4. Sheeba Kapil : "Financial Management " Pearson, 2011

5. P.V. Kulakarni: "Financial Management " Himalaya Publishing House Bombay

6. Khan & Jain : Cases in "Financial Management " Tata Publishing House Ltd, Delh

LESSON-6

VALUE OF A FIRM: BONDS, PREFERENCE SHARES & EQUITY

Aims and Objectives

After studying this lesson you should be able to:

- Know the Forms of Business Organization
- Understand the Financial Intermediaries
- Explain the Financial Markets: Money market & Capital market

Structure

6.1. INTRODUCTION

Value is the monetary, material, or assessed worth of an asset, good, or service. "Value" is attached to a myriad of concepts including shareholder value, the value of a firm, fair value, and market value. The process of calculating and assigning a value to a company or an asset is called valuation.

Values are individual beliefs that motivate people to act one way or another. They serve as a guide for human behavior. Generally, people are predisposed to adopt the values that they are raised with. People also tend to believe that those values are “right” because they are the values of their particular culture.

Values are individual beliefs that motivate people to act one way or another. They serve as a guide for human behavior. Generally, people are predisposed to adopt the values that they are raised with. People also tend to believe that those values are “right” because they are the values of their particular culture.

Our values are important because they help us to grow and develop. They help us to create the future we want to experience. Every individual and every organization is involved in making hundreds of decisions every day.

A firm's value, also known as Firm Value (FV), Enterprise Value (EV). It is an economic concept that reflects the value of a business. It is the value that a business is worthy of at a particular date. Theoretically, it is an amount that one needs to pay to buy/take over a business entity. Like an asset, the value of a firm can be determined on the basis of either book value or market value. But generally, it refers to the market value of a company. EV is a more comprehensive substitute for market capitalization and can be calculated by following more than one approach.

6.2. CALCULATING A FIRM'S VALUE

The value of a firm is basically the sum of claims of its creditors and shareholders. Therefore, one of the simplest ways to measure the value of a firm is by adding the market value of debt, equity, and minority interest. Cash and cash equivalents would be then deducted to arrive at the net value.

For example, if company ABC has total assets worth $500 million. And its total liabilities amounting to $450 million, the book value of the firm would be $50 million (by deducting the value of liabilities from that of assets). This means that if a company XYZ is to purchase company ABC, then it will have to shell $50 million out of its pocket, the actual book value of buying company ABC.

Formula for Calculating a Firm's Value

EV = Market value of Common equity + Market value of Preference equity + Market value of debt + Minority

One of the reasons why the concept of EV has gained more importance than market capitalization is because the former is more inclusive. Besides equity, it includes the value of debt as well as cash reserves which have an important role to play in a corporation's valuation. A buyer would have to pay off a firm's debt when taking over the firm. And the same could be net off from the cash and cash equivalents available with the firm.

Another sound approach towards computing the value of a firm is to determine the present value of its future operating free cash flows. The idea is to draw a comparison between two similar firms. By similar firms, we mean similar in size, same industry, etc. The firm whose present value of future operating cash flows is better than the other is more likely to attract higher valuation from the investors. Operating Free Cash Flow (OFCF) is calculated by adjusting the tax rate, adding back depreciation and deducting the amount of capital expenditure, working capital and changes in other assets from earnings before interest and taxes. The formula for computing OFCF is as below –

Formula for Computing Operating Free Cash Flow (OFCF)

OFCF = EBIT (1-T) + Depreciation – CAPEX – working capital – any other assets

Where, EBIT = earnings before interest and taxes,
T = tax rate CAPEX = capital expenditure

Calculating OFCF in such a way gives a more accurate picture of cash-generating capabilities of a firm. Once OFCF is computed, one can use a suitable discount rate to find the present value of OFCF. On the basis of the sum of all the present value of future operating cash flows, one can decide on whether to take over a firm or not. While the above approaches may seem cumbersome, one can also make use of business valuation calculators.

Value of a Firm Calculator can help buyers and sellers in determining the true value in no time. For different industries, different business valuation calculators have been developed by finance experts.

6.3. BOOK VALUE OF A FIRM

As the name implies, the book value of the firm is its value as reflected in its 'books' or financial statements. It is the difference between the assets and liabilities of a firm as per its balance sheet. It is the shareholder's equity in the balance sheet. This is the true worth of a business when its liabilities are net off from its assets. The book values of assets are routinely compared to market values as part of various financial analyses. For example, if a bought a machine for $50,000 and its associated depreciation was $10,000 per year, then at the end of the second year, the machine would have a book value of $30,000.
What is book value formula?

What is book value?

Book value refers to the value of an asset recorded on a balance sheet—that is, its value after accounting for accumulated depreciation. Every business owns several assets. Therefore, every business also has a book value representing the current value of its assets minus its liabilities or outstanding debts. In other words, the book value of a business is the total amount of money a company would generate if it was liquidated without selling any assets at a loss.

6.3.1 What is the book value formula?

The book value is the amount of money a firm can reasonably expect if it sold all of its assets at current market prices. Stock prices are often quite a bit higher than the book value, so a P/B under 1.0 often indicates a good value. Value investors often use a P/B of 3.0 as a good threshold. Understanding how to evaluate a business's financial condition is an essential skill, both for accountants and potential investors. One way to evaluate a business is to analyze the book value of its assets. It is important to distinguish between book value and similar concepts like market value and carrying value. In this article, we define book value and show you how to read balance sheets to determine the book values of assets, companies and shares of stock.

There are three important formulas for book value:

i) Book value of an asset = total cost - accumulated depreciation.
ii) Book value of a company = assets - total liabilities.
iii) Book value per share (BVPS) = (shareholders' equity - preferred stock) / average shares outstanding.

6.3.2. Important aspects in the book value of a business

i) The book value of a business is the total amount a company would generate if it was liquidated without selling any assets at a loss.
ii) The book value of a share is called “shareholders’ equity.”
iii) Book value is not the same as carrying value. However, they both are methods to evaluate an asset.
iv) A company’s book value is typically less than its market value.

6.3.3. How to calculate book value

To find the figures necessary to calculate the book value of an asset or a company, you can refer to the company's balance sheet. A balance sheet contains a section for assets (and the amount by which they've depreciated) and one for liabilities. You can plug these values into the appropriate formula to compute book value.

When accountants amortize an asset that is not depreciable, they factor that amortization into the asset's value on the balance sheet. Therefore, the book value of such an asset is the same as its value on the balance sheet.

To calculate BVPS, you divide the company's shareholders' equity (i.e., book value) by the number of shares outstanding. You can find the number of shares outstanding on websites that provide reliable market data. Not all companies offer preferred stock but if they do, you need to subtract the total value of its preferred stock from the book value before dividing. You can find the total value of a company's preferred stock in the equity section of its balance sheet.

6.3.4. Book value vs. market value

The market value of an asset is the price it would sell for on the free market. The market value of a business is the total price of all its outstanding shares. The market value of a business is often higher than its book value because some factors affecting demand for stock do not appear on its balance sheet. For example, a company might trade for more than its book value, if its CEO has a reputation as a brilliant businessperson. Reputation is not an asset that accountants can quantify on a balance sheet but can use to attract investments.

6.4. MARKET VALUE OF A FIRM

One of the main reasons why market value is important is because it provides a concrete method that eliminates ambiguity or uncertainty for determining what an asset is worth. In the marketplace, customers and sellers often have different perceptions of the value of a product. The market value of a company, also known as market capitalization, is its value as reflected in the stock exchange. It is calculated by multiplying a company’s outstanding share by its current market price.For example, if company ABC has 10 million shares outstanding and the market price of each share is $50; then the market value of the company would be $500 million, assuming there are only common shares issued in the market. Market value and the book value of the firm are two different concepts. There is quite a possibility of a huge difference between the book and market value of a company at a given point of time.

What approach of calculating the value of a firm we follow depends on the firm in question. Also, whether to consider the book value or market value of a company while making a

decision to buy is a policy and strategy decision. One can engage companies that exclusively deal with estimating the true value of firms. There are several ways to calculate the market value of a company. This is of critical importance to an investor, who wants to understand whether it makes sense to buy or sell a firm's shares.

6.4.1. Valuation of a Company by Stock Price

When the shares of a company are already publicly-held, the easiest way to calculate its market value is to multiply the number of shares outstanding by the current price at which the shares sell on the applicable stock exchange. If the shares only trade over the counter, then the trading volume may be so thin that the trading prices are not realistic.

6.4.2. Valuation of a Company by Sales Multiples

A reasonable alternative is to develop a multiple of the sales for those companies that have reasonable trading volume to their market prices, and apply this multiple to the sales of the business. This latter approach can be subject to some uncertainty, since the more robust comparison entities may justifiably be worth more than the companies for which a valuation is being compiled. If so, it is likely that an excessively high market value will be generated.

6.4.3. Valuation of a Company by Comps

Another valuation approach is to investigate how much similar companies are selling for as a percentage of their sales, and use the same multiple to develop an estimate for the business. A major flaw in this approach is that the best companies are more likely to be sold first, and so attract the best multiples; companies selling after this first tranche do not perform as well, and so should probably sell at a lower multiple.

6.4.4. Valuation Examples

As an example of the first situation, a business has 1,000,000 common shares outstanding, which trade at $30 on a major national exchange. Its market value is $30,000,000. As an example of the second situation, a company is developing a market value for itself based on a comparison to another business. The other business has a sales to market value ratio of 0.5 to 1. The company being measured has sales of $5,000,000, so its derived market value is $2,500,000. As an example of the third situation, the average selling price as a percentage of reported sales within an industry over the past year has been 50%; a business is currently generating annual sales of $50 million, and so might expect to sell for $25 million.

6.5. THE VALUATION OF A FIRM—TYPES OF APPROACHES

Some of the commonly used methods for calculating the valuation of a firm are as follows: 1. Capitalised Earnings 2.Assets Approach 3.Market Value Approach 4. Earnings per Share.

A) **Capitalised Earnings** Approach**:**

The capitalised earnings method is based on the philosophy that the price which a buyer would like to pay for the property of a concern will depend upon the present and expected earning capacity of the business. The present price is paid in the expectations of future returns

from such investments. The capitalised earnings will depend upon the (1) Estimate of earnings, and (2) Rate of capitalisation.

The estimation of earnings will involve the study of past earnings. The past earnings over a long period will give an exact idea about the earning position of the business. The past earnings of one or two years may be influenced by abnormal causes such as price fluctuations, etc.; so, a true and fair opinion will not be made available and nothing should be concealed.

If the earnings are showing a stability then the earnings will be easily calculated; if, on the other hand, the earnings are showing a trend then some allowance should be made for the conditions prevailing at that time.

After estimating the average earnings, the earnings should be capitalised to arrive at an investment value. A decision about the rate of earnings at which the profits are to be capitalised is very difficult. It is a sort of arbitrary figure. One should be guided by economic factors only while calculating capitalisation rate. If the earnings per share are Rs. 5 and the capitalisation rate is 10%, then the value of the share will be Rs. 50.

B) Assets Approach:

Assets approach is the commonly used method of valuation. The assets may be taken at book value, reproduction value and liquidation value. In book value method, the values of assets are taken from a current balance sheet. The excess of assets over debts will determine the assets values, divided by the number of equity shares will give the value of one share.

If preference stock is also outstanding then preference stock should be deducted before dividing the assets values by the number of equity shares. This approach is also known, as net worth value. There is a difference of opinion about the assets to be included and assets such as goodwill, patent rights, and deferred expenses should be excluded.

Another view is that goodwill and patents should be included while fictitious assets such as deferred expenses should only be excluded. The fixed assets are taken at book value less depreciation upto present balance sheet period. A company following a rigorous depreciation policy may be at a disadvantage than the company providing lower depreciations.

Public utilities may use the reproduction value of assets while valuing the properly. Liquidation values of assets are used on the assumption that if the concern is liquidated at present then what values will be fetched by the assets. The concern is taken as a going concern and as such current book values of assets are used in most of the cases.

C) Market Value Approach:

This approach is based on the actual market price of securities settled between the buyer and the seller. The market value will be the realistic value because buyers will be ready to pay in lieu of a purchase. The price of a security in the free market will be its most appropriate value.

Market price is affected by the factors like demand and supply and position of money market. The price of a security in the free market will be its most appropriate value. Market value is a device which can be readily applied at any time.

A number of practical problems are faced while applying market value approach. The market value will be available for securities of big companies only. The number of shares offered in the market is generally small and it will not be advisable to apply the same value to the whole lot of shares of the company.

Another objection against this method is that there are many upward and downward trends in values of securities in the stock exchanges and it becomes a problem to decide about the price to be taken for valuation. Despite practical limitations, market value approach may be used under many conditions.

D) Earnings per Share Approach:

Another method of determining the values of the firms under merger or consolidation is the earnings per share. According to this approach, the value of a prospective merger or acquisition is a function of the impact of merger/acquisition on the earnings per share.
Such impact could either be positive resulting into the increases in EPS or may be negative resulting into dilution of EPS. As the market price per share is a function (product) of EPS and Price-Earning Ratio, the future EPS will have an impact on the market value of the firm. The following illustrative examples explain the effect of merger/acquisition on EPS.

6.6. VALUATION OF BONDS OR DEBENTURES

When a bond or debenture is irredeemable, its present value can be determined by simply discounting the stream of interest payments for the infinite period by an appropriate capitalization rate or discount rate.

6.6.1. Bond

A bond is a debt instrument that provides a periodic stream of interest payments to investors while repaying the principal sum on a specified maturity date. A bond's terms and conditions are contained in a legal contract between the bu[illegible] and the seller, known as the indenture. A bond is a contract that requires the borrower to pay the interest income to th[illegible]ender. It resembles the promissory note issued by the government and corporate. The par value of the bond indicates the face value of the bond i.e., the value stated on the bond p[illegible]er. Most of the bonds make fixed inte[illegible]t payment till the maturity period. This specific rate of interest is [illegible]own as coupon rate. Coupons are paid quarterly, semi-annually and annually. At the end of the maturity period, the value is repaid. A bond is more or less the same as a debenture.

6.6.2. Nature/Features of Bonds

i) Indenture: The indenture is a long, complicated legal instrument containing the restrictions, pledges and promises of the contract. Bond indenture involves three parties.
ii) Face Value: The face value (also known as the par value) of a bond is the price at which the bond is sold to investors when first issued.
iii) Coupon Rate: The periodic interest payments promised to bond holders are computed as a fixed percentage of the bond's face value. This percentage is known as the coupon rate.

iv) Repayment of Principal: The face value of the bond represents the promise to repay the amount to the bondholder at the end of the specified period. This, in other words, may be called the most important feature of bond, return of the principal to the lender on a fixed date specified earlier.

v) Maturities / Specified Time Period: Maturities vary widely. Bonds are usually grouped by their maturity classes..

vi) Interest Payment: Bond interest is usually paid semi-annually, though annual payments are also popular. The method of payment depends upon whether the bond is a coupon (bearer) or registered bond.

6.6.3. Bond/Debenture Valuation

The value of bonds or debentures is, generally, determined through the technique known as Capitalization. It is the process of determining the fair price of a bond/Debenture. As with any security or capital investment, the fair value of a bond is the present value of the stream of cash flows it is expected to generate. Hence, the price or value of a bond is determined by discounting the bond's expected cash flows to the present using the appropriate discount rate. The process of determination of the present value of a bond/debenture can be classified into two parts:

1) Redeemable Bond/Debenture (Have Finite Maturity Period)
2) Irredeemable (Perpetual) Bond/Debenture (Infinite Maturity Period)

6.6.4. What is Bonds and Valuation of Bonds?

EMI Valuation of bonds and calculating EMI

Bonds also known as debentures is a debt or a long-term loan which upon maturity, will be paid upon the principal amount or the periodical interest. The process of determining these bonds is called bond valuation. It is used to determine the theoretical price or fair price or intrinsic price of the bonds.

A bond is generally a security for a debt, in which the person who is issuing holds a debt against the person who has taken the loan and thereby is obliged to pay the interest and the principal amount. Usually, bonds are issued for longer periods which are usually greater than one year. To understand the value of the bond, let's understand the concept, based on which the valuation is done.

6.6.5. Illustration

Let us suppose that, there is a person called Arun. Arun wants to invest a certain amount in one of the following companies. All the following companies will return the same amount i.e. Rs. 110 on the investment. One government company which is risk-free, other is company X which is low risk and company Y which is at high risk.

Now the rate of return for all these companies is 10%, 12%, and 15% respectively. So how much will Arun invest in each of these so that Arun gets the same amount he wants. When you lend someone the money, the interest rate on depends on the risk it is involved in the transaction.

Suppose you are lending the money to a student than you will charge high-interest rate, while if you lend a professional the money than you will charge the person low-interest rate. In the above case, for a government company, Arun will have to invest Rs. 100 to get an investment of Rs. 110. Because percentage of return = interest/investment x 100.

While for company X, Arun will have to invest Rs. 98.22 on which 12% return he will get an investment will result in Rs. 110. While for the company Y Arun will have invested the least amount which is Rs. 95.65, as the return, is the highest for company Y. Thus, it is clear that company Y will give the maximum returns, but it also has the highest risk among the three companies.

So, the value of your investment depends upon two factors: cash inflow and required return. If the amount you invest today is less than you will have more return and vice versa. So, Present value of future inflow = investment value today.

6.6.6. Terms Related to Bonds and Bond Valuation

i) Par Value or Face Value

We call the value on the face of the bond as the face value. Usually, the value of the bond is assumed to be at face value if there is no other value specified in the question. The par value or the face value can be Rs. 100 or 1000 based on the values given in the question.

ii) Coupon Rate

The interest rate that is fixed and is surely received by the bondholder as payment for interest is what we call coupon rate. The value of the coupon rate remains the same until the maturation of the bond.

iii) Redeem Value

When the value of the bond is matured, the bondholder receives a value and this is called redeemed value. Here also, if there nothing specific about the redeeming value in the question than we assume the bonds to be redeemed on the par or the face value.

iv) Yield Rate

Yield rate or current yield is the value that the bondholder receives as a part of the interest income for the current value of that bond. Thus, yield rate/current yield = Interest income/current value. The market value of the bond yield to maturity when the bond is held till it's maturity period then we call the rate of the earning as yield to maturity.

v) Calculating EMI

As the bonds are long-term debts, the issuer decides the fixed EMI, so that the holder can pay it equally in the period which is decided. The most important term that we use when we talk about the loan is EMI, which is equated monthly instalment. It is usually monthly payment and includes the contribution from the principal as well as interest on the loan amount taken. Mathematically, we calculate EMI as,

$$EMI = P \times r \times (1 + r)n / ((1 + r)n - 1)$$

Example

Find the EMI for a principal amount of Rs. 1,00,000 for 12 months at 10% rate of interest.

Here, P = Rs. 1,00,000 r = 10% and n = 12 months. So, the EMI calculated will be, Rs. 8792.

6.7. VALUATION OF PREFERENCE SHARES

The valuation of preference shares is a very straightforward exercise. Usually preference shares pay a constant dividend. This dividend is the percentage of the face value of the share. For instance, a preference share with the face value of $100 which pays 5% dividend will pay $5 in dividends.

Like valuing any other financial asset, the valuation of preferred shares is the present value of the expected future cash flows discounted by a rate of return. This rate would be reflective of risk connected with the preferred shares.

The par value of a share of preferred stock is the amount upon which the associated dividend is calculated. Thus, if the par value of the stock is $1,000 and the dividend is 5%, then the issuing entity must pay $50 per year for as long as the preferred stock is outstanding.

Kp = D/P X 100 = 100000 / 10, 00,000 X 100 = 10% it is same as dividend rate but Kpr is more than Kp. So, Kpr will give you correct result.

Preference Shares are issued by corporations or companies with the primary aim of generating funds. In general, in case of any exit event, preference shareholders have preferential rights for payment of dividend and the liquidation preference over common shareholders.

6.7.1. Characteristics of Preference Shares

There are three main characteristics which define and drive a preference share Valuation – nature of coupon/dividend, redemption terms and conversion terms.

i) Coupon/Dividend: Coupon can be zero, cumulative or non-cumulative. Additionally, one might see instances involving moratorium in accrual/payment of coupon for a part of the preference share tenure.

ii) Redemption: Redemption is the settlement in cash, either at maturity or in an amortizing fashion over multiple redemption dates. Redemption may be defined in terms of a fixed redemption premium, but far more popular option is to define it by an effective IRR requirement, with redemption premium quantum getting adjusted for coupon payments already made prior to redemption.

iii) Conversion: Conversion indicates settlement in equity shares of the Issuer. Conversion may be defined in terms of a fixed or formula driven conversion ratio/ price.

6.7.2. Various Types of Preference

Combinations of the above characteristics lead to various types of preference shares. Some of them are discussed below:

i) Cumulative: All dividends are carried forward until specified, and paid out only at the end of the specified period.

ii) Non-cumulative: Dividends are paid out of profits for every year as per terms of the agreement. There are no arrears carried over a time period to be paid at the end of the term.

iii) Redeemable: A company issues them to shareholders and later redeems them. This means the company can buy back the shares at a later date.

iv) Non-Redeemable: Such shares cannot be redeemed during the lifetime of the company, but can only be obtained at the time of winding up (liquidation) of assets.

v) Convertible: The shares can be converted into equity shares after a time period as per the conditions laid down in the terms.

vi) Non-convertible: Non-convertible preference shares as per name explains cannot be, at any time, converted into equity shares.

vii) Participating: Such shares have the right to participate in any additional profits to the extent as per conditions laid down in the terms, after paying the equity shareholders.

viii) Non-Participating: Non-participating preference shares do not possess any right to participate in any surplus profits at the time of liquidation of the company.

6.7.3. Indian Accounting Standards

The following Indian Accounting Standards or Ind AS standards apply to them:

Ind AS 32: Presentation and classification of financial instruments

Ind AS 109: Recognition, de-recognition, classification and measurement of financial instruments

Ind AS 113: Principles of fair value measurement that would be applicable to financial instruments

Ind AS 107: Disclosures required with respect to financial instruments.

For Fair Value Measurement (FMV) of preference shares, we rely primarily on the principles discussed in Ind AS 113 and terms of its measurement as indicated in Ind AS 109.

6.7.4. Valuation Approaches

Let's have a quick look at three classical Valuation Approaches which are typically applied in business valuation and can be extended to financial instruments as well.

A) Income Approach: The discounted cash flow (DCF) analysis is the primary methodology used for Valuation of compulsorily convertible preference shares and the redeemable preferred shares. Two inputs to the DCF model are cash-flows and the discount factor. Cash can flows take any form i.e. dividends, coupon, redemption, or maturity amount, underlying equity shares upon conversion at triggering event or at the end of the term. A Valuer must assess the availability of cash-flows, triggering condition and the likelihood of each event which can impact the cash flows available during and/or at the end of the period as indicated in the term sheet of preference shares.

B) Market Approach: Our quick assessment of the listed preference shares market in India indicates that the market lacks the depth. Most of the preference shares are privately placed and full feature disclosure is not available in the public domain. Further, trade information/ frequency in case of listed preference shares is low. This poses a challenge to carrying out any meaningful analysis based on comparable transaction method. Therefore, market approach is seldom applicable in case of preferred shares valuation.

C) Cost Approach: Ind AS 109 allows recognizing financial asset/ liabilities through the amortized cost method, under specific circumstances, when the concept of SPPI (Solely held to collect principal and interest) is fully satisfied, particularly in case of RPS, which is non-convertible but redeemable at maturity.

Importantly, in most of the cases where preferred shares are deriving its value from the conversion into its underlying equity shares, as first step, it would require business/ equity valuations using the combination of above mentioned three approaches depending on the nature, size and requirement of valuation.

Once the value of the company is determined, next step is to allocate the value among different class of securities like convertible debt, common equity and preferred equity. Each class of shares/instruments have different rights and preferences like liquidation preference, participation rights, conversion rights, redemption rights, anti- dilution rights, voting rights and many other features attached with the securities. Some are qualitative in nature and difficult to quantify like voting rights differential, however most of them are quantifiable as economic gain or loss can be ascertained in favorable and/or unfavorable events.

The Option Pricing Method (OPM) is most commonly used for allocation of enterprise value among different security classes. OPM treats securities, including debt, common and preferred stock, as a series of call options on the enterprise's value, with exercise prices based on the securities'respective liquidation preferences, redemption premium and/or conversion terms. Thus, the common stock is a call option with a claim on the enterprise at an exercise price equal to the remaining value immediately after the liquidation preferences are fulfilled and considering the relevant rights of the preferred stock (e.g., participation) as well as the potential dilution from other outstanding securities such as options and warrants.

Binomial lattice method and Monte Carlo simulation method are the other two methods to value the complex instruments depending on whether the payoffs are linear or non-linear, path dependent or not, and/or risk neutral assumption in OPM method holds true or not.

6.8. VALUATION OF EQUITY SHARES

Equity valuation is a blanket term and is used to refer to all tools and techniques used by investors to find out the true value of a company's equity. In accounting, equity refers to the book value of stockholders' equity on the balance sheet, which is equal to assets minus liabilities.

The three primary equity valuation models are the discounted cash flow (DCF), the cost, and the comparable (or comparables) approach. The comparable model is a relative valuation approach. The first primary comparable approach is the most common and looks at market comparables for a firm and its peers.

Since the valuation of shares is made on the basis of Yield, it is called Yield-Basis Method. Further, it can be classified as (a) Rate of earning and (b) Rate of dividend. In other words, yield may be earning yield and dividend yield. Value per share = Capitalized Value/Number of Shares.

6.8.1. Methods of Valuation of Shares:

Valuation of shares is the process of determining the fair value of the company shares. The methods of valuation depend on the purpose for which valuation is required. Share valuation is done based on quantitative techniques and share value will vary depending on the market demand and supply. Generally, there are three methods of valuation of shares:

A) Net Assets Method of Valuation of Shares

Under this method, the net value of assets of the company is divided by the number of shares to arrive at the value of each share. Since the valuation is made on the basis of the assets of the company, it is known as Asset-Basis or Asset- Backing Method. For the determination of the net value of assets, it is necessary to estimate the worth of the assets and liabilities. The goodwill, as well as non-trading assets, should also be included in total assets. Under this method, the value of the net assets of the company is to be determined first. The following points should be considered while valuing of shares according to this method:

Goodwill must be properly valued

The fictitious assets such as preliminary expenses, discount on issue of shares and debentures, accumulated losses, etc. should be eliminated.
The fixed assets should be taken at their realizable value.
Provision for bad debts, depreciation, etc. must be considered.
All unrecorded assets and liabilities (if any) should be considered.
Floating assets should be taken at market value.
The external liabilities such as sundry creditors, bills payable, loan, debentures, etc. should be deducted from the value of assets for the determination of net value.

The net value of assets, determined so has to be divided by a number of equity shares for finding out the value of the share. Thus the value per share can be determined by using the following formula:

Value Per Share=(Net Assets-Preference Share Capital)/Number of Equity Shares

B) Yield or Market Value Method of Valuation of Shares

Yield is the effective rate of return on investments that is invested by the investors. The expected rate of return in investment is denoted by yield. The term “rate of return” refers to the return which a shareholder earns on his investment. Since the valuation of shares is made on the basis of Yield, it is called Yield-Basis Method. Further, it can be classified as (a) Rate of earning and (b) Rate of dividend. In other words, yield may be earning yield and dividend yield.

i) Earnings Yield

Under this method, shares are valued on the basis of expected earning and a normal rate of return. The value per share is calculated by applying the following formula:

Value Per Share = (Expected rate of earning/Normal rate of return) X Paid-up value of equity share

Expected rate of earning = (Profit after tax/paid-up value of equity share) X 100

ii) Dividend Yield

Under this method, shares are valued on the basis of expected dividend and normal rate of return. The value per share is calculated by applying following formula:

Expected rate of dividend = (profit available for dividend/paid up equity share capital) X 100

Value per share = (Expected rate of dividend/normal rate of return) X 100

iii) Earning Capacity Method of Valuation of Shares

Under this method, the value per share is calculated on the basis of disposable profit of the company. The disposable profit is found out by deducting reserves and taxes from net profit. The following steps are applied for the determination of value per share under earning capacity:

Step 1: To find out the profit available for dividend
Step 2: To find out the capitalized value
Capitalized Value =(Profit available for equity dividend/Normal rate of return) X 100
Step 3: To find out value per share
Value per share = Capitalized Value/Number of Shares.

6.9. SUMMARY:

This lesson is entitled that "Valuation of the Firm**:** Bonds, Preference Shares & Equity**"** The aim of this lesson is to know and understand the Concept of value of the firm – Book value- Market value –Valuation of Bonds or Debentures – Valuation of Preference Shares – Valuation of Equity Shares

6.10. TECHNICAL TERMS:

Firm : A firm is a for-profit business, usually formed as a partnership that provides professional services, such as legal or accounting services. The theory of the firm posits that firms exist to maximize profits.

Bond : A bond is a debt security, similar to an IOU. Borrowers issue bonds to raise money from investors willing to lend them money for a certain amount of time. When you buy a bond, you are lending to the issuer, which may be a government, municipality, or corporation.

Preference Share : Preference shares, more commonly referred to as preferred stock, are shares of a company's stock with dividends that are paid out to shareholders before common stock dividends are issued. If the company enters bankruptcy, preferred stockholders are entitled to be paid from company assets before common stockholders.

Equity : Equity represents the value that would be returned to a company's shareholders if all of the assets were liquidated and all of the company's debts were paid off. We can also think of equity as a degree of residual ownership in a firm or asset after subtracting all debts associated with that asset.

Valuation : Valuation is a quantitative process of determining the fair value of an asset or a firm. In general, a company can be valued on its own on an absolute basis, or else on a relative basis compared to other similar companies or assets.

6.11. SELF ASSESSMENT QUESTION:

1) What is firm value?
2) How do we calculate the value of the firm?
3) Why the concept of economic value is more popular than market capitalization?
4) What is the formula for computing operating free cash flows?
5) What do you mean by the book value of the firm?
6) How do we calculate the market value of the firm?

6.12. SUGGESTED READINGS

1. I.M. Panday: "Financial Management " Vikas Publishing House (P) Ltd
2. Chandra, Prasanna "Financial Management " Tata Publishing House Ltd, New Delhi
3. S.N. Maheswari : "Principles of Financial Management " Sultan Chand, Delhi
4. Sheeba Kapil : "Financial Management " Pearson, 2011
5. P.V. Kulakarni: "Financial Management " Himalaya Publishing House Bombay
6. Khan & Jain : Cases in "Financial Management " Tata Publishing House Ltd, Delh

LESSON - 7
FINANCIAL MANAGEMENT- CONCEPT

Aims and Objectives

After studying this lesson you should be able to:

- Know the meaning and features of financial management
- Understand the Scope, Nature and Importance of financial management
- Explain the concept of Finance function
- Reveal the role of financial manager

Structure

7.1. INTRODUCTION

An organization requires financial management for various activities. For examples: approving loans or credit lines, hiring employees, building customer's relationship, creating company's credit rating, adjustment in budgets, managing cash inflow and outflow activities, risk management and more. Financial management is strategic planning, organising, directing, and controlling of financial undertakings in an organisation or an institute. It also includes applying management principles to the financial assets of an organisation, while also playing an important part in fiscal management.

Financial management is the core of entire finance study. The term financial management also has lots of definitions. Out of all the definitions most popular and widely accepted definition of financial management is delivered by S.C. Kuchhal. According to him, "Financial Management deals with procurement of funds and their effective utilization in the business."

7.2.DEFINITIONS OF FINANCIAL MANAGEMENT

i) In words of Solomon, "Financial management aims to effectively use the capital funds which also happens to be a significant economic resource."

ii) Financial management definition by different author – Phillippatus has given a more amplified meaning of financial management. According to him "Financial Management is concerned with the managerial decisions that results in the acquisition and financing of short and long term credits for the organizations."

iii) In views of Howard and Upton, "Financial management should be considered as an application of general managerial principles to the area of financial decision-making."

iv) According to Weston and Brigham, "Financial management is province of financial decision-making, harmonizing individual motives and enterprise goals".

v) "Financial management is the activity concerned with planning, raising, controlling and administering of funds used in the business." – Guthman and Dougal

vi) "Financial management is that area of business management devoted to a judicious use of capital and a careful selection of the source of capital in order to enable a spending unit to move in the direction of reaching the goals." – J.F. Brandley

viii) "Financial management is the operational activity of a business that is responsible for obtaining and effectively utilizing the funds necessary for efficient operations."- Massie

7.3.ELEMENTS OF FINANCIAL MANAGEMENT

Investment decisions includes investment in fixed assets (called as capital budgeting). Investment in current assets are also a part of investment decisions called as working capital decisions.

Financial decisions - They relate to the raising of finance from various resources which will depend upon decision on type of source, period of financing, cost of financing and the returns thereby.

Dividend decision - The finance manager has to take decision with regards to the net profit distribution. Net profits are generally divided into two:

Dividend for shareholders- Dividend and the rate of it has to be decided.

Retained profits- Amount of retained profits has to be finalized which will depend upon expansion and diversification plans of the enterprise.

7.4.NATURE, OF FINANCIAL MANAGEMENT

Financial management is an organic function of any business. Any organization needs finances to obtain physical resources, carry out the production activities and other business operations, pay compensation to the suppliers, etc. There are many theories around financial management:

Some experts believe that financial management is all about providing funds needed by a business on terms that are most favorable, keeping its objectives in mind. Therefore, this approach concerns primarily with the procurement of funds which may include instruments, institutions, and practices to raise funds. It also takes care of the legal and accounting relationship between an enterprise and its source of funds.

Another set of experts believe that finance is all about cash. Since all business transactions involve cash, directly or indirectly, finance is concerned with everything done by the business.

The third and more widely accepted point of view is that financial management includes the procurement of funds and their effective utilization. For example, in the case of a manufacturing company, financial management must ensure that funds are available for installing the production plant and machinery. Further, it must also ensure that the profits adequately compensate the costs and risks borne by the business.

In a developed market, most businesses can raise capital easily. However, the real problem is the efficient utilization of the capital through effective financial planning and control.

7.5. SCOPE OF FINANCE FUNCTION

The scope of finance function is very wide. While accounting is concerned with the routine type of work, finance function is concerned with financial planning, policy formulation and control. Earnest W. Walker and William are of the opinion that the financial function has always been important in business management. The financial organiastion depends upon the nature of the organization – whether it is a proprietary organsation, a partnership firm or corporate body. The significance of the finance function depends on the nature and size of a business firm. The role of various finance officers must be clearly defined to avoid conflicts and the overlapping of responsibilities. The operational functions of finance include: 1. Financial planning, 2.Deciding the capital structure, 3. Selection of source of finance, 4. Selection of pattern of investment

7.5.1. Financial Planning:

The first task of a financial manager is to estimate short-term and long-term financial requirements of his business. For this purpose, he will prepare a financial plan for present as well as for future. The estimation of fund is essential to purchase fixed assets as well as for the rotation of working capital. The estimations should be based on sound financial principles so that neither there are inadequate nor excess funds with the concern. The inadequacy of funds will adversely affect the day-to-day operations of the concern whereas excess funds may tempt a management to indulge in extravagant spending or speculative activities.

7.5.2. Deciding Capital Structure:

The Capital structure refers to the kind and proportion of different securities for raising funds. After deciding about the quantum of funds required it should be decided which type of securities should be raised. It may be wise to finance fixed assets through long-term debts. Even if gestation period is longer, then share capital may be most suitable. Long-term funds should be raised. It may be wise to finance fixed assets through long-term debts. Even here if gestation period is longer, then share capital may be most suitable. Long-term funds should be employed to finance working capital also, if not wholly then partially. Entirely depending upon overdrafts and cash creditors for meeting working capital needs may not be suitable. A

decision about various sources for funds should be linked to the cost of raising funds. If cost of raising funds is very high then such sources may not be useful for long.

7.5.3. Selection of Source of Finance:

After preparing a capital structure, an appropriate source of finance is selected. Various sources, from which finance may be raised, include share capital, debentures, financial institutions, commercial banks, public deposits, etc. If finances are needed for short periods then banks, public deposits and financial institutions may be appropriate; on the other hand, if long-term finances are required then share capital and debentures may be useful. If the concern does not want to tie down assets as securities then public deposits may be a suitable source. If management does not want to dilute ownership then debentures should be issued in preference to share.

7.5.4. Selection of Pattern of Investment:

When funds have been procured then a decision about investment pattern is to be taken. The selection of an investment pattern is related to the use of funds. A decision will have to be taken as to which assets are to be purchased? The funds will have to be spent first on fixed assets and then an appropriate portion will be retained for Working Capital. The decision-making techniques such as Capital Budgeting, Opportunity Cost Analysis, etc. may be applied in making decisions about capital expenditures. While spending on various assets, the principles of safety, profitability and liquidity should not he ignored. A balance should be struck even in these principles.

7.6. IMPORTANCE OF FINANCIAL MANAGEMENT

Financial management is one of the most important aspects in business. In order to start up or even run a successful business, you will need excellent knowledge in financial management. So what exactly is this form of management and why is it important? Read on to find out more.

A) **What is financial management?**

Financial management refers to the strategic planning, organising, directing, and controlling of financial undertakings in an organisation or an institute. It also includes applying management principles to the financial assets of an organisation, while also playing an important part in fiscal management. Take a look at the objectives involved:

i) Maintaining enough supply of funds for the organisation;
ii) Ensuring shareholders of the organisation to get good returns on their investment;
iii) Optimum and efficient utilization of funds;
iv) Creating real and safe investment opportunities to invest in.

Financial management is also made up of certain elements. These include:

B) Financial planning:

This is the process of calculating the amount of capital that is required by an organisation and then determining its allocation. A financial plan includes certain key objectives, which are:

i) Determining the amount of capital required;

ii) Determining the capital organisation and structure;
iii) Framing of the organisation's financial policies and regulations.

C) Financial control:

This is one of the key activities in financial management. Its main role is to assess whether an organisation is meeting its objectives or not. Financial control answers the following questions:

i) Are the organisation's assets being used competently?
ii) Are the organisation's assets secure?
iii) Is the management acting in the best financial interests of the organisation and the key stakeholders?

D) Financial decision-making:

This involves investment and financing with regards to the organisation. This department takes decisions about how the organisation should raise finance, whether they should sell new shares, or how the profit should be distributed.

The financial management department of any firm is handled by a financial manager. This department has **numerous functions** such as:

E) Calculating the capital required: (The Role of financial manager)

The financial manager has to calculate the amount of funds an organisation requires. This depends upon the policies of the firm with regards to expected expenses and profits.
The amount required has to be estimated in such a way that the earning capability of the organisation increases.

i) Formation of capital structure: Once the amount of capital the firm requires has been estimated, a capital structure needs to be formed. This involves debt equity analysis in the short-term and the long-term. This depends upon the amount of the capital the firm owns, and the amount that needs to be raised via external sources.

ii) Investing the capital: Every organisation or firm needs to invest money in order to raise more capital and gain regular returns. Hence, the financial manager needs to invest the organisation's funds in safe and profitable ventures.

iii) Allocation of profits: Once the organisation has earned a good amount of net profit, it is the financial manager's duty to efficiently allocate it. This could involve keeping a part of the net profit for contingency, innovation, or expansion purposes, while another part of the profit can be used to provide dividends to the shareholders.

iv) Effective management of money: This department is also responsible for effectively managing the firm's money. Money is required for various purposes in the firm such as payment of salaries and bills, maintaining stock, meeting liabilities, and the purchase of any materials or equipment.

v) Financial control: Not only does the financial manager have to plan, organise, and obtain funds, but he also has to control and analyse the firm's finances in the short-term and the

long-term. This can be done using financial tools such as financial forecasting, ratio analysis, risk management, and profit and cost control.

Why is Financial Management important?

F) This form of management is important for various reasons. Take a look at some of these reasons:

i) Helps organisations in financial planning;
ii) Assists organisations in the planning and acquisition of funds;
iii) Helps organisations in effectively utilising and allocating the funds received or acquired;
iv) Assists organisations in making critical financial decisions;
v) Helps in improving the profitability of organisations;
vi) Increases the overall value of the firms or organisations;
vii) Provides economic stability;
viii) Encourages employees to save money, which helps them in personal financial planning.

7.7. OBJECTIVES OF FINANCIAL MANAGEMENT

The financial management is generally concerned with procurement, allocation and control of financial resources of a concern. The objectives can be-

i) To ensure regular and adequate supply of funds to the concern.

ii) To ensure adequate returns to the shareholders which will depend upon the earning capacity, market price of the share, expectations of the shareholders.

iii) To ensure optimum funds utilization. Once the funds are procured, they should be utilized in maximum possible way at least cost.

iv) To ensure safety on investment, i.e, funds should be invested in safe ventures so that adequate rate of return can be achieved

v) To plan a sound capital structure-There should be sound and fair composition of capital so that a balance is maintained between debt and equity capital.

7.8. GOALS OF THE FIRM:

The Primary Goal of any Firm is to maximize its assets that would in turn maximize the entire valuation of the firm and establish the trust of the investors and the shareholders in the credibility of the firm. A large corporation may have hundreds of thousandsof shareholders. These shareholders differ in many ways, such as their wealth, risk tolerance, and investment capability. Yet we will see that they usually endorse the same financial goal: they want the financial managers to increase the value of the corporation and its current stock price.Thus the secret of success in financial management is to increase value. That is easy to say, but not very helpful. Instructing the financial manager to increase value is like advising an investor in the stock market to“buy low, sell high.”

To actually be able to do it is not easy and requires a very good understanding of the financial resources of your corporation and the financial environment of the Financial markets. In finance, the goal of the firm is always described as "maximization of shareholders' wealth".

Profit Maximization - is always used as a goal of the firm in microeconomics. Focus on short term goal to be achieved within a year. It stresses on the efficient use of capital resources. In order to maximize profit, the financial manager will implement actions that would result in maximum profits without considering the consequence of his actions towards the company's future performance.

Drawbacks of Profit Maximization

- Profit maximization is a short-term concept.
- Profit maximization does not consider the timing of returns.
- Profit maximization ignores risk.

Maximization of Shareholders' Wealth

The goal is o maximize the shareholders' wealth for whom it is being operated. It being measured by the share price of the stock, which in turn is based on the timing of returns, the amount of the returns and the risk or uncertainty of the returns.

It also means maximizing the total market value of the existing shareholders' common stock. All financial decisions will affect the achievement of this goal. Shareholders' wealth maximization can be achieved by considering the present and potential future earnings per share, timing of returns, dividend policy and other factors that affect the market price of the company's stock.

7.8.1. FINANCIAL GOAL - PROFIT VS WEALTH

Every firm has a predefined goal or an objective. Therefore the most important goal of a financial manager is to increase the owner's economic welfare. Here economics welfare may refer to maximization of profit or maximization of shareholders wealth. Therefore Shareholders wealth maximization (SWM) plays a very crucial role as far as financial goals of a firm are concerned.

Profit is the remuneration paid to the entrepreneur after deduction of all expenses. Maximization of profit can be defined as maximizing the income of the firm and minimizing the expenditure. The main responsibility of a firm is to carry out business by manufacturing goods and services and selling them in the open market. The mechanism of demand and supply in an open market determine the price of a commodity or a service. A firm can only make profit if it produces a good or delivers a service at a lower cost than what is prevailing in the market. The margin between these two prices would only increase if the firm strives to produce these goods more efficiently and at a lower price without compromising on the quality.

The demand and supply mechanism plays a very important role in determining the price of a commodity. A commodity which has a greater demand commands a higher price and hence may result in greater profits. Competition among other suppliers also effect profits. Manufacturers tends to move towards production of those goods which guarantee higher profits. Hence there comes a time when equilibrium is reached and profits are saturated.

According to Adam Smith - business man in order to fulfill their profit motive in turn benefits the society as well. It is seen that when a firm tends to increase profit it eventually makes use of its resources in a more effective manner. Profit is regarded as a parameter to measure firm's productivity and efficiency. Firms which tend to earn continuous profit eventually improvise their products according to the demand of the consumers. Bulk production due to massive demand leads to economies of scale which eventually reduces the cost of production. Lower cost of production directly impacts the profit margins. There are two ways to increase the profit margin due to lower cost. Firstly a firm can produce at lower sot but continue to sell at the original price, thereby increasing the revenue. Secondly a firm can reduce the final price offered to the consumer and increase its market thereby superseding its competitors.

Both ways the firm will benefit. The second way would increase its sale and market share while the first way only tend to increase its revenue. Profit is an important component of any business. Without profit earning capability it is very difficult to survive in the market. If a firm continues to earn large amount of profits then only it can manage to serve the society in the long run. Therefore profit earning capacity by a firm and public motive in some way goes hand in hand. This eventually also leads to the growth of an economy and increase in National Income due to increasing purchasing power of the consumer.

7.8.2. Profit Maximization Criticisms

Many economists have argued that profit maximization has brought about many disparities among consumers and manufacturers. In case of perfect competition it may appear as a legitimate and a reward for efforts but in case of imperfect competition a firm's prime objective should not be profit maximization.

In olden times when there was not too much of competition selling and manufacturing goods were primarily for mutual benefit. Manufacturers didn't produce to earn profits rather produced for mutual benefit and social welfare. The aim of the single producer was to retain his position in the market and sustain growth, thereby earning some profit which would help him in maintaining his position. On the other hand in today's time the production system is dominant by two tier system of ownership and management. Ownership aims at maximizing profit and management aims at managing the system of production thereby indirectly increasing the income of the business.

These services are used by customers who in turn are forced to pay a higher price due to formation of cartels and monopoly. Not only have the customers suffered but also the employees. Employees are forced to work more than their capacity. they is made to pay in extra hours so that production can increase.

Many times manufacturers tend to produce goods which are of no use to the society and create an artificial demand for the product by rigorous marketing and advertising. They tend to make the product so tempting by packaging and labeling that its difficult for the consumer to resist. These happen mainly with products which aim to target kids and teenagers. Ad commercials and print ads tend to provide with wrong information to artificially hike the expectation of the product.

In case of oligopoly where the nature of the product is more or less same exploit the customer to the max. Since they form cartels and manipulate prices by giving very less flexibility to the consumer to negotiate or choose from the products available. In such a scenario it is the

consumer who becomes prey of these activities. Profit maximization motive is continuously aiming at increasing the firm's revenue and is concentrating less on the social welfare.

Government plays a very important role in curbing this practice of charging extraordinary high prices at the cost of service or product. In fact a market which experiences a high degree of competition is likely to exploit the customer in the name of profit maximization, and on the other hand where the production of a particular product or service is limited there is a possibility to charge higher prices is greater. There are few things which need a greater clarification as far as maximization of profit is concerned

Profit maximization objective is a little vague in terms of returns achieved by a firm in different time period. The time value of money is often ignored when measuring profit.
It leads to uncertainty of returns. Two firms which use same technology and same factors of production may eventually earn different returns. It is due to the profit margin. It may not be legitimate if seen from a different stand point.

7.9.ROLE OF A FINANCIAL MANAGER

Financial activities of a firm is one of the most important and complex activities of a firm. Therefore in order to take care of these activities a financial manager performs all the requisite financial activities.A financial manger is a person who takes care of all the important financial functions of an organization. The person in charge should maintain a far sightedness in order to ensure that the funds are utilized in the most efficient manner. His actions directly affect the profitability, growth and goodwill of the firm.
Financial Manager is the executive who manages the financial matters of a business. Some of the major functions of a financial manager are as follows: 1. Estimating the Amount of Capital Required 2. Determining Capital Structure 3. Choice of Sources of Funds 4. Procurement of Funds 5. Utilisation of funds 6. Disposal of Profits or Surplus 7. Management of Cash 8. Financial Control. The functions of Financial Manager are discussed below:

i) **Estimating the Amount of Capital Required:** This is the foremost function of the financial manager. Business firms require capital for:

(i) purchase of fixed assets,(ii) meeting working capital requirements, and (iii) modernisation and expansion of business.The financial manager makes estimates of funds required for both short-term and long-term.

ii) **Determining Capital Structure:** Once the requirement of capital funds has been determined, a decision regarding the kind and proportion of various sources of funds has to be taken. For this, financial manager has to determine the proper mix of equity and debt and short-term and long-term debt ratio. This is done to achieve minimum cost of capital and maximise shareholders wealth.

iii) Choice of Sources of Funds: In order to meet the obligation of the business it is important to have enough cash and liquidity. A firm can raise funds by the way of equity and debt. It is the responsibility of a financial manager to decide the ratio between debt and equity. It is important to maintain a good balance between equity and debt. Before the actual procurement of funds, the finance manager has to decide the sources from which the funds are to be raised. The management can raise finance from various sources like equity

shareholders, preference shareholders, debenture- holders, banks and other financial institutions, public deposits, etc.

iv) Procurement of Funds: The financial manager takes steps to procure the funds required for the business. It might require negotiation with creditors and financial institutions, issue of prospectus, etc. The procurement of funds is dependent not only upon cost of raising funds but also on other factors like general market conditions, choice of investors, government policy, etc.

v) Utilisation of Funds: The funds procured by the financial manager are to be prudently invested in various assets so as to maximise the return on investment: While taking investment decisions, management should be guided by three important principles, viz., safety, profitability, and liquidity.

vi) Disposal of Profits or Surplus: The financial manager has to decide how much to retain for ploughing back and how much to distribute as dividend to shareholders out of the profits of the company. The factors which influence these decisions include the trend of earnings of the company, the trend of the market price of its shares, the requirements of funds for self-financing the future programmes and so on.

vii) Management of Cash: Management of cash and other current assets is an important task of financial manager. It involves forecasting the cash inflows and outflows to ensure that there is neither shortage nor surplus of cash with the firm. Sufficient funds must be available for purchase of materials, payment of wages and meeting day-to-day expenses.

viii) Financial Control: Evaluation of financial performance is also an important function of financial manager. The overall measure of evaluation is Return on Investment (ROI). The other techniques of financial control and evaluation include budgetary control, cost control, internal audit, break-even analysis and ratio analysis. The financial manager must lay emphasis on financial planning as well.

ix) Allocation of Funds: Once the funds are raised through different channels the next important function is to allocate the funds. The funds should be allocated in such a manner that they are optimally used. In order to allocate funds in the best possible manner the following point must be considered: The size of the firm and its growth capability, Status of assets whether they are long-term or short-term; Mode by which the funds are raised.These financial decisions directly and indirectly influence other managerial activities. Hence formation of a good asset mix and proper allocation of funds is one of the most important activities.

x) **Profit Planning:** Profit earning is one of the prime functions of any business organization. Profit earning is important for survival and sustenance of any organization. Profit planning refers to proper usage of the profit generated by the firm.

Profit arises due to many factors such as pricing, industry competition, state of the economy, mechanism of demand and supply, cost and output. A healthy mix of variable and fixed factors of production can lead to an increase in the profitability of the firm.

Fixed costs are incurred by the use of fixed factors of production such as land and machinery. In order to maintain a tandem it is important to continuously value the depreciation cost of fixed cost of production. An opportunity cost must be calculated in order to replace those

factors of production which has gone thrown wear and tear. If this is not noted then these fixed cost can cause huge fluctuations in profit.

xi) Understanding Capital Markets: Shares of a company are traded on stock exchange and there is a continuous sale and purchase of securities. Hence a clear understanding of capital market is an important function of a financial manager. When securities are traded on stock market there involves a huge amount of risk involved. Therefore a financial manger understands and calculates the risk involved in this trading of shares and debentures. It's on the discretion of a financial manager as to how to distribute the profits. Many investors do not like the firm to distribute the profits amongst share holders as dividend instead invest in the business itself to enhance growth. The practices of a financial manager directly impact the operation in capital market.

7.10. FINANCE FUNCTIONS

[Managerial Finance Functions (or) Functions of Financial Manager] Managerial finance functions are functions that require managerial skills in their planning, execution and control. The managerial finance functions are as follows:

The following explanation will help in understanding each finance function in detail

A) **Investment Decision**

One of the most important finance functions is to intelligently allocate capital to long term assets. This activity is also known as capital budgeting. It is important to allocate capital in those long term assets so as to get maximum yield in future. Following are the two aspects of investment decision Evaluation of new investment in terms of profitability; Comparison of cut off rate against new investment and prevailing investment.Since the future is uncertain therefore there are difficulties in calculation of expected return.

Investing decision is the managerial decision regarding investment in long-term proposals. It includes the decision concerned with acquisition, modification and replacement of long-term assets such as plant, machinery, equipment, land and buildings. Long term assets require huge amount of capital outlay at the beginning but the benefits are derived over several periods in the future. Because the future benefits are not known with certainty, long-term investment proposals involve risks.The financial manager should estimate the expected risk and return of the long-term investment and then should evaluate the investment proposals in terms of both expected returns and risk. The financial manager accepts the proposal only if the investment maximizes the shareholders wealth.

Investment decision not only involves allocating capital to long term assets but also involves decisions of using funds which are obtained by selling those assets which become less profitable and less productive. It wise decisions to decompose depreciated assets which are not adding value and utilize those funds in securing other beneficial assets. An opportunity cost of capital needs to be calculating while dissolving such assets. The correct cut off rate is calculated by using this opportunity cost of the required rate of return (RRR)

B) Financing Decision

Financial decision is yet another important function which a financial manger must perform. It is important to make wise decisions about when, where and how should a business acquire funds. Funds can be acquired through many ways and channels. Broadly speaking a correct

ratio of an equity and debt has to be maintained. Financing decision which is also known as capital structure decision, is concerned with determining the sources of funds and deciding upon the proportionate mix of funds from different sources. It calls for raising of funds from different sources maintaining appropriate mix of capital. The sources of long-term funds include equity capital and debt capital. A particular combination of debt and equity may be more beneficial to the firm than any others. The financial manager should decide an optimal structure of debt and equity capital.

A firm tends to benefit most when the market value of a company's share maximizes this not only is a sign of growth for the firm but also maximizes shareholders wealth. On the other hand the use of debt affects the risk and return of a shareholder. It is more risky though it may increase the return on equity funds. A sound financial structure is said to be one which aims at maximizing shareholders return with minimum risk. In such a scenario the market value of the firm will maximize and hence an optimum capital structure would be achieved. Other than equity and debt there are several other tools which are used in deciding a firm capital structure.

C) Dividend Decision

Dividend decision is the decision about the allocation of earnings to common shareholders. It is concerned with deciding the portion of earnings to be allocated to common shareholders. The net income after paying preference dividends belongs to common shareholders. The financial manager has three alternatives regarding dividend decision:

* *Pay all earnings as dividend*
* *Retain all earnings for reinvestment*
* *Pay certain percentage of earning and retain the rest for reinvestment*.

The financial manager must choose among the above alternatives. The choice should be optimum in the sense that it should maximize the shareholders wealth. While taking dividend decisions, the financial manager should consider the preferance of shareholders as well as the vestment opportunities available to the firm

Earning profit or a positive return is a common aim of all the businesses. But the key function a financial manger performs in case of profitability is to decide whether to distribute all the profits to the shareholder or retain all the profits or distribute part of the profits to the shareholder and retain the other half in the business.

It's the financial manager's responsibility to decide a optimum dividend policy which maximizes the market value of the firm. Hence an optimum dividend payout ratio is calculated. It is a common practice to pay regular dividends in case of profitability Another way is to issue bonus shares to existing shareholders.

D) Working Capital Decision

Working capital decisions refers to the commitment of funds to current assets and deciding on their financing pattern. It refers to the current assets investment and financing decision. Investment in current assets affects firm's profitability and liquidity. More investment in current assets enhances liquidity. Liquidity refers to the capacity to meet short-term obligation of the firm. At the same time more investment in current assets negatively affects the profitability because current assets earn nothing or they earn much less than their cost of capital. Similarly, less investment in current assets negatively affects the firm's liquidity and the firm may lose its profitable opportunities. So, a financial manager should achieve a proper

trade-off between liquidity and profitability which requires maintaining optimal investment in current assets.

Current assets should properly be valued and disposed of from time to time once they become non profitable. Currents assets must be used in times of liquidity problems and times of insolvency. It is very important to maintain a liquidity position of a firm to avoid insolvency. Firm's profitability, liquidity and risk all are associated with the investment in current assets. In order to maintain a tradeoff between profitability and liquidity it is important to invest sufficient funds in current assets. But since current assets do not earn anything for business therefore a proper calculation must be done before investing in current assets.

7.11. ORGANIZATION OF FINANCE FUNCTION

Today, finance function has obtained the status of a science and an art. As finance function has far reaching significance in overall management process, structural organization for further function becomes an outcome of an important organization problem. The ultimate responsibility of carrying out the finance function lies with the top management. However, organization of finance function differs from company to company depending on their respective requirements. In many organizations one can note different layers among the finance executives such as Assistant Manager (Finance), Deputy Manager (Finance) and General Manager (Finance). The designations given to the executives are different. They are: i) Chief Finance Officer (CFO),ii) Vice-President (Finance), iii) Financial Controller, iv)GeneralManager(Finance),v)FinanceOfficers

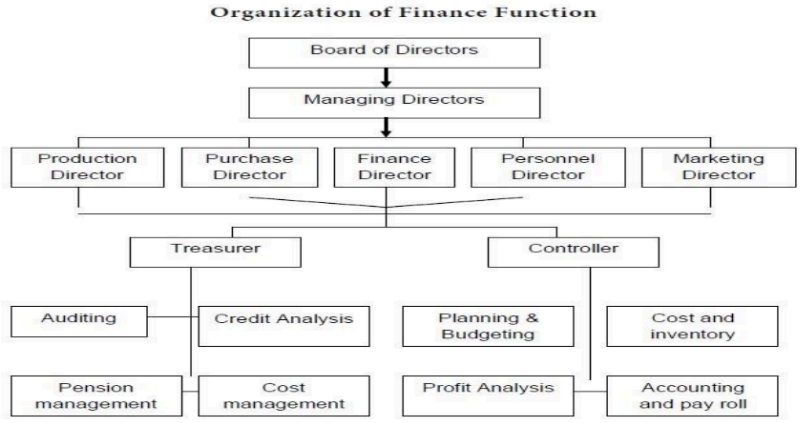
Finance, being an important portfolio, the finance functions is entrusted to top management. The Board of Directors, who are at the helm of affairs, normally constitutes a 'Finance Committee' to review and formulate financial policies. Two more officers, namely '***treasurer'*** and '***controller'*** – may be appointed under the direct supervision of CFO to assist him/her. In larger companies with modern management, there may be Vice-President or Director of finance, usually with both controller and treasurer. The organization of finance function is portrayed below:

7.11.1. Meaning of Controller and Treasurer

The terms 'controller' and 'treasurer' are in fact used in USA. This pattern is not popular in Indian corporate sector. Practically, the controller / financial controller in India carried out the functions of a Chief Accountant or Finance Officer of an organization. Financial controller who has been a person of executive rank does not control the finance, but monitors whether funds so augmented are properly utilized. The function of the treasurer of an organization is to raise funds and manage funds. The treasures functions include forecasting the financial requirements, administering the flow of cash, managing credit, flotation of securities, maintaining relations with financial institutions and protecting funds and securities. The controller's functions include providing information to formulate accounting and costing policies, preparation of financial reports, direction of internal auditing, budgeting, inventory control payment of taxes, etc. According to Prof. I.M. Pandey, while the controller's functions concentrate the asset side of the balance sheet, the treasurer's functions relate to the liability side.

It is evident from the above that Board of Directors is the supreme body under whose supervision and control Managing Director, Production Director, Personnel Director,

Financial Director, Marketing Director perform their respective duties and functions. Further while auditing credit management, retirement benefits and cost control banking, insurance, investment function under treasurer, planning and budgeting, inventory management, tax administration, performance evaluation and accounting functions are under the supervision of controller.



7.12. TIME VALUE OF MONEY

The time value of money is a basic financial concept that holds that money in the present is worth more than the same sum of money to be received in the future. This is true because money that you have right now can be invested and earn a return, thus creating a larger amount of money in the future. (Also, with future money, there is the additional risk that the money may never actually be received, for one reason or another.) The time value of money is sometimes referred to as the net present value (NPV) of money.

7.12.1. How the Time Value of Money Works

A simple example can be used to show the time value of money. Assume that someone offers to pay you one of two ways for some work you are doing for them: They will either pay you $1,000 now or $1,100 one year from now.

Which pay option should you take? It depends on what kind of investment return you can earn on the money at the present time. Since $1,100 is 110% of $1,000, then if you believe you can make more than a 10% return on the money by investing it over the next year, you should opt to take the $1,000 now. On the other hand, if you don't think you could earn more than 9% in the next year by investing the money, then you should take the future payment of $1,100 – as long as you trust the person to pay you then.

7.12.2. Time Value and Purchasing Power

The time value of money is also related to the concepts of inflation and purchasing power. Both factors need to be taken into consideration along with whatever rate of return may be realized by investing the money. Why is this important? Because inflation constantly erodes the value, and therefore the purchasing power, of money. It is best exemplified by the prices of commodities such as gas or food. If, for example, you were given a certificate for $100 of free gasoline in 1990, you could have bought a lot more gallons of gas than you could have if you were given $100 of free gas a decade later.

Inflation and purchasing power must be factored in when you invest money because to calculate your real return on an investment, you must subtract the rate of inflation from whatever percentage return you earn on your money. If the rate of inflation is actually higher than the rate of your investment return, then even though your investment shows a nominal positive return, you are actually losing money in terms of purchasing power. For example, if you earn a 10% on investments, but the rate of inflation is 15%, you're actually losing 5% in purchasing power each year (10% – 15% = -5%).

7.12.3. Time Value of Money Formula

The time value of money is an important concept not just for individuals, but also for making business decisions. Companies consider the time value of money in making decisions about investing in new product development, acquiring new business equipment or facilities, and establishing credit terms for the sale of their products or services. A specific formula can be used for calculating the future value of money so that it can be compared to the present value:

$FV = PV \times [1 + (i/n)]^{(n \times t)}$

Where:

FV = the future value of money
PV = the present value
i = the interest rate or other return that can be earned on the money
t = the number of years to take into consideration
n = the number of compounding periods of interest per year

Using the formula above, let's look at an example where you have $5,000 and can expect to earn 5% interest on that sum each year for the next two years. Assuming the interest is only compounded annually, the future value of your $5,000 today can be calculated as follows:

FV = $5,000 x (1 + (5% / 1) ^ (1 x 2) = $5,512.50

7.12.4. Present Value of Future Money Formula

The formula can also be used to calculate the present value of money to be received in the future. You simply divide the future value rather than multiplying the present value. This can be helpful in considering two varying present and future amounts. In our original example, we considered the options of someone paying your $1,000 today versus $1,100 a year from now. If you could earn 5% on investing the money now, and wanted to know what present value would equal the future value of $1,100 – or how much money you would need in hand now in order to have $1,100 a year from now – the formula would be as follows:

PV = $1,100 / (1 + (5% / 1) ^ (1 x 1) = $1,047

The calculation above shows you that, with an available return of 5% annually, you would need to receive $1,047 in the present to equal the future value of $1,100 to be received a year from now.To make things easy for you, there are a number of online calculators to figure the future value or present value of money.

Net Present Value Example: Below is an illustration of what the Net Present Value of a series of cash flows looks like. As you can see, the Future Value of cash flows are listed across the top of the diagram and the Present Value of cash flows are shown in blue bars along the bottom of the diagram.

7.13. AGENCY CONFLICT:

The agency problem is a conflict of interest inherent in any relationship where one party is expected to act in another's best interests. In corporate finance, the agency problem usually refers to a conflict of interest between a company's management and the company's stockholders. The three types of agency problems are stockholders v/s management, stockholders v/s bondholders/ creditors, and stockholders v/s other stakeholders like employees, customers, community groups, etc.

There can be various causes of agency problems. These causes differ from the position of an individual in the company. The root cause of these problems is the same in all cases that are mismatch or conflict of interests. When the agenda of the stockholder clashes with the other groups then the agency problem is definitely going to take place. In the case of employees, the reason would be the failure of stockholders to meet employees' expectations with respect to salary, incentives, working hours, etc. In the case of customers, the cause would be the failure of stockholders to meet customers' expectations like the sale of poor quality goods, poor supply, high-pricing, etc. In the case of management, the causes of agency problems could be the misalignment of goals, separation of ownership and management, etc.

7.13.1. Stockholders vs Management – Large companies may have a huge number of equity holders. It is always crucial for an organization to separate the management from ownership since there is no reason for them to form a part of management. Segregating ownership from management has endless advantages as it does not have any implications upon the regular business operations and the company will hire professionals for managing the key operations of the same. But hiring outsiders may become troublesome for stakeholders. The managers hired may take unjust decisions and might even misuse the shareholders' money and this can be a reason for the conflict of interests between the two and hence, agency problems.

7.13.2. Stockholders v/s Creditors – The stockholders might pick up risky projects for making more profits and this increased risk might elevate the required ROR on the company's debt and hence, the overall value of the pending debts might fall. If the project sinks, the bondholders will supposedly have to participate in losses and this can result in agency problems with the stockholders and the creditors.

7.13.3. Stockholders v/s other Stakeholders – The stakeholders of a company may have a conflict of interests with other stakeholders like customers, employees, society, and communities. For example, the employees might be asking for a hike in their salaries which if rejected by the stakeholders then there are probabilities of agency problems to take place.

7.14. SUMMARY:

The present title of the lesson is that "Financial Management and its concepts". For the purpose this lesson is that to understand several concepts of financial management, which are briefly revealed as follows: 1.Introduction,2.Definition of financial management 3. Elements of financial management,4.Nature of financial management 5. Scope of financial management, 6. Importance of financial management, 7. Objectives, 8. Goals of Financial & firms 9. Role of a Financial Manager, 10. Finance functions, 11. Organization of Finance function 12. Time value of Money and 13. Agency conflict.

7.15. TECHNICAL TERMS:

Financial Management : Financial management is strategic planning, organising, directing, and controlling of financial undertakings in an organisation or an institute. It also includes applying management principles to the financial assets of an organisation, while also playing an important part in fiscal management.

Concepts : Every idea begins as a concept. Write notes on the infinite canvas, make mind-maps and mood boards, sketch plans, designs and illustrations.

Elements : any substance that cannot be decomposed into simpler substances by ordinary chemical processes. Elements are the fundamental materials of which all matter is composed.

Nature : Nature, in the broadest sense, is the physical world or universe. "Nature" can refer to the phenomena of the physical world, and also to life in general. The study of nature is a large, if not the only, part of science.

Scope : Scope refers to the combined objectives and requirements needed to complete a project. The term is often used in project management as well as in consulting. Properly defining the scope of a project allows managers to estimate costs and the time required to finish the project.

Importance : Some common synonyms of importance are consequence, moment, significance, and weight. While all these words mean "a quality or aspect having great worth or significance," importance implies a value judgment of the superior worth or influence of something or someone.

Objectives : An objective is **a goal**, but to be objective is to be unbiased. If you're objective about something, you have no personal feelings about it. In grammar land, objective relates to the object of a sentence.

Goals : First consider what you want to achieve, and then commit to it. Set SMART (specific, measureable, attainable, relevant and time-bound) goals that motivate you ...

Functions : A technical definition of a function is: a relation from a set of inputs to a set of possible outputs where each input is related to exactly one output.

7.16. SELF ASSESSMENT QUESTIONS:

1) Define financial management.
2) What are the elements included in financial management?
3) Explain the nature of financial management.
4) Discuss the scope of financial management.
5) What is the importance of financial management?
6) What are the objectives of financial management?
7) Explain the Profit maximization criticism.
8) What are the financial goals and firms goals?
9) Discuss finance functions and organization of finance function.
10) What is the time value of money?
11) What is agency conflict? Explain it

7.17. SUGGESTED READINGS

1. I.M. Panday: "Financial Management " Vikas Publishing House (P) Ltd

2. Chandra, Prasanna "Financial Management " Tata Publishing House Ltd, New Delhi

3. S.N. Maheswari : "Principles of Financial Management " Sultan Chand, Delhi

4. Sheeba Kapil : "Financial Management " Pearson, 2011

5. P.V. Kulakarni: "Financial Management " Himalaya Publishing House Bombay

6. Khan & Jain : Cases in "Financial Management " Tata Publishing House Ltd, Delh

LESSON-8
FINANCIAL MANAGEMENT AND FINANCIAL DECISIONS

Aims and Objectives

After studying this lesson you should be able to:

- Know the financial decions
- Understand the Investment decision—
- Financing decision -Dividend decision—Liquidity decision

Structure

8.1. INTRODUCTION

The objective of financial management is to maximize shareholders' wealth. Hence, investment decision is most crucial in attaining the objective. After a careful analysis of risk return trade-off, the size of plant should be determined.

The key aspects of financial decision-making relate to financing, investment, dividends and working capital management. Decision making helps to utilize the available resources for achieving the objectives of the organization, unless minimum financial performance levels are achieved, it is impossible for a business enterprise to survive over time. Therefore financial management basically provides a conceptual and analytical framework for financial decision making. Further, Investment decision not only involves allocating capital to long term assets but also involves decisions of utilizing surplus funds in the business, any idle cash earns no further interest and therefore not productive. So, it has to be invested in various as marketable securities such as bonds, deposits that can earn income.

Most of the investment decisions are uncertain and a complex process as it involves decisions relating to the investment of current funds for the benefit to be achieved in future. Therefore while considering investment proposal it is important to take into consideration both expected return and the risk involved. Thus, finance department of an organization has to decide to

allocate funds into profitable ventures so that there is safety on investment and regular returns is possible.

8.2. FINANCIAL DECISIONS

Financial decisions are the decisions that managers take with regard to the finances of a company. These are crucial decisions for the financial well-being of the company. These decisions can be in terms of acquisition of assets, financing and raising funds, day-to-day capital and expenditure management, etc. Everything you need to know about the types of financial decisions taken by a company. The key aspects of financial decision-making relate to financing, investment, dividends and working capital management. A firm has to decide the method of funding by assessing its financial situation and the characteristics of the source of finance. For example, interest on borrowed funds has to be paid whether or not a firm has made a profit. Likewise, borrowed funds have to be repaid at a fixed time.

.Decision making helps to utilize the available resources for achieving the objectives of the organization, unless minimum financial performance levels are achieved, it is impossible for a business enterprise to survive over time. Therefore financial management basically provides conceptual and analytical framework for financial decision making.

There are four main financial decisions:- 1. Capital Budgeting or Long term Investment Decision 2. Capital Structure or Financing Decision 3. Dividend Decision 4. Working Capital Management Decision.

8.2.1. Inter-Relationships between Financial Decisions:

All the four financial management decisions explained above are not inde-pendent but related with each other's. Capital budgeting decision requires calculation of present values of cost and benefits for which we need some appropriate discount rate. Cost of capital which is the result of capital structure decision of a firm is generally used as the discount rate in capital budgeting decision.

Hence investment and financing decisions are inter-related. When operating risk of a business is high due to huge investment in long term assets (i.e. capital budgeting decision) then companies should have low debt capital and less financial risk. Dividend decision depends upon the operating profitability of a firm which in turn depends on the capital budgeting decision.

Sometimes firms use retained earnings for financing their investment projects and if some amount of profit is left, that amount is distributed as dividend. Hence there is a relationship between dividends and capital budgeting on one hand and dividends and financing decision on the other.

8.3. INVESTMENT DECISION:

It is more important than the other two decisions. It begins with a determination of the total amount of assets needed to be held by the firm. In other words investment decision relates to the selection of assets, on which a firm will invest funds. A financial decision which is concerned with how the firm's funds are invested in different assets is known as investment decision. Investment decision can be long-term or short-term. A long term investment decision is called capital budgeting decisions which involve huge amounts of long term investments and are irreversible except at a huge cost. Short-term investment decisions are

called working capital decisions, which affect day to day working of a business. It includes the decisions about the levels of cash, inventory and receivables. A bad capital budgeting decision normally has the capacity to severely damage the financial fortune of a business. A bad working capital decision affects the liquidity and profitability of a business.

To take a long-term investment decision, various capital budgeting techniques are used. Risk return trade-off is involved in capital budgeting decision. For a given degree of risk, project giving the maximum net present value is selected. Investment decisions are the financial decisions taken by management to invest funds in different assets with an aim to earn the highest possible returns for the investors. It involves evaluating various possible investment opportunities and selecting the best options. The investment decisions can be long term or short term.

8.3.1. The required assets fall into two groups:

(i) Long-term Assets (fixed assets – plant & machinery land & buildings, etc.,) which involve huge investment and yield a return over a period of time in future. Investment in long-term assets is popularly known as "capital budgeting". It may be defined as the firm's decision to invest its current funds most efficiently in fixed assets with an expected flow of benefits over a series of years.

(ii) Short-term Assets (current assets – raw materials, work-in-process, finished goods, debtors, cash, etc.,) that can be converted into cash within a financial year without diminution in value. Investment in current assets is popularly termed as "working capital management". It relates to the management of current assets.

It is an important decision of a firm, as short-survival is the prerequisite for long-term success. Firm should not maintain more or less assets. More assets reduces return and there will be no risk, but having less assets is more risky and more profitable. Hence, the main aspects of working capital management are the trade-off between risk and return. Management of working capital involves two aspects. One determination of the amount required for running of business and second financing these assets.

8.3.2. Capital Budgeting Decision:

The process of planning and managing a firm's long-term investments is called capital budgeting. In capital budgeting, the financial manager tries to identify profitable investment opportunities, i.e., assets for which value of the cash flow generated by asset exceeds the cost of that asset. Evaluating the size, timing, and risk of future cash flows (both cash inflows & outflows) is the essence of capital budgeting.

A finance manager has to find answers to questions such as:

i. What should be the size of firm?

ii. In which assets / projects funds should be invested?

iii. Investments in which assets / projects should be reduced or discon-tinued?

Capital budgeting decisions determine the fixed assets composition of a firm's Balance Sheet. Capital budgeting decision gives rise to operating risk or business risk of a firm.

8.3.3. Factors Affecting Investment Decisions / Capital Budgeting Decisions:

While taking a capital budgeting decision, a business has to evaluate the various options available and check the viability and feasibility of the available options. The various factors which affect capital budgeting decisions are: (i) Cash Flow of the Project- (ii) The Rate of Return- (iii) The Investment Criteria Involved-

i) Cash flows of the project- The series of cash receipts and payments over the life of an investment proposal should be considered and analyzed for selecting the best proposal. Before considering an investment option, business must carefully analyse the net cash flows expected from the investment during the life of the investment. Investment should be done only if the net cash flows are more than the funds invested.

ii) Rate of return- The expected returns from each proposal and risk involved in them should be taken into account to select the best proposal. The rate of return is the most important factor while taking an investment decision. The investment must be done in the projects which earn the higher rate of return provided the level of risk is same.

iii) Investment criteria involved- The various investment proposals are evaluated on the basis of capital budgeting techniques. Which involve calculation regarding investment amount, interest rate, cash flows, rate of return etc. It is to be considered which technique to use for evaluation of projects. Before taking decision, each investment opportunity must be compared by using the various capital budgeting techniques. These techniques involve calculation of rate of return, cash flows during the life of investment, cost of capital etc.

8.3.4. Risk-Return Trade-Off:

Risk and return move in tandem. Higher the risk, higher the return. Lower the risk, lower the return. This holds true for all investments (projects & assets).

A finance manager seeks to select projects / assets which:

(a) Minimize the risk for given level of return or

(b) Maximize return for given degree of risk.

Hence there is a risk return trade off in case of capital budgeting decision. Investment in small plant is less risky than investment in large plant. But at the same time small plant generates lower return than a large plant. Hence deciding about the optimal size of the plant requires a careful analysis of risk and return.

8.3.5. The scope of investment decision

The scope of investment decision includes allocation of funds towards following areas:

i. Expansion of business
ii. Diversification of business

iii. Productivity improvement
iv. Product improvement
v. Research and Development
vi. Acquisition of assets (tangible and intangible), and
vii. Mergers and acquisitions.

8.3.6. Long Term Investment Decisions:

Long term investment decisions are all such decisions which are related to investing of funds for a long period of time. They are also called as Capital Budgeting decisions.

The long term investment decisions are related to management of fixed capital. These decisions involve huge amounts of investments and it is very difficult to reverse such decisions. Therefore, it is must that such decisions are taken only by those people who have comprehensive knowledge about the company and its requirements. Any bad decision may severely damage the financial fortune of the business enterprise.

Importance of long term investment decisions:

(i) They directly affect the profitability or earning capacity of the business enterprise.
(ii) They affect the size of assets, scale of operations and competitiveness of business enterprise.
(iii) They involve huge amounts of investment which remains blocked in the fixed assets for a long period of time.
(iv) The investments are irreversible except at a huge cost.

Examples of capital budgeting decisions:

(i) Investment in plant and machinery
(ii) Purchase or takeover of an existing business firm
(iii) Starting a new factory or sales office
(iv) Introducing new product line

This decision in financial management is concerned with allocation of funds raised from various sources into acquisition assets or investment in a project.

8.4.CAPITAL BUDGETING ANALYSIS METHODS (CAPITAL BUDGETING TECHNIQUES)

There are several capital budgeting analysis methods that can be used to determine the economic feasibility of a capital investment. They include the Payback Period, Discounted Payment Period, Accounting Rate of Return, Net Present Value, Profitability Index, Internal Rate of Return, and Modified Internal Rate of Return.

1. Payback Period

The payback period is the time you need to recover the cost of your investment. In simple terms, it is time an investment takes to reach the break-even point. It would help if you retrieved the investment costs of a project as soon as possible to make a profit.

In simple terms, the payback period is calculated by dividing the cost of the investment by the annual cash flow until the cumulative cash flow is positive, which is the payback year. Payback period is generally expressed in years.

The payback period is expressed in years and fractions of years. For example, if a company invests $300,000 in a new production line, and the production line then produces positive cash flow of $100,000 per year, then the payback period is 3.0 years ($300,000 initial investment ÷ $100,000 annual payback).

8.4.2. Discounted Payment Period

The Discount Payment Period (DPP) refers to the period of time in which a payment on a purchase can be made for a discount incentive. A DDP can lead to advantages for both sides of the transaction. On one side, if the buyer makes the payment during the DDP, the buyer saves money and drives down costs.

There are two steps involved in calculating the discounted payback period. First, we must discount (i.e., bring to the present value) the net cash flows that will occur during each year of the project. Second, we must subtract the discounted cash flows. Learn to determine the value of a business.

A single payment is discounted using the formula: PV = Payment / (1 + Discount)^Periods As an example, the first year's return of $30,000 can be discounted by a 3 percent rate of inflation. The rate of inflation is converted to its decimal format of 0.03 by dividing by 100.

8.4.3. Accounting Rate of Return

The accounting rate of return (ARR) formula is helpful in determining the annual percentage rate of return of a project. ARR is calculated as average annual profit / initial investment. ARR is commonly used when considering multiple projects, as it provides the expected rate of return from each project**.** For example, if a new machine being considered for purchase will have an average investment cost of $100,000 and generate an average annual profit increase of $20,000, the accounting rate of return will be 20%. The ARR on this investment is 0.20 x 100 or 20%.

The ARR formula is simple: ARR = (Overall Subscription Cost Per Year + Recurring Revenue From Add-ons or Upgrades) - Revenue Lost from Cancellations. It's important to note that any expansion revenue earned through add-ons or upgrades must affect the annual subscription price of a customer.

The total revenue for your business considers all of your cash coming into the business, while ARR measures solely your subscription-based revenue. For example, if you provide one-time implementation fees or have an offering outside of your subscription business, then that revenue would not be part of your ARR.

8.4.4. Net Present Value

As an organization expands, it needs to take important decisions which involve immense capital investment. An organization must take the decisions regarding the expansion of business and investment very wisely. In such cases, the organization will take assistance of

Capital Budgeting tools, one of the most popular NPV method and take a call on the most profitable investment.

Net present value (NPV) is the difference between the present value of cash inflows and the present value of cash outflows over a period of time. NPV is used in capital budgeting and investment planning to analyze the profitability of a projected investment or project. NPV analysis is used to help determine how much an investment, project, or any series of cash flows is worth. It is an all-encompassing metric, as it takes into account all revenues. It's a metric that helps companies foresee whether a project or investment will be profitable. NPV plays an important role in a company's budgeting process and investment decision-making.

NPV = (Today's value of the expected future cash flows) – (Today's value of invested cash)

Net Present Value (NPV) is the value of all future cash flows (positive and negative) over the entire life of an investment discounted to the present. NPV analysis is a form of intrinsic valuation and is used extensively across finance and accounting for determining the value of a business, investment security, capital project, new venture, cost reduction program, and anything that involves cash flow.

8.4.5. Internal rate of return

The internal rate of return (IRR) is a metric used in financial analysis to estimate the profitability of potential investments. IRR is a discount rate that makes the net present value (NPV) of all cash flows equal to zero in a discounted cash flow analysis.

The internal rate of return (IRR) rule states that a project or investment should be pursued if its IRR is greater than the minimum required rate of return, also known as the hurdle rate. The IRR Rule helps companies decide whether or not to proceed with a project.

The IRR is a great way to evaluate and compare the returns of different investments. The IRR provides an easy-to-understand average performance of variable cash flows over the life of an investment. It is important to compare the IRR of an investment against appropriate performance benchmarks.

Internal Rate of Return (IRR) is the discount rate that makes the net present value (NPV) of a project zero. In other words, it is the expected compound annual rate of return that will be earned on a project or investment. In the example below, an initial investment of $50 has a 22% IRR. That is equal to earning a 22% compound annual growth rate.

Internal Rate of Return is widely used in analyzing investments for private equity and venture capital, which involves multiple cash investments over the life of a business and a cash flow at the end through an IPO or sale of the business.

8.4.6. Profitability Index

The profitability index is an appraisal technique applied to potential capital outlays. The method divides the projected capital inflow by the projected capital outflow to determine the profitability of a project. As indicated by the aforementioned formula, the profitability index uses the present value of future cash flows and the initial investment to represent the aforementioned variables.

The profitability index (PI) is a measure of a project's or investment's attractiveness. The PI is calculated by dividing the present value of future expected cash flows by the initial investment amount in the project.

The profitability index (PI), alternatively referred to as value investment ratio (VIR) or profit investment ratio (PIR), describes an index that represents the relationship between the costs and benefits of a proposed project. It is calculated as the ratio between the present value of future expected cash flows and the initial amount invested in the project. A higher PI means that a project will be considered more attractive.

The profitability index (PI) is a measure of a project's or investment's attractiveness. The PI is calculated by dividing the present value of future expected cash flows by the initial investment amount in the project. A PI greater than 1.0 is deemed as a good investment, with higher values corresponding to more attractive projects. Under capital constraints and mutually exclusive projects, only those with the highest PIs should be undertaken.

The PI is helpful in ranking various projects because it lets investors quantify the value created per each investment unit. A profitability index of 1.0 is logically the lowest acceptable measure on the index, as any value lower than that number would indicate that the project's present value (PV) is less than the initial investment. As the value of the profitability index increases, so does the financial attractiveness of the proposed project.

The Formula

Profitability Index = Present Value of Future Cash Flows ÷ Initial Investment in the Project. The present value of future cash flows is a method of discounting future cash to its current value, and requires the implementation of the time value of money calculation.

8.4.7. Modified Internal Rate of Return

The modified internal rate of return, or MIRR, is a measurement used to determine if an investment is worth a potential investor's time. Study the definition and example of the modified internal rate of return, and how to calculate the MIRR. *Updated: 12/20/2021*

The internal rate of return (IRR) is a performance metric in the form of an interest rate that is used in business to measure the attractiveness of a particular project or business investment. The higher a project's internal rate of return, the more attractive the project becomes for the business. Think of the IRR as a measure of the potential return on a project. However, the modified internal rate of return (MIRR) is a modified version of the internal rate of return and is also used to measure how appealing or lucrative an investment is to a potential investor.

When a company invests money in a project, the company usually makes an **initial investment** during the early phases of the project. This is negative cash flow. As the project progresses, the project will yield cash profits resulting in positive cash flow. When cash flows change from negative to positive throughout the project lifecycle, there can be several internal rates of return for each change (from positive to negative). The modified rate of return addresses the issue of multiple IRRs by accounting for the positive and negative cash flows separately.

For example, a company invests $10,000 into the creation of a new machine. Some other companies started hearing about the new machine and offered to invest as well, for a total of $10,000. During the project, the company had to invest another $15,000. The cash flow in this scenario is moving from negative to positive and back to negative again. The MIRR allows a company to determine the return on investment while accounting for these cash flow changes.

The modified internal rate of return (MIRR) is a financial measure of an investment's attractiveness. It is used in capital budgeting to rank alternative investments of equal size. As the name implies, MIRR is a modification of the internal rate of return (IRR) and as such aims to resolve some problems with the IRR. You can calculate the MIRR of an investment by calculating the future value of the investment's cash flows using the reinvestment rate, and then calculating the rate of return that grows the cost of the investment to the future value of the reinvested cash flows.

The MIRR is also useful because the conventional IRR assumes that profits are reinvested in the same project and will return the rate calculated in the IRR. This is often not realistic because maybe a project doesn't require any additional funds. The MIRR solves this problem by allowing profits to be reinvested at more realistic rates that reflect market conditions. It allows the user to set the reinvestment rate to get a more realistic result.
The MIRR solves for the limitations of the IRR and accounts for what the company does with positive cash flows when received such as reinvesting at a specific reinvestment interest rate. The MIRR also assumes a finance rate for any negative cash flows. The MIRR is used to compare projects with non-conventional cash flow methods, whereas the IRR is not useful to measure non-conventional cash flow.
The formula for the modified internal rate of return is:

$$MIRR = \sqrt[n]{\frac{FV(PositiveCashFlows, cost of capital)}{PV\ (InitialOutlays, FinancingCost)}} - 1$$

FV = Future Value
PV = Present Value
n = number of periods

Calculating the MIRR
There are three different approaches to the modified internal rate of return that business analysts and investors use to review potential investment returns. The three approaches to calculating the modified rate of return are the discounting approach, reinvestment approach, and combination approach.

MIRR: Discounting Approach
Discounting cash flows of a project is the exact opposite of compounding interest on an investment. The MIRR **discounting approach** involves discounting all negative cash flows of a project back to the initial start of the project. The negative cash flows are discounted at an assumed finance rate.

8.5. FINANCING DECISION:

A financial decision which is concerned with the amount of finance to be raised from various long term sources of funds like, equity shares, preference shares, debentures, bank loans etc. Is called financing decision. In other words, it is a decision on the 'capital structure' of the

company. Capital Structure Owner's Fund + Borrowed Fund Financing decisions are the financial decisions related to raising of finance. It involves identification of various sources of finance and the quantum of finance to be raised from long-term and short-term sources. A firm can raise long term finance either through shareholders' funds or borrowed capital. The financial management as part of financing decision, calculates the cost of capital and the financial risks for various options and then decides the proportion in which the funds will be raised from shareholders' funds and borrowed funds.

Financing decision is concerned with the capital structure of the firm. The decision is basically taken about proportion of equity capital and debt capital in total capital of the firm. Higher the proportion of debt in capital of the firm, higher is the risk. A capital structure having a reasonable mix of equity capital and debt capital is called optimum capital structure.

Financing should be from sources having lowest cost of capital. A number of factors affect the capital structure of a firm. Debt has lower cost of capital, but it increases risk in the business of the firm. A leveraged firm carries higher degree of risk in business. A reasonable mix of debt and equity capital should be selected to maintain the balance between risk and return. The two aspects of capital structure are- One capital structure theories and two determination of optimum capital structure.

Definition: The Financing Decision is yet another crucial decision made by the financial manager relating to the financing-mix of an organization. It is concerned with the borrowing and allocation of funds required for the investment decisions.

The financing decision involves two sources from where the funds can be raised: using a company's own money, such as share capital, retained earnings or borrowing funds from the outside in the form debenture, loan, bond, etc. The objective of financial decision is to maintain an optimum capital structure, i.e. a proper mix of debt and equity, to ensure the trade-off between the risk and return to the shareholders.

After estimation of the amount required and the selection of assets required to be purchased, the next financing decision comes into the picture. Financial manager is concerned with makeup of the right hand side of the balance sheet. It is related to the financing mix or capital structure or leverage. Financial manager has to determine the proportion of debt and equity in capital structure.

It should be on optimum finance mix, which maximises shareholders' wealth. A proper balance will have to be struck between risk and return. Debt involves fixed cost (interest), which may help in increasing the return on equity but also increases risk. Raising of funds by issue of equity shares is one permanent source, but the shareholders will expect higher rates of earnings.

8.5.1. While taking financing decision following points need to be considered:

(i) While borrowed funds carry interest to be paid irrespective of whether or not a firm earns profit but the shareholders' funds do not carry any commitment of returns to be paid. Shareholders receive dividends when business earns profits.

(ii) Borrowed funds have to be repaid at the end of a fixed period of time and there is financial risk in case of default in payment but shareholders' funds are repayable only at the time of liquidation of business.

(iii) The fixed cost paid on borrowed funds is a business expense, it saves tax leading to reduced cost of capital whereas the dividends paid on shareholders' funds is appropriation of profits thus does not reduce tax liability of business.

(iv) The fund raising exercise involves floatation cost which must be considered while evaluating different sources.

In order to raise capital with controlled risk and minimum cost of capital a firm must have a judicious mix of both debt and equity. Therefore, cost of each type of finance is calculated before taking the financial decision of how much funds to be raised from which source. This decision determines the overall cost of capital and the financial risk for the enterprise.

8.5.2. Factors Affecting Financing Decision:

A firm's capital structure or financing decision is concerned with obtain-ing funds to meet firm's long term investment requirements. It refers to the specific mixture of long-term debt and equity, which the firm uses to finance its assets. The finance manager has to decide exactly how much funds to raise, from which sources to raise and when to raise. Different feasible combinations of raising required funds must be carefully evalu-ated and an optimal combination of different sources of funds should be selected. The optimal capital structure is one which minimises overall cost of capital and maximises firm's vale. Capital structure decision gives rise to financial risk of a firm.

From the above discussions, you must have realized that financing decisions are affected by various factors. Some of the important factors are Affecting Financing Decision:1. Cost- 2. Risk- 3. Flotation cost- 4. Cash flow position of the business- 5. Control considerations- 6. State of capital markets-

(i) Cost: Cost of raising funds influence the financing decisions. A prudent financial manager selects the cheapest sources of finance. The cost of raising funds from different sources is different. The cost of equity is more than the cost of debts. The cheapest source should be selected prudently. The Cost involved in raising the funds. The manager chose the source with minimum cost.

(ii) Risk: Each source of finance has different degree of risk. Finance manager considers the degree of risk involved in each source of finance before taking financing decision. For example, borrowed funds have high risk as compared to equity capital. The risk associated with different sources is different. More risk is associated with borrowed funds as compared to owner's fund as interest is paid on it and is also repaid after a fixed period of time or on expiry of its tenure. The Risk involved in raising the funds. The risk is higher in the case of debt as compared to the equity. The risk of default on payment of periodical interest and repayment of capital on 'borrowed funds' is called financial risk.

(iii) Floatation Costs: Floatation cost is the cost of raising finance. A finance manager estimates the floatation cost of various sources and selects the source with least floatation cost. Therefore, higher the floatation cost less attractive is the source of finance. The cost involved in issuing securities such as broker's commission, underwriter's fees, expenses on prospectus etc. Is called flotation cost. Higher the flotation cost, less attractive is the source of finance. Thus, securities with minimum cost must be chosen.

(iv) Cash Flow Position of the Business: A business with strong cash flow position prefers to raise funds from debts as it can easily pay interest and the principal. Interest is a deductible expense, saves tax liability of the business making the source of finance cheaper. However, during liquidity crisis business prefers to raise funds from equity. In case the cash flow position of a company is good enough then it can easily use borrowed funds. The Cash Flow from the operations of the business also determines the source from where the funds shall be raised. High cash flow enables to borrow debt as interest can be easily paid.

(v) Level of Fixed Operating Costs: Fixed operating costs of a business influence its financing decisions. For a business with high operating cost, funds must be raised from equity as lower debt financing would be better. On the other hand, if the operating cost is low, business can afford to pay high fixed charges therefore, more of debt financing may be preferred.

(vi) Control Considerations: Financing decisions consider the degree of control the business is willing to dilute. A company would prefer debt financing if it wants to retain complete control of the business with existing shareholders. On the other hand, a company willing to lose control will raise funds from equity. In case the existing shareholders want to retain the complete control of business then finance can be raised through borrowed funds but when they are ready for dilution of control over business, equity shares can be used for raising finance. The Level of Control, the shareholders, want in the organization also determines the composition of capital structure. They usually prefer the borrowed funds since it does not dilute the ownership.

(vii) State of Capital Markets: During boom period, finance can easily be raised by issuing shares but during depression period, raising finance by means of debt is easy.

ii. Capital Structure Decision: Health of the capital market may also affect the financing decision. During boom period, investors are ready to invest in equity but during depression investors look for secured options for investment. Therefore it is easy for companies to raise funds from equity during boom period.

8.5.3. Risk-Return Trade-Off:

Risk return tradeoff is involved in capital structure decision as well. Usually Debt is considered cheaper than equity capital because interest on debt is tax deductible. Also since debt is paid before equity, risk is lower for investors and so they demand lower return on debt investments. But excessive debt is riskier than equity capital from the company's viewpoint as debt obligations have to be compulsorily met even if firm incurs losses.

Thus there is a risk-return trade-off in deciding the optimal financing mix. On one hand, debt has lower cost of capital thus employing more debt would mean higher returns but is riskier while on the other hand, equity capital gives lower return due to higher cost of capital but is less risky.

All organizations irrespective of type of business must raise funds to buy the assets necessary to support operations.

Thus financing decisions involves addressing two questions:

I. How much capital should be raised to fund the firm's operations (both existing & proposed?)

II. What is the best mix of financing these investment proposals?

The choice between the use of internal versus external funds, the use of debt versus equity capital and the use of long-term versus short-term debt depends on type of source, period of financing, cost of financing and the returns thereby. Prior to deciding a specific source of finance it is advisable to evaluate advantages and disadvantages of different sources of finance and its suitability for purpose.

Efforts are made to obtain an optimal financing mix, an optimal financing indicates the best debt-to-equity ratio for a firm that maximizes its value, in simple words, and the optimal capital structure for a company is the one which offers a balance between cost and risk.

8.6. DIVIDEND DECISION

This is the third financial decision, which relates to dividend policy. Dividend is a part of profits, which are available for distribution to equity shareholders. Payment of dividends should be analysed in relation to the financial decision of a firm. There are two options available in dealing with net profits of a firm, viz., distribution of profits as dividends to the ordinary shareholders where there is no need of retention of earnings or they can be retained in the firm itself if they are required for financing of any business activity.

But distribution of dividends or retaining should be determined in terms of its impact on the shareholders' wealth. Financial manager should determine the optimum dividend policy, which maximises market value of the share thereby market value of the firm. Considering the factors to be considered while determining dividends is another aspect of dividend policy.

A financial decision which is concerned with deciding how much of the profit earned by the company should be distributed among shareholders (dividend) and how much should be retained for the future contingencies (retained earnings) is called dividend decision. Dividend refers to that part of the profit which is distributed to shareholders. The decision regarding dividend should be taken keeping in view the overall objective of maximizing shareholder s wealth.

Shareholders are the owners and require returns, and how much money to be paid to them is a crucial decision. Thus payment of dividend is decision involves deciding whether profits earned by the business should be retained rather than distributed to shareholders in the form of dividends.

If dividends are too high, the business may be starved of funding to reinvest in growing revenues and profits further. Keeping this in mind an optimum dividend payout ratio is calculated by the finance manager that would help the firm to maximize its market value.

8.6.1. Factors affecting Dividend Decision:

Dividend decisions are the financial decisions related to distribution of share of profits amongst shareholders in the form of dividends. The dividend decision involves deciding the amount of profit (after tax) to be distributed to the shareholders as dividends and the amount

of profit to be retained in the business for further growth of the business. Dividend decisions should be taken keeping in view the overall objective of maximizing shareholders' wealth.

The decision regarding the amount of profits to be distributed as dividends depends on various factors. Some of the factors may be stated as follows: (i) Earnings (ii) Stability of Earnings, (iii) Stability of Dividends, (iv) Growth Opportunities, (v) Cash Flow Positions, (vi) Shareholders' Preference, (vii) Taxation Policy, (viii) Stock Market Reactions, (ix) Access to Capital Markets, (ix) Access to Capital Markets, (x) Legal Constraints, (xi) Contractual Constraints.

i) Earnings- Company having high and stable earning could declare high rate of dividends as dividends are paid out of current and past earnings. Dividends represent the share of profits distributed amongst shareholders. Therefore, earnings is a major determinant of the decision regarding dividends.

(ii) Stability of Earnings: A company with stable earnings is not only in a position to declare higher dividends but also maintain the rate of dividend in the long run. However a company with fluctuating earnings may declare smaller dividend.

iii) Stability of dividends- Companies generally follow the policy of stable dividend. The dividend per share is not altered in case earning changes by small proportion or increase in earnings is temporary in nature. In order to maintain dividend per share, a company prefers to declare same rate of dividends. However the decision to change the rate of dividend can be taken only if there is increase in the company's potential to earn profits not only in the current year but also in the future.

iv) Growth prospects- The growing companies prefer to retain larger share of profits to finance their investment requirements. Therefore, the rate of dividend declared by them is smaller as compared to companies who have achieved certain goals of growth and can share larger share of profits with shareholders. In case there are growth prospects for the company in the near future then, it will retain its earnings and thus, no or less dividend will be declared.

v) Cash flow positions- Dividends involve outflow of cash. A profitable company is in a position to declare dividends but it may have liquidity problems. As a result of which it may not be in a position to pay dividends to its shareholders. Therefore availability of cash also influences dividend decision. Dividends involve an outflow of cash and thus, availability of adequate cash is foremost requirement for declaration of dividends.

vi) Preference of shareholders- Management of a company takes into consideration its share-holders expectations for dividends and try to take dividend decisions accordingly. For example, a company may declare higher or stable rate of dividend if it has a large number of shareholders who depend on dividends as their regular income. While deciding about dividend the preference of shareholders is also taken into account. In case shareholders desire for dividend then company may go for declaring the same. In such case the amount of dividend depends upon the degree of expectations of shareholders.

vii) Taxation policy- Dividends are a tax free income for shareholders but the company has to pay tax on share of profits distributed as dividend. Therefore, the decision regarding the amount of profit to be distributed as dividends depends on the tax rate. Company would

prefer to pay lesser dividends if tax rate on dividends is high. A company is required to pay tax on dividend declared by it. If tax on dividend is higher, company will prefer to pay less by way of dividends whereas if tax rates are lower, then more dividends can be declared by the company.

(viii) Stock Market Reactions: The share price is directly related to the rate of dividend declared by the company. Share prices of a company increase if the company declares higher rate of dividend. Therefore, the financial management considers the potential effect of dividends on the share prices before declaring dividends.

(ix) Access to Capital Markets: Decision regarding amount of dividend to be declared depends on the need of profits to be retained for future investments. Companies who have easy access to the capital market to raise funds may not require large amount of profits to be retained and therefore may decide to declare high dividend rate. On the other hand, small companies who find it difficult to raise funds from capital markets may decide to share lesser profits with their shareholders.

(x) Legal Constraints: Every company is required to adhere to the restrictions or provisions laid by the Companies Act regarding dividend payouts.

(xi) Contractual Constraints: Sometimes companies are required to enter into contractual agreements with their lenders with respect to the payment of dividends in future. The dividend decisions need to consider such restrictions while declaring dividend rate to ensure that terms of loan agreement are not violated.

Dividend decision involves two issues-whether to distribute dividends and how much of profits to distribute as dividends. A finance manager has to decide what percentage of after tax profit is to be retained in the business to meet future investment requirements and what proportion has to be distributed as dividend among shareholders. Should the firm retain all profits or distribute all profits or retain a portion and distribute the balance?

Proportion of profits distributed as dividend is called dividend pay-out ra-tio and the proportion of profits retained in the business is retention ratio. Finance manager here is concerned with determining the optimal dividend pay-out ratio which maximises shareholder's wealth. However, the actual decision is affected by availability of profitable investment opportunities, firm's financial needs, shareholder's expectations, legal constraints, liquidity position of the firm and other factors.

8.6.2. Risk Return Trade Off:

Dividend decision also involves risk return trade off. Generally investors expect dividends because dividends resolve future un-certainty attached with capital gains. So a company should pay dividends. However when a company, having profitable investment opportunities pays dividends, it has to raise funds from external sources which are costlier than retained earnings.

Hence return from the project reduces. A high divi-dend payout is less risky but also results in less return while a low dividend payout is more risky but results in high return in case of growing firms. Therefore a firm has to strike a balance between dividends and retained earnings so as to satisfy investors' expectations.

8.7. WORKING CAPITAL MANAGEMENT DECISION (LIQUIDITY):

Management of working capital involves risk-return trade-off. If the level of current assets of the firm is very high, it has excess liquidity. When the firm does so its rate of return will decline as more funds are tied up in idle cash. If the firm's level of current assets is low, it would result in interrupted production and sales. This would lead to reduction in profit. Thus a firm should maintain optimum level of current assets.

Working capital management is concerned with management of a firm's short-term or current assets, such as inventory, cash, receivables and short-term or current liabilities, such as creditors, bills payable. Assets and Liabilities which mature within the operating cycle of business or within one year are termed as current assets and current liabilities respectively.

The principle of effective working capital management focuses on balancing liquidity and profitability. The term liquidity implies the ability of the firm to meet bills and the firm's cash reserves to meet emergencies. Whereas the profitability means the ability of the firm to obtain highest returns within the funds available. In order to maintain a balance between profitability and liquidity forecasting of cash flows and managing cash flows is very important.

A firm needs working capital to manage the day-to-day affairs smoothly. Working capital means firm's total investment in current assets. Net working capital is equal to difference between the total current assets and current liabilities.

8.7.1 In working capital management, a finance manager has to take decision on following issues:

(i) What should be the total investment in working capital of the firm?
(ii) What should be the level of individual current assets?
(iii) What should be the relative proportion of different sources to finance the working capital requirement?
(iv) What should be the firm's credit policy while selling to customers?

8.7.2. Working capital management involves following issues:

(1) What are the possible sources of raising short term funds?
(2) In what proportion should the funds be raised from different short term sources?
(3) What should be the optimum levels of cash and inventory?
(4) What should be the firm's credit policy while selling to customers?

8.7.3. Working Capital Decisions:

In simple words working capital signifies amount of funds used in its day-to-day trading operations. Working capital primarily deals with currents assets and current liabilities. Infact it is calculated as the current assets minus the current liabilities. One of the key objectives of working capital management is to ensure liquidity position of a firm to avoid insolvency.

he following are key areas of working capital decisions:

i. How much inventory to keep?
ii. Deciding ratio of cash and credit sales
iii. Proper management of cash
iv. Effective administration of bills receivables and payables
v. Investment of surplus cash.

8.7.4. Short Term Investment Decisions:

Short term investment decisions are the decisions related to day to day working of a business enterprise. They are also called as working capital decisions because they are related to current assets and current liabilities like management of cash, inventories, receivable etc.

The short term decisions are important for a business enterprise because:

(i) They affect the liquidity and profits earned in the short run.

(ii) Efficient decisions help to maintain sound working capital.

8.7.5. Risk-Return Trade-Off:

Working capital management also involves risk-re- turn trade off as it affects liquidity and profitability of a firm. Liquidity is inversely related to profitability, i.e., increase in liquidity results in decrease in profitability and vice versa. Higher liquidity would mean having more of current assets. This reduces risk of default in meeting short term obliga-tions.

But current assets provide lower return than fixed assets and hence reduce profitability as funds that could earn higher return via investment in fixed assets are blocked in current assets. Thus higher liquidity would mean lower risk but also lower profits and lower liquidity would mean more risk but more returns. Therefore the finance manager should have optimal level of working capital.

8.8. SUMMARY

The present lesson is entitled as "Financial Management & Financial Decisions". The aim of the lesson is to understand about financial decisions. Some of the aspects are revealed in this lesson are as follows: 1. Introduction, 2. Financial decisions,3. Investment decision, 4.Financing decision, 5.Dividend decision, 6. Liquidity decision,

8.9. TECHNICAL TERMS

Risk-Return Trade-Off : The risk-return tradeoff is an investment principle that indicates that the higher the risk, the higher the potential reward. To calculate an appropriate risk-return tradeoff, investors must consider many factors, including overall risk tolerance, the potential to replace lost funds and more.

Investment decision : Investment decision refers to selecting and acquiring the long-term and short-term assets in which funds will be invested by the business.

Financing decision : Financing decisions refer to the decisions that companies need to take regarding what proportion of equity and debt capital to have in their capital structure. This plays a very important role vis-a-vis financing its assets, investment-related decisions, and shareholder value creation.

Dividend decision : Dividend decision determines the division of earnings between payments to shareholders and retained earnings. The Dividend Decision, in Corporate finance, is a decision made by the directors of a company about the amount and timing of any cash payments made to the company's stockholders.

Liquidity decision : The liquidity decision is concerned with the management of the current assets, which is a pre-requisite to long-term success of any business firm. This is also called as working capital decision.

8.9. SELF ASSESSMENT QUESTIONS

1) What is financial management?
2) Explain different types of financial decisions.
3) Define financing decision. What is the factors influence on financing decision?
4) What is investment decision? What is the factors influence on investment decision?
5) What is dividend? What is the factors influence on dividend decision?
6) What is Liquidity? What is the factors influence on working capital?
7) Discuss various capital budgeting techniques.

8.10. SUGGESTED READINGS

1. I.M. Panday: "Financial Management " Vikas Publishing House (P) Ltd

2. Chandra, Prasanna "Financial Management " Tata Publishing House Ltd, New Delhi

3. S.N. Maheswari : "Principles of Financial Management " Sultan Chand, Delhi

4. Sheeba Kapil : "Financial Management " Pearson, 2011

5. P.V. Kulakarni: "Financial Management " Himalaya Publishing House Bombay

6. Khan & Jain : Cases in "Financial Management " Tata Publishing House Ltd, Delh

LESSON-9
TYPES & POLICIES OF DIVIDEND

Aims and Objectives

After studying this lesson you should be able to:

- Know the Dividend decision
- Understand the types and policies of dividend decision

Structure

9.1. INTRODUCTION

Dividend is usually a part of the profit that the company shares with its shareholders. Description: After paying its creditors, a company can use part or whole of the residual profits to reward its shareholders as dividends. A dividend is a distribution of profits by a corporation to its shareholders. When a corporation earns a profit or surplus, it is able to pay a proportion of the profit as a dividend to shareholders. Any amount not distributed is taken to be re-invested in the business (called retained earnings). Dividend income is paid out of the profits of a corporation to the stockholders. It is considered income for that tax year rather than a capital gain. However, the U.S. federal government taxes qualified dividends as capital gains instead of income.

A dividend's value is determined on a per-share basis and is to be paid equally to all shareholders of the same class (common, preferred, etc.). The payment must be approved by the Board of Directors. When a dividend is declared, it will then be paid on a certain date, known as the payable date. Steps of how it works: The company generates profits and retained earnings. The management team decides some excess profits should be paid out to shareholders (instead of being reinvested). The board approves the planned dividend. The company announces the dividend (the value per share, the date when it will be paid, the record date, etc.). The dividend is paid to shareholders. Dividends per share is calculated by dividing the total number of dividends paid out by a company (including interim dividends) over a period of time, by the number of shares outstanding.

9.1.1. Who Makes Dividend Decision?

The company's Board of Directors makes dividend decisions. They are faced with the decision to pay out dividends or to reinvest the cash into new projects. The tradeoff between

paying dividends and retaining profits within the company: The dividend policy decision is a trade-off between retaining earnings v/s paying out cash dividends.

Dividend policies must always consider two basic objectives:
1. Maximizing owners' wealth
2. Providing sufficient financing

While determining a firm's dividend policy, management must find a balance between current income for stockholders (dividends) and future growth of the company (retained earnings). In applying a rational framework for dividend policy, a firm must consider the following two issues:

1. How much cash is available for paying dividends to equity investors, after meeting all needs-debt payments, capital expenditures and working capital (i.e. Free Cash Flow to Equity - FCFE)

2. To what extent are good projects available to the firm (i.e. Return on equity - ROE > Required Return)

9.1.2. What are Dividend Decisions?

Dividend decisions, as the very name suggests, refers to the decision-making mechanism of the management to declare dividends. It is crucial for the top management to determine the portion of earnings distributable as the dividend at the end of every reporting period. A company's ultimate objective is the maximization of shareholders wealth. It must, therefore, be very vigilant about its profit-sharing policies to retain the faith of the shareholders. Dividend payout policies derive enormous importance by virtue of being a bridge between the company and shareholders for profit-sharing. Without an organized dividend policy, it would be difficult for the investors to judge the intentions of the management.

Moreover, the dividend policies of an organization have a significant bearing on the market value of stocks. Dividends must be distributed in line with the industry standards. The shareholders will otherwise perceive this variability negatively. It casts a suspicion on the financial health and motives of the management (signaling effect). In aggregate, an inefficient dividend decision mechanism would adversely impact the valuation of the company.

If the company is known for regularly paying dividends, a pressure for maintaining the payout hovers over it. A one-off year, where it may not want to pay dividends and divert the funds for capital investment or retention may be hazardous. Conversely, an interesting phenomenon occurs in cases of company depicting no stability in dividend policies. When it does declare a dividend, the share prices see a huge spike before the ex-dividend date. More and more people seek to make a quick buck by buying its shares on dividend declaration. These shares are then sold as soon as the dividends are declared. This is followed by a fall in the share prices (dividend stripping). Thus the shares of a sparsely dividend paying company undergo great volatility between the date of dividend declaration and payment.

Only a company with sustainable profitability and cash flows can expect to reasonably pay dividend year after year. If any other company claims the same, it is a hoax. If the stock of the company in question is a growth stock such as Qualcomm (NYSE), the shareholders may

pardon a stingy dividend policy. Such shareholders expect to be compensated via a fat capital appreciation and hardly through the dividend. On the hand, if the shareholders are sensitive to dividend decisions of the company it is not a good idea to have an irregular policy. For example, Avista Corp and CMS Energy Corporation (NYSE) have been consistently paying dividends for a while. Investors which buy into these companies are conditioned to expect the same. Having established the expectation of regular dividends, the companies must ensure regular payouts. The failure of same could drive down the prices.

Once a company makes a profit, it must decide on what to do with those profits. They could continue to retain the profits within the company, or they could pay out the profits to the owners of the firm in the form of dividends. The dividend policy decision involves two questions:

9.2. DIVIDEND DECISIONS

The objective of the financial management is the **Maximization of Shareholder's Wealth**. Therefore, the finance manager must ensure a win-win situation for both the shareholders and the company. The optimal dividend decision is when the wealth of shareholders increases with the increase in the value of shares of the company. Therefore, the finance department must consider all the decisions viz. Investment, Financing and Dividend while computing the payouts. If attractive investment opportunities exist within the firm, then the shareholders must be convinced to forego their share of dividend and reinvest in the firm for better future returns. At the same time, the management must ensure that the value of the stock does not get adversely affected due to less or no dividends paid out to the shareholders.

9.2.1. Definition:

According to the Institute of Chartered Accountants of India, dividend is "a distribution to Shareholders out of profits or reserves available for this purpose." "The term dividend refers to that portion of profit (after tax) which is distributed among the owners / shareholders of the firm".

The **Dividend Decision** is one of the crucial decisions made by the finance manager relating to the payouts to the shareholders. The payout is the proportion of **Earning Per Share** given to the shareholders in the form of dividends.

In other words, dividend is that part of the net earnings of a corporation that is distributed to its stockholders. It is a payment made to the equity shareholders for their investment in the company. Dividend is a reward to equity shareholders for their investment in the company. It is a basic right of equity shareholders to get dividend from the earnings of a company.

The companies can pay either dividend to the shareholders or retain the earnings within the firm. The amount to be disbursed depends on the preference of the shareholders and the investment opportunities prevailing within the firm.

9.2.2. Objects of Dividend Decisions

i. Cash Requirement

The financial manager must take into account the capital fund requirements while framing a dividend policy. Generous distribution of dividends in capital-intensive periods may put the company in financial distress.

ii. Evaluation of Price Sensitivity

Companies chosen by investors for its regularity of dividend must have a more stringent dividend policy than others. It becomes essential for such companies to take effective dividend decisions for maintaining stock prices.

iii. Stage of Growth

Dividend decision must be in line with the stage of the company- infancy, growth, maturity & decline. Each stage undergoes different conditions and therefore calls for different dividend decisions.

9.3. TYPES OF DIVIDENDS:

Classifications of dividends are based on the form in which they are paid. Following given below are the different types of dividends: i, Stable dividend ii, Constant dividend iii, Cash dividend iv, Bonus Shares referred to as stock dividend v. Interim dividend, annual dividend. vi. Special- dividend, extra dividend etc. vii. Regular Cash dividend viii. Scrip dividend ix. Liquidating dividend x. Property dividend xi. Alternative dividend.

i. *Stable Dividends*: Same amounts of dividends are paid out every year irrespective of the profitability. Shareholders remain immune to fluctuations and volatility faced by the company. Only long-standing and established companies with steady cash flows can afford to follow this policy. Investors that buy into these companies have a low risk appetite. They also do not get to participate in the profits of the company

ii. Constant Dividends: Dividends are paid at a fixed percentage of the profits. The brunt of recession is as much borne them as much they reap benefits of the boom. This policy is suitable for companies in their infancy stage as well as those prone to volatility. Investors of these companies are risk-taking. They prefer to swing with the company in its earnings

iii. Cash dividend:

Companies mostly pay dividends in cash. A Company should have enough cash in its bank account when cash dividends are declared. If it does not have enough bank balance, arrangement should be made to borrow funds. When the Company follows a stable dividend policy, it should prepare a cash budget for the coming period to indicate the necessary funds, which would be needed to meet the regular dividend payments of the company. It is relatively difficult to make cash planning in anticipation of dividend needs when an unstable policy is followed. The cash account and the reserve account of a company will be reduced when the cash dividend is paid. Thus, both the total assets and net worth of the company are reduced when the cash dividend is distributed. The market price of the share drops in most cases by the amount of the cash dividend distributed.

Stock dividend or bonus shares:

A stock dividend is a distribution of additional shares of stock to existing shareholders on a pro-rata basis i.e. so much stock for each share of stock held. Thus, a 10% stock dividend would give a holder of ICQ shares, as additional 10 shares, whereas a 250% stock dividend would give him 250 additional shares. A stock dividend has no immediate effect upon assets. It results in a transfer of an amount from the accumulated earnings or surplus account to the share capital account. In other words, the reserves are capitalised and their ownership is formally transferred to the shareholders.

The equity of the shareholders in the corporation increases. Stock dividends do not alter the cash position of the company. They serve to commit the retained earnings to the business as a part of its fixed capitalisation. An issue of bonus share is the distribution of shares free of cost to the existing shareholders, In India, bonus shares are issued in addition to the cash dividend and not in lieu of cash dividend. Hence, Companies in India may supplement cash dividend by bonus issues. Issuing bonus shares increases the number of outstanding shares of the company. The bonus shares are distributed proportionately to the existing shareholder. Hence there is no dilution of ownership The declaration of the bonus shares will increase the paid-up Share Capital and reduce the reserves and surplus retained earnings) of the company. The total net-worth (paid up capital plus reserves and surplus) is not affected by the bonus issue. Infact, a bonus issue represents a recapitalization of reserves and surplus. It is merely an accounting transfer from reserves and surplus to paid up capital.

Reasons for declaring a stock dividend: Two principal reasons which usually actuate the directors to declare a stock dividend are:

(1) They consider it advisable to reduce the market value of the stock and thereby facilitate a broader distribution of ownership.
(2) The corporation may have earnings but may find it inadvisable to pay cash dividends. The declaration of a stock dividend will give the stock holders evidence of the increase in their investment without interfering with the company's cash position. If the stock holders prefer cash to additional stock in the company, they can sell the stock received as dividend.
Sometimes, a stock dividend is declared to protect the interests of old stock holders when a company is about to sell a new issue of stock (so that new shareholders should not share the accumulated surplus).

Limitations of stock dividends:

The bonus shares entail an increase in the capitalisation of the corporation and this can only be justified by a proportionate increase in the earning capacity of the corporation. Young companies with uncertain earnings or companies with fluctuating income are likely to take great risk by distribution stock dividends.

Every stock dividend carries an implied promise that future cash dividends will be maintained at a steady level because of the permanent capitalisation of reserves. Unless the corporate management has reasonable grounds of entertaining this hope, the wisdom of large stock dividend is always subject to grave suspicion.

The existence of legal sanction for distributing the accumulated earnings or reserves does not warrant the issue of stock dividends from the point of view of sound financial practice. There should be other conditioning factors also for the issue of stock dividend.

(a) Bonus shares bring about a capitalisation of undistributed profits in the companies where the profits originate and this lead to a linear development of corporate enterprise and greater concentration of economic power.

(b) By issuing stock dividends-the corporations deprive the capital market of 'secondary' funds which would otherwise have flowed into more widely dispersed investments.

(c) Bonus shares enable companies to appropriate to their own use undistributed profits which, otherwise, would have led either to an increase in the share of labour or a reduction in prices for the consumer.

The following are advantages of the bonus shares to shareholders:

1) Tax benefit: One of the advantages to shareholders in the receipt of bonus shares is the beneficial treatment of such dividends with regard to income taxes.
2) Indication of higher future profits: The issue of bonus shares is normally interpreted by shareholders as an indication of higher profitability.
3) Future dividends may increase: if a Company has been following a policy of paying a fixed amount of dividend per share and continues it after the declaration of the bonus issue, the total cash dividend of the shareholders will increase in the future.
4) Psychological Value: The declaration of the bonus issue may have a favorable psychological effect on shareholders. The receipt of bonus shares gives them a chance sell the shares to make capital gains without impairing their principal investment. They also associate it with the prosperity of the company. Please note from exam point of view only cash dividend and bonus dividend are important.

v, Interim dividend: During the year any time company declares a dividend, it is defined as Interim dividend. ***Annual dividend***: When annually company declares and pay dividend is defined as annual dividend.

vi, ***Special dividend :*** In special circumstances Company declares Special dividends. Generally company declares special dividend in case of abnormal profits. ***Extra- dividend:*** An extra dividend is an additional non-recurring dividend paid over and above the regular dividends by the company. Companies with fluctuating earnings payout additional dividends when their earnings warrant it, rather than fighting to keep a higher quantity of regular dividends.

vii. Regular cash dividends: They may be paid quarterly, monthly, semiannually or annually.

viii. Scrip dividends: These are promises to make the payment of dividend at a future date: Instead of paying the dividend now, the firm elects to pay it at some later date. The 'scrip' issued to stockholders is merely a special form of promissory note or notes payable.

***ix. Liquidating dividends*:** These dividends are those which reduce paid-in capital: It is a prorata distribution of cash or property to stockholders as part of the dissolution of a business.

When a company decides to terminate the operation, it liquidates all its assets. These assets include not just inventory, but also machines, building, and

x. Property dividends: These dividends are payable in assets of the corporation other than cash. For example, a firm may distribute samples of its own product or shares in another company it owns to its stockholders.

xi. Alternate Dividend Decisions: A company may not always issue the dividend in cash. A stock dividend is a significant option with the management for recourse to non-cash options. It is a handy tool to which management may resort to when it wants to balance both, shortage of cash and shareholder expectations. Such decisions are only made in exceptional circumstances.

9.4. DIVIDEND POLICY

"Dividend policy determines the ultimate distribution of the firm's earnings between retention (that is reinvestment) and cash dividend payments of shareholders." "Dividend policy means the practice that management follows in making dividend payout decisions, or in other words, the size and pattern of cash distributions over the time to shareholders." In other words, dividend policy is the firm's plan of action to be followed when dividend decisions are made. It is the decision about how much of earnings to pay out as dividends versus retaining and reinvesting earnings in the firm.

Dividend policy must be evaluated in light of the objective of the firm namely, to choose a policy that will maximize the value of the firm to its shareholders. The dividend policy of a company reflects how prudent its financial management is. The future prospects, expansion, diversification mergers are effected by dividing policies and for a healthy and buoyant capital market, both dividends and retained earnings are important factors. As we know in corporation, owners are shareholders but management is done through Board of directors. It is the Board of Directors to decide whether to pay dividend or retain earnings for future projects. It is a matter of conflict between shareholders and directors. Shareholders expect a quick return on their capital. On the other hand, directors have to consider a number of factors in determining divided policy. Most of the company follows some kind of dividend policy. The usual policy of a company is to retain a position of net earnings and distribute the remaining amount to the shareholders. Many factors have to be evaluated before forming a long term dividend policy.

WHAT IS A DIVIDEND POLICY?

A company's dividend policy dictates the amount of dividends paid out by the company to its shareholders and the frequency with which the dividends are paid out. When a company makes a profit, they need to make a decision on what to do with it. They can either retain the profits in the company (retained earnings on the balance sheet), or they can distribute the money to shareholders in the form of dividends.

Examples of Dividend Policies

The dividend policy used by a company can affect the value of the enterprise. The policy chosen must align with the company's goals and maximize its value for its shareholders.

While the shareholders are the owners of the company, it is the board of directors who make the call on whether profits will be distributed or retained.

The directors need to take a lot of factors into consideration when making this decision, such as the growth prospects of the company and future projects. There are various dividend policies a company can follow such as:

9.4.1. TYPES OF DIVIDEND POLICY

How do firms view their dividend policies?
In a classic study, Lintner surveyed a number of managers in the 1950's and asked how they set their dividend policy. Most of the respondents said that there were a target proportion of earnings that determined their policy. One firm's policy might be to pay out 40 % of earnings as dividends whereas another company might have a target of 50 %.

On the basis of interviews with corporate executives, Lintner concluded that firms select target payout ratios to which they gradually adjust actual dividend payments over time. This would suggest that dividends change with earnings. However, dividend policies may vary between various firms as every firm sets its own policy for dividend distribution.

Firms may pursue any one of the following dividend policies:

i. Generous or liberal dividend policy: Firms that follow this policy reward shareholders generously by stepping up dividend over the time.

Stable dividend policy: Firms may follow the policy of: Stable dividend payout ratio: Under the stable dividend policy, the percentage of profits paid out as dividends is fixed. For example, if a company sets the payout rate at 6%, it is the percentage of profits that will be paid out regardless of the amount of profits earned for the financial year. Whether a company makes $1 million or $100,000, a fixed dividend will be paid out. Investing in a company that follows such a policy is risky for investors as the amount of dividends fluctuates with the level of profits. Shareholders face a lot of uncertainty as they are not sure of the exact dividend they will receive. According to this policy, the percentage of earnings paid out of dividends remains constant. The dividends will fluctuate with the earnings of the company. Stable rupee (inflation adjusted) dividend policy: As per this policy the rupee level of dividends remains stable.

iii. Regular dividend policy Under the regular dividend policy, the company pays out dividends to its shareholders every year. If the company makes abnormal profits (very high profits), the excess profits will not be distributed to the shareholders but are withheld by the company as retained earnings. If the company makes a loss, the shareholders will still be paid a dividend under the policy. The regular dividend policy is used by companies with a steady cash flow and stable earnings. Companies that pay out dividends this way are considered low-risk investments because while the dividend payments are regular, they may not be very high.

iv. Low regular dividend plus extra dividend policy: As per this policy, a low, regular dividend is maintained and when times are good an extra dividend is paid. Extra dividend is the additional dividend optionally paid by the firm if earnings are higher than normal in a

given period. Although the regular portion will be predictable, the total dividend will be unpredictable.

v.No dividend policy: Under the no dividend policy, the company doesn't distribute dividends to shareholders. It is because any profits earned is retained and reinvested into the business for future growth. Companies that don't give out dividends are constantly growing and expanding, and shareholders invest in them because the value of the company stock appreciates. For the investor, the share price appreciation is more valuable than a dividend payout.

vi. Residual dividend policy: Under this policy, dividends are paid out of earnings not needed to finance new acceptable capital projects. The dividends will fluctuate depending on investment opportunities available to the company.

vii. ***Multiple dividend increase policy:*** Some firms follow the policy of very frequent and small dividend increases. The objective is to give shareholders an illusion of movement and growth.

viii. Uniform cash dividend plus bonus policy: Under this policy, the minimum rate of dividend per share is paid in cash plus bonus shares are issued out of accumulated reserves. However, bonus shares are not given compulsorily on an annual basis. They may be given over a period of a certain number of years, for example 3-5 years depending on the accumulated reserves of the company that can be utilized for the purpose of issuing bonus.

ix. Irregular dividend policy: Under the irregular dividend policy, the company is under no obligation to pay its shareholders and the board of directors can decide what to do with the profits. If they a make an abnormal profit in a certain year, they can decide to distribute it to the shareholders or not pay out any dividends at all and instead keep the profits for business expansion and future projects. The irregular dividend policy is used by companies that do not enjoy a steady cash flow or lack liquidity. Investors who invest in a company that follows the policy face very high risks as there is a possibility of not receiving any dividends during the financial year.

9.4.2. Stable Dividend Policy: A Policy of Dividend Smoothing

Lintner (1956) had observed that managers tend to value stable dividend policies and corporations tend to smooth dividends relative to earnings. That is, dividends are increased gradually and rarely cut, resulting in a much lower variability of dividends as compared to the variability in earnings. Most Companies adapt a basic policy of maintaining its internal reserves to ensure stable income far into the future, while at the same time seek to distribute a sufficient amount of earnings to shareholders in accordance with business results. with a decrease in EPS, DPS has decreased and with increase in earnings the dividend per share has increased. However increase in dividends is lagging behind increase in earnings in order to 'smoothen' or 'stabilize' dividend payments over the time.

9.4.2.1. Firm may adapt any of the following stable dividend policies:

i. Stable dividend payout ratio ii. Stable dividends per share iii. A regular plus extra dividend policy

Dividend payout Ratio: it is calculated by dividing the total dividend to equity shareholders

by the net income available to them for that period as follows:
Dividend payout Ratio = Total dividend paid/ Net income after tax OR
Dividend payout Ratio = Annual dividend paid per share/ EPS OR
Dividend payout Ratio = 1- Retention Ratio
Where retention ratio = Retained Earnings/ Net income
Retention Ratio + Dividend payout Ratio = 1 (which means whatever amount is not paid by dividend is retained by the company to reinvest)

i. Stable dividend payout ratio As per this policy the percentage of dividends paid out of earnings remains constant. Time (Years) Example: if a company adopts a 30% payout ratio and if EPS is Rs 100, then shareholder having 10 shares will receive Rs.300 as dividend under this policy.

ii. ***Stable dividends per share:*** According to this policy, the firm pays a certain fixed amount of dividend per share every year. Annual dividend per share is increased only when the company reaches a new level of earnings and expects to maintain it. EPS DPS

iii. ***A regular plus extra dividend policy:*** According to this policy a certain fixed percentage or a minimum amount of dividend is paid every year, which is referred to as regular dividend. The firm pays 'additional' or 'extra' dividend if earnings are higher than normal in any year.

9.4.2.2. ***Rationale for stable dividend policy:***

Most firms adapt a stable dividend policy. If a firm's earnings are temporarily depressed or if it needs a substantial amount of funds for investment, then it might well maintain its regular dividend using borrowed funds to meet its needs, until things returned to normal. The logic or rationale for stable dividend policy is:

i. Stockholders like stable dividends- many of them depend on dividend income, and if dividends were cut, this might cause serious hardship to them. A stable dividend policy is desirous for many investors such as retired persons, who take dividends as a source to meet their current living expenses.

ii. Reduce investor uncertainty- A stable dividend policy would reduce investor uncertainty, and reductions in uncertainty are generally associated with lower capital costs and higher stock prices, other things being equal.

iii. ***prefer to invest in companies***- Institutional investors generally prefer to invest in companies having stable dividend records
iv. ***Raising funds from external sources***-- Adoption of stable dividends is advantageous for a company interested in raising funds from external sources as shareholders willingly invest in companies having stable dividends as they have more confidence in such companies. The disadvantage is that such a policy might decrease corporate flexibility. Once a company has adapted a stable dividend policy, any change in such a policy may have adverse effects on the company image and may result in creating serious doubts in the minds of investors about financial standing of the company, which might prove to be very dangerous for the company at a later stage.EPS DPS

9.5. GOOD DIVIDEND POLICY

There does not exist a single dividend decision process that works for every organization. A decision suitable for one company may prove fatal for another company. For example, businesses with a consistent order book such as telecom and banking are expected to pay regular dividends. It may impact the stock prices if they do not pay dividends regularly. To the contrary, sectors of pharmaceutical and technology are highly research oriented. Huge cash expenses are required to further their operations. Therefore they cannot afford to pay a regular dividend. Investors of such stocks earn income mainly through capital appreciation. In essense, there are a lot of factors affecting dividend policy or decision.

We can refer to following renowned theories on Dividend Policy:

- Modigliani- Miller Theory on Dividend Policy
- Gordon's Theory on Dividend Policy
- Walter's Theory on Dividend Policy

A good financial manager must, therefore, answer the following questions before taking crucial dividend decisions

9.6. SUMMARY:

After studying this lesson you should be able to: Know the Dividend decision & Understand the types and policies of dividend decision. This lesson is presented into nine aspects such as : Introduction, Dividend Decisions, Types of Dividends, Dividend Policy, Good dividend Policy, Summary, Technical terms, Self Assessment Questions,. Suggested Readings

9.7. TECHNICAL TERMS:

Stable Dividend : A business with a stable dividend policy pays out a steady dividend every given period, regardless of the volatility. It indicates the level of risk associated with the price changes of a security.

Multiple dividend : The multistage dividend discount model is an equity valuation model that builds on the Gordon growth model by applying varying growth rates to the calculation. Under the multistage model, changing growth rates are applied to different time periods.

Residual Dividend : Residual dividend is a dividend policy used by companies whereby the amount of dividends paid to shareholders amounts to what profits are left over after the company has paid for its capital expenditures (CapEx) and working capital costs.

Regular dividend : A dividend on common stock that is intended to be paid periodically in equal amounts over the course of a year, typically quarterly, after being declared by the issuer of the stock.

No dividend : When a company decides not to offer a dividend, it keeps more money for its own operations. Instead of rewarding investors with a payment, it can invest in its operations or fund expansion in hopes of rewarding investors with more valuable shares of a stronger company.

Irregular dividend: An extra dividend, sometimes called a special or irregular dividend, is a one-time dividend paid to a company's shareholders of record.

9.8. SELF ASSESSMENT QUESTIONS

1. What is dividend? Explain about different types of dividend.
2. What is stable dividend? Briefly discuss about it.
3. What is stock dividend? Explain the merits and demerits of stock dividend policy.
4. Explain different types of dividend decision policies in India.

9.9. SUGGESTED READINGS

1. I.M. Panday: "Financial Management " Vikas Publishing House (P) Ltd

2. Chandra, Prasanna "Financial Management " Tata Publishing House Ltd, New Delhi

3. S.N. Maheswari : "Principles of Financial Management " Sultan Chand, Delhi

4. Sheeba Kapil : "Financial Management " Pearson, 2011

5. P.V. Kulakarni: "Financial Management " Himalaya Publishing House Bombay

6. Khan & Jain : Cases in "Financial Management " Tata Publishing House Ltd, Delh

LESSON-10
DIVIDEND DETERMINANTS
OR FACTORS

Aims and Objectives

After studying this lesson you should be able to:

- Know the Dividend decision
- Understand the Dividend Determinants(factors) influencing on dividend decision

Structure

10.1. INTRODUCTION

The declaration of dividends involves some legal as well as financial considerations. From the point of legal considerations, the basic rule is that dividend can only be paid out profits without the impairment of capital in any way. But the various financial considerations present a difficult situation to the management for coming to a decision regarding dividend distribution discussed below: A stable dividend policy should not be taken to mean an inflexible or rigid policy. On the other hand, it entails the payment of a fair rate of return, taking into account the normal growth of business and the gradual impact of external events. A stable dividend record makes future financing easier. It not only enhances the credit-standing of the company but also stabilises market values of the securities outstanding. The confidence of shareholders in the corporate management is also strengthened.

10.2. LEGAL RULES GOVERNING PAYMENT OF DIVIDENDS

It is illegal to pay a dividend, if after its payment; the capital would be impaired (reduced). This requirement might be met if only capital surplus existed. An upward revaluation of assets, however, would create a capital surplus, but at the same time might operate as a fraud on creditors and for that reason is illegal. Basically the dividend laws were intended to protect creditors and therefore prohibit payment of a dividend if a corporation is insolvent or if the dividend payment will cause insolvency. The corporate laws must be taken into consideration by the directors before they declare a dividend. The company can postpone the distribution of dividend in cash, which may be conserved for strengthening the financial condition of the company by declaring stock dividend or bonus shares. To sum up, the decision with regard to dividend policy rests on the judgment of the management, since it is not a contractual

obligation like interest. The formulation of dividend policy requires a balanced financial judgement by judiciously weighting the different factors affecting the policy.

10.3. INTERNAL & MARKET DETERMINANTS OF DIVIDEND POLICY

The 'dividend puzzle' may have multiple underlying determinants. Most studies on this topic focus on investigating the determinants of dividend payments in developed economies.

i. Profits

Dividend policy depends on current or future earnings of the firm and the percentage share of retained earnings. According to DeAngelo, DeAngelo and Stulz, dividend payment correlates positively with the ratio of retained earnings to total equity (DeAngelo, DeAngelo, & Stulz, 2006). Fama and Babiak (1968) identify the impact of income from previous years on current dividends. This significant relation between dividends and past earnings was also confirmed by Benartzi, Michaely and Thaler (1997). These findings are consistent with the signalling theory, according to which a significant increase in earnings in the current and previous years affects subsequent dividend payout decisions.

ii. Profitability

The level of profitability is a determining factor in dividend payouts. High ROE and ROA tend to correspond to high dividend payouts (Benavides, Berggrun, & Perafan, 2016; DeAngelo, DeAngelo, & Skinner, 1996; DeAngelo et al., 2006; Denis & Osobov, 2008; Fama & French, 2001). The results of the study by Kaźmierska-Jóźwiak (2015) indicate that there is a significant but negative relationship between profitability (ROE) and the dividend payout ratio. In the research sample, in the case of ROA there was a stronger correlation with dividend payouts than in the case of ROE, which could point to a specific capital structure correlation among listed companies operating in emerging markets. ROA serves as a proxy for the availability of internal funds, growth opportunities, the scale of agency problems and information asymmetry. This study recognises that the dividend payout correlates positively with profitability.

iii. Free cash flow

The free cash flow theory is based on the idea that managers rely on the dividend policy as a means of communication with the investors to signal income growth levels and future prospects of the company growth as well (Bena & Hanousek, 2008). Firms that predict declining investment opportunities are more inclined to increase dividends (Grullon, Michaely, & Swaminathan, 2002). The dividend policy of a given company can be used as a monitoring tool to reduce free cash flows in order to decrease the agency costs associated with the separation of ownership and control in companies (Brunzell, Liljeblom, Löflund, & Vaihekoski, 2014).

iv. Growth

Dividend policy is strongly linked to fundamental firm characteristics such as growth opportunities (Denis & Stepanyan, 2011). Growth in sales and in the market-to-book value is used as predictors of investment opportunities. However, in the effect of growth opportunities on the possibility of dividend payouts has been shown to be inconsistent. Allen and

Michaely's results and other researchers show that firms with a high degree of information asymmetry and high growth opportunities should avoid paying dividends (Allen & Michaely, 2003; Chen & Steiner, 1999; Jensen, Solberg, & Zorn, 1992; Rozeff, 1982). However, low-growth firms could pay out relatively high dividends in the situation of limited opportunities for profitable investment (Alli, Khan, & Ramirez, 1993).

v. Company size

The size of the company matters, as in all countries dividends were paid by the biggest and most profitable firms (Denis & Osobov, 2008). However, this factor is related to profitability, as bigger and more profitable firms are more likely to pay dividends (Consler & Lepak, 2016; DeAngelo et al., 2006). According to Authors, the size of a firm has a significant impact on the relation of retained earnings to total equity. This correlation was also evidenced in Fama and French's study (Fama & French, 2001)..

vi. Financial leverage

In the long run, variation in dividends is significantly related to the capital structure of the firm (Belo, Collin-Dufresne & Goldstein, 2015). The higher the leverage that the company relies on, the lower the likelihood that this company will pay dividends (Von Eije & Megginson, 2008). Firms which increase dividend payouts by a large amount subsequently increase their leverage (Cooper & Lambertides, 2018). A high level of debt could be related to the decision not to pay out dividends, which could be explained by the need to maintain higher levels of free cash to meet the creditors' demands. Therefore, higher debt ratios are related to lower dividend payouts or lack of dividends (Chay & Suh, 2009).

vii. Liquidity

The level of liquidity and the structure of current assets affect the decisions on dividend payments in a firm. High cash surpluses could translate into the distribution of retained earnings in the form of dividends to shareholders or into investments in the firm's capital stock as part of reinvestment in the firm (Alstadsaeter, Jacob, & Michaely, 2017). Many studies provide evidence of the relationship between the current ratio, or the working capital level (as proxy for liquidity), and the possibility of dividend payouts (Ho, 2003; Kaźmierska-Jóźwiak, 2015). Companies which make a decision to disburse cash from profit retain a higher level of financial liquidity (Franc-Dąbrowska, 2007). The positive correlation between dividend payouts and liquidity is supported by the signalling theory.

viii. Market risk

The market ratios explain the investors' attitude to a given firm's dividend policy. The value of price per earnings ratio can be interpreted as a risk measure. The increase of the P/E value may suggest an growth of future earnings expectations (Al-Malkawi, 2008). In this manner, business risk is also used as an indicator of future profitability (DeAngelo et al. 2006). Overall, this study recognises that dividend payout correlates positively with company value on the market, represented by stock price. dividend payment and the P/E ratio.

ix. Dividend payers and non-payers

According to the study by Baker et al. on developing markets, growth opportunities, low profitability and cash constraints are the main reasons not to pay dividends (Baker, Chang, Dutta, & Saadi, 2012). According to Ferris, Sen and Unlu, the large proportion of non-payers

can be explained by an increase in the percentage share of firms that have never paid dividends (Ferris, Sen, & Unlu, 2009). Furthermore, firms that pay dividends are more attractive for investors, who choose to invest in these firms rather than in the non-dividend-paying ones (Goldstein et al., 2015). Dividend payers tend to be mature firms, while young, high-growth firms do not usually pay dividends (Baker, 2009).

x. Industry characteristics

The industry effect on the dividend policy verifies that industries with high-growth options pay fewer dividends (Gaver & Gaver, 1993; Ho, 2003; Smith & Watts, 1992). The statement that dividend and investment decisions are not independent and that they are dependent on industry effects is advanced in a study by Michel and Shaked and Al-Malkawi (Al-Malkawi, 2008; Michel, 1979; Michel & Shaked, 1986). Different firms have various possibilities of achieving high income and, thereby, high return. This information is transmitted to the market in the form of various signals that a dividend payout is likely to happen in the immediate future (Bhattacharyya, 2007).

Furthermore, Van Canegham and Aerts' study, showed that firms paying dividends are more similar in their dividend payout strategy to firms from the same sector than to companies from other sectors (Van Caneghem & Aerts, 2011). The food industry produces primary products and responds to a relatively inflexible demand in at times turbulent economic conditions. In addition to the seasonality of the production process and the dependence on natural and political conditions, the unfavourable price developments in the long run or a relatively low profitability of investments can contribute to discouraging investment levels (Mądra-Sawicka 2017; Pasek, 2015)

10.4. DETERMINANTS OF DIVIDEND POLICY

A company is raising funds from different sources, and it includes debentures, preference shares, and equity shares. Payment to debenture holders and preference shareholders is at a fixed rate. No commitment is made to equity shareholders in terms of return. If there is a loss, then no payment will be made to them. However, if there is a profit, then the company needs to decide whether to pay dividends or not. If the dividend is to be paid, then what amount to be paid is required to be decided. Again, the company will take this dividend decision so that it maximizes the wealth of shareholders. There are various types of dividend policies – regular, stable, constant, and irregular. In this post, we will discuss various factors affecting dividend policy.

Some of the most important determinants of dividend policy are: (i) Type of Industry (ii) Age of Corporation (iii) Extent of share distribution (iv) Need for additional Capital (v) Business Cycles (vi) Changes in Government Policies (vii) Trends of profits (vii) Trends of profits (viii) Taxation policy (ix) Future Requirements and (x) Cash Balance. xi) Ownership Structure xii) Different Shareholders' Expectations xiii) Leverage xiv) Profitability xv) Liquidity xvi) Legal Rules xvii) Inflation xviii) Control Objectives and others.

The following are the various factors/determinants that impact the dividend policy of a company:

i. Type of Industry

The nature of the industry to which the company belongs has an important effect on the dividend policy. Industries where earnings are stable may adopt a consistent dividend policy as opposed to the industries where earnings are uncertain and uneven. They are better off having a conservative approach to dividend payout. Industries that are characterised by stability of earnings may formulate a more consistent policy as to dividends than those having an uneven flow of income. For example, public utilities concerns are in a much better position to adopt a relatively fixed dividend rate than the industrial concerns.

ii. Age of Corporation

Newly formed companies will have to retain a major part of their earnings for further growth and expansion. Thus, unlike established companies they have to follow a conservative policy that can pay higher dividends from their reserves. Newly established enterprises require most of their earning for plant improvement and expansion, while old companies which have attained a longer earning experience, can formulate clear cut dividend policies and may even be liberal in the distribution of dividends. The age of the company also influences the dividend decision of a company. A newly established concern has to limit payment of dividend and retain substantial part of earnings for financing its future growth and development, while older companies which have established sufficient reserves can afford to pay liberal dividends.

iii. The Extent of Share Distribution

A company with a large number of shareholders will have a difficult time getting them to agree to a conservative policy. On the other hand, a closely held company has more chances of succeeding in finalizing conservative dividend payouts. A closely held company is likely to get consent of the shareholders for the suspension of dividends or for following a conservative dividend policy. But a company with a large number of shareholders widely scattered would face a great difficulty in securing such assent. Reduction in dividends can be affected but not without the co-operation of shareholders.

iv. Need for additional Capital

The extent to which the profits are ploughed back into the business has got a considerable influence on the dividend policy. The income may be conserved for meeting the increased requirements of working capital or future expansion.

v. Business Cycles

During the boom, prudent corporate management creates good reserves for facing the crisis which follows the inflationary period. Higher rates of dividend are used as a tool for marketing the securities in an otherwise depressed market. When the company experiences a boom, it is prudent to save up and make reserves for dips. Such reserves will help a company to maintain dividends even in depressing markets to plow back and attract more shareholders.

vi. Changes in Government Policies

Sometimes government limits the rate of dividend declared by companies in a particular industry or in all spheres of business activity. The Government put temporary restrictions on payment of dividends by companies in July 1974 by making amendment in the Indian Companies Act, 1956. The restrictions were removed in 1975. There could be a change in a company's dividend policy due to the imposed changes by the government. The Indian government had put temporary restrictions on companies to pay dividends during 1974-75.

vii. Trends of Profits

Even if the company has been profitable over the years, the trend should be properly analyzed to find the company's average earnings. This average number should then be studied in relation to the general economic conditions. This will help in opting for a conservative policy if depression is approaching. The past trend of the company's profit should be thoroughly examined to find out the average earning position of the company. The average earnings should be subjected to the trends of general economic conditions. If depression is approaching, only a conservative dividend policy can be regarded as prudent.

viii. Taxation Policy

Corporate taxes will affect dividend policy, either directly or indirectly. The taxes directly reduce the residual earnings after-tax available for the shareholders. If dividend income is taxable in the hands of investors and capital gain is exempt, the company may retain its earnings to increase the price per share, which ultimately gives a higher return to investors and vice versa. Further, if it is possible that bifurcate all shareholders into a high tax bracket or low tax bracket, accordingly dividend policy can be framed. Finally, the objective is to give maximum return to shareholders. Corporate taxes affect dividends directly and indirectly— directly, in as much as they reduce the residual profits after tax available for shareholders and indirectly, as the distribution of dividends beyond a certain limit is itself subject to tax. At present, the amount of dividend declared is tax free in the hands of shareholders.

The taxation policy of the Government also affects the dividend decision of a firm. A high or low rate of business taxation affects the net earnings of company (after tax) and thereby its dividend policy. Similarly, a firm's dividend policy may be dictated by the income-tax status of its shareholders. If the dividend income of shareholders is heavily taxed being in high income bracket, the shareholders may forego cash dividend and prefer bonus shares and capital gains.

ix. Future Financial Requirements / Reinvestment Opportunity

It is not only the desires of the shareholders but also future financial requirements of the company that have to be taken into consideration while making a dividend decision. The management of a concern has to reconcile the conflicting interests of shareholders and those of the company's financial needs. If a company has highly profitable investment opportunities it can convince the shareholders of the need for limitation of dividend to increase the future earnings and stabilise its financial position. But when profitable investment opportunities, do not exist then the company may not be justified in retaining substantial part of its current earnings. Thus, a concern having few internal investment

opportunities should follow high payout ratio as compared to one having more profitable investment opportunities.

The dividend payout will also depend on the future requirements for the additional capital. A company having profitable investment opportunities is justified in retaining its earnings. However, a company with no capital requirements should opt for a higher dividend. Accumulation of profits becomes necessary to provide against contingencies (or hazards) of the business, to finance future- expansion of the business and to modernise or replace equipments of the enterprise. The conflicting claims of dividends and accumulations should be equitably settled by the management.

x. Cash Balance

If the working capital of the company is small liberal policy of cash dividend cannot be adopted. Dividend has to take the form of bonus shares issued to the members in lieu of cash payment. The regularity of dividend payment and the stability of its rate are the two main objectives aimed at by the corporate management. They are accepted as desirable for the corporation's credit standing and for the welfare of shareholders. High earnings may be used to pay extra dividends but such dividend distributions should be designed as "Extra" and care should be taken to avoid the impression that the regular dividend is being increased.

xi. Ownership Structure

The ownership structure of a company also impacts the policy. A company with a higher promoter's holdings will prefer a low dividend payout as paying out dividends may cause a decline in the value of the stock. Whereas high institutional ownership will favor a high dividend payout as it helps them increase control over the management.

xii. ***Different Shareholders' Expectations***

Another factor that impacts the policy is the diversity in the type of shareholders a company has. A different group of shareholders will have different expectations. A retired shareholder will have a different requirement vis-a-vis a wealthy investor. The company needs to clearly understand the different expectations and formulate a successful dividend policy. Psychologically, a cash dividend will give more satisfaction to shareholders in comparison to capital appreciation.

xiii. ***Leverage***

A company having more leverage in its financial structure and, consequently, more interest payments may decide on a low dividend payout to increase its net worth and to make sure that it can make payment of financial charges even in case of earnings of the company are falling. Whereas a company utilizing more of its own financing will prefer high dividends.

xiv. Profitability

The net profit ratio and the ratio of profit to total assets reflect a firm's profitability. A highly profitable company has the capacity to pay higher dividends, and a company with less profits will adopt a conservative dividend policy.

xv. Liquidity

Liquidity has a direct relation with the dividend policy. Often, a company with high profit may have a majority of profit blocked in working capital, or it may acquire assets. In that case, its liquidity is poor. In that case, a company should pay less dividend. High dividend payment is possible only if a company has good earnings and sound liquidity.

xvi. Legal Rules

Legal provisions relating to dividends as laid down in sections 93,205,205A, 206 and 207 of the Companies Act, 1956 are significant because they lay down a framework within which dividend policy is formulated. These provisions require that dividend can be paid only out of current profits or past profits after providing for depreciation or out of the moneys provided by Government for the payment of dividends in pursuance of a guarantee given by the Government.

The Companies (Transfer of Profits to Reserves) Rules, 1975 require a company providing more than ten per cent dividend to transfer certain percentage of the current year's profits to reserves. Companies Act, further, provides that dividends cannot be paid out of capital, because it will amount to reduction of capital adversely affecting the security of its creditors. There are certain legal restrictions on the companies for dividend payments. It is legal to pay a dividend only if the capital is not reduced post payment. These rules are in place to protect creditors' interests. Most importantly, providing depreciation is mandatory before making payment of dividends. Depreciation is to be provided at minimum rates provided. Providing depreciation is very important because with that company is able to retain an amount of profit for the replacement of fixed assets in the future.

xvii. Inflation

Inflationary environments compel companies to retain a major part of their earnings and indulge in lower dividends. As the prices rise, the companies need to increase their capital reserves to purchase fixed assets. In the case of an inflationary situation, the same quantity of closing stock will have more valuation, so payment of tax also increases. Inflation acts as a constraint in the payment of dividends. Profits as arrived from the profit and loss account on the basis of historical cost have a tendency to be overstated in times of rise in prices due to over valuation of stock-in-trade and writing off depreciation on fixed assets at lower rates.

As a result, when prices rise, funds generated by depreciation would not be adequate to replace fixed assets, and hence to maintain the same assets and capital intact, substantial part of the current earnings would be retained. Otherwise, imaginary and inflated book profits in the days of rising prices would amount to payment of dividends much more than warranted by the real profits, out of the equity capital resulting in erosion of capital.

xviii. Control Objectives

When a company pays high dividends out of its earnings, it may result in the dilution of both control and earnings for the existing shareholders. As in case of a high dividend pay-out ratio, the retained earnings are insignificant and the company will have to issue new shares to raise funds to finance its future requirements. The control of the existing shareholders will be diluted if they cannot buy the additional shares issued by the company. Similarly, issue of

new shares shall cause increase in the number of equity shares and ultimately cause a lower earnings per share and their price in the market. Thus, under these circumstances to maintain control of the existing shareholders, it may be desirable to declare lower dividends and retain earnings to finance the firm's future requirements.

The firms aiming for more control in the hands of current shareholders prefer a conservative dividend payout policy. It is imperative to pay fewer dividends to retain more control and the company's earnings. In a nutshell, a company's management is completely free to frame the required dividend policy. It does not require adhering to any obligations. So, the company needs to judiciously weigh all the above-mentioned factors and formulate a balanced dividend policy. A dividend policy can also be revised in the wake of changes in any of the factors affecting dividend policy.

xix. Magnitude and Trend of Earnings

The amount and trend of earnings is an important aspect of dividend policy. It is rather the starting point of the dividend policy. As dividends can be paid only out of present or past year's profits, earnings of a company fix the upper limits on dividends. The dividends should, generally, be paid out of current year's earnings only as the retained earnings of the previous years become more or less a part of permanent investment in the business to earn current profits. The past trend of the company's earnings should also be kept in consideration while making the dividend decision.

xx. Desire and Type of Shareholders

Although, legally, the discretion as to whether to declare dividend or not has been left with the Board of Directors, the directors should give the importance to the desires of shareholders in the declaration of dividends as they are the representatives of shareholders. Desires of shareholders for dividends depend upon their economic status. Investors, such as retired persons, widows and other economically weaker persons view dividends as a source of funds to meet their day-to-day living expenses. To benefit such investors, the companies should pay regular dividends. On the other hand, a wealthy investor in a high income tax bracket may not benefit by high current dividend incomes.

Such an investor may be interested in lower current dividends and high capital gains. It is difficult to reconcile these conflicting interests of the different type of shareholders, but a company should adopt its dividend policy after taking into consideration the interests of its various groups of shareholders.

xxi. Nature of Industry

Nature of industry to which the company is engaged also considerably affects the dividend policy. Certain industries have a comparatively steady and stable demand irrespective of the prevailing economic conditions. For instance, people used to drink liquor both in boom as well as in recession. Such firms expect regular earnings and hence can follow a consistent dividend policy. On the other hand, if the earnings are uncertain, as in the case of luxury goods, conservative policy should be followed. Such firms should retain a substantial part of their current earnings during boom period in order to provide funds to pay adequate dividends in the recession periods. Thus, industries with steady demand of their products can follow a higher dividend payout ratio while cyclical industries should follow a lower payout ratio.

xxii. Government's Economic Policy

The dividend policy of a firm has also to be adjusted to the economic policy of the Government as was the case when the Temporary Restriction on Payment of Dividend Ordinance was in force. In 1974 and 1975, companies were allowed to pay dividends not more than 33 per cent of their profits or 12 per cent on the paid-up value of the shares, whichever was lower.

xxiii. Requirements of Institutional Investors

Dividend policy of a company can be affected by the requirements of institutional investors such as financial institutions, banks insurance corporations, etc. These investors usually favour a policy of regular payment of cash dividends and stipulate their own terms with regard to payment of dividend on equity shares.

xxiv. Stability of Dividends

Stability of dividends is another important guiding principle in the formulation of a dividend policy. Stability of dividend simply refers to the payment of dividend regularly and shareholders, generally, prefer payment of such regular dividends. Some companies follow a policy of constant dividend per share while others follow a policy of constant payout ratio and while there are some other who follows a policy of constant low dividend per share plus an extra dividend in the years of high profits.

A policy of constant dividend per share is most suitable to concerns whose earnings are expected to remain stable over a number of years or those who have built-up sufficient reserves to pay dividends in the years of low profits. The policy of constant payout ratio, i.e., paying a fixed percentage of net earnings every year may be supported by a firm because it is related to the firm's ability to pay dividends. The policy of constant low dividend per share plus some extra dividend in years of high profits is suitable to the firms having fluctuating earnings from year to year.

xxv. Liquid Resources

The dividend policy of a firm is also influenced by the availability of liquid resources. Although, a firm may have sufficient available profits to declare dividends, yet it may not be desirable to pay dividends if it does not have sufficient liquid resources. Hence the liquidity position of a company is an important consideration in paying dividends.

If a company does not have liquid resources, it is better to declare stock-dividend i.e. issue of bonus shares to the existing shareholders. The issue of bonus shares also amounts to distribution of firm's earnings among the existing shareholders without affecting its cash position.

10.5. SUMMARY

After studying this lesson you should be able to Know the Dividend decision and Understand the Dividend Determinants(factors) influencing on dividend decision. This lesson is divided and presented into seven components which are discussed as follows:

10.1. Introduction, 10.2. Internal & Market Determinants 10.3. Determinants of Dividend Policy 10.4.Summary 10.5. Technical Terms 10.6. Self Assessment Questions 10.7. Suggested Readings

10.6. TECHNICAL TERMS

Liquidity : Liquidity refers to the ease with which an asset, or security, can be converted into ready cash without affecting its market price. Cash is the most liquid of assets, while tangible items are less liquid. The two main types of liquidity include market liquidity and accounting liquidity.

Liquid Resource : Liquid Resource means cash or those assets that may readily be converted to cash, such as a life insurance policy that has a cash value, stock certificates, or a guaranteed line of credit from a financial institution.

Control objectives : Control objectives are statements that address how risk is going to be effectively managed by an organization, and your auditor will be validating whether or not your organization meets these control objectives during a SOC 1 or SOC 2 audit.

Inflation : In economics, inflation is a general increase in the prices of goods and services in an economy. When the general price level rises, each unit of currency buys fewer goods and services; consequently, inflation corresponds to a reduction in the purchasing power of money.

Magnitude : The magnitude of the force is defined as the sum of all the forces acting on an object. Calculating magnitudes for forces is a vital measurement of physics. The 'magnitude' of a force is its 'size' or 'strength', in spite of the path in which it acts.

Legal Rules: Rule of law, the mechanism, process, institution, practice, or norm that supports the equality of all citizens before the law, secures a non-arbitrary form of government, and more generally prevents the arbitrary use of power.

10.7. SELF ASSESSMENT QUESTIONS

1. What is stable dividend.? How is it impact on dividend policy?
2. What is the meaning of control objectives? Explain briefly about it.
3. Define Government Economic Policy? How is it impact on dividend policy?
4. What are internal and market determinants of dividend policy? Discuss .
5. What are the dividend factors? How is it impact on dividend policy?

10.8. SUGGESTED READINGS

I.M. Panday: "Financial Management " Vikas Publishing House (P) Ltd
2. Chandra, Prasanna "Financial Management " Tata Publishing House Ltd, New Delhi
3. S.N. Maheswari : "Principles of Financial Management " Sultan Chand, Delhi
4. Sheeba Kapil Financial Management " Pearson, 2011
5. P.V. Kulakarni: "Financial Management " Himalaya Publishing House Bombay
6. Khan & Jain : Cases in "Financial Management " Tata Publishing House Ltd, Delh
7. Van Horne, James C. : Financial Management
8. Bhalla V.K. : Finanacial Management

LESSON - 11
DIVIDEND THEORIES

Aims and Objectives

After studying this lesson you should be able to:

- Know the Dividend Theories
- Understand the case studies on dividend theories

Structure

11.1. INTRODUCTION

Dividends and share price growth are the two ways in which wealth can be provided to shareholders. There is an interaction between dividends and share price growth: if all earnings are paid out as dividends, none can be reinvested to create growth, so all profitable companies have to decide on what fraction of earnings they should pay out to investors as dividends and what fraction of earnings should be retained.

A dividend theory is a formulation of an apparent relationship which purports to explain a connection between dividend patterns and various causal factors impacting these patterns. Practiced dividend policies on the other hand are based upon observed corporate behavior describing its payout procedures.

This theory states that dividend patterns have no effect on share values. Broadly it suggests that if a dividend is cut now then the extra retained earnings reinvested will allow futures earnings and hence future dividends to grow. There are four types of dividend policy. First is regular dividend policy, second irregular dividend policy, third stable dividend policy and lastly no dividend policy. The stable dividend policy is further divided into per share constant dividend, pay-out ratio constant, stable dividend plus extra dividend. The tax preference theory of dividends: The tax preference theory states that some investors prefer long-term capital gains to current dividend yield and will pay more for the stock of a firm that plows back its earnings into capital-appreciating projects instead of paying these earnings out as dividends.

There are three theories: Dividends are irrelevant: Investors don't care about payout. Bird in the hand: Investors prefer a high payout. Tax preference: Investors prefer a low payout, hence growth. Some of the major different theories of dividend in financial management are as follows: 1. Walter's model 2. Gordon's model 3. Modigliani and Miller's hypothesis. Walter has developed a theoretical model which shows the relationship between dividend policies and common stocks prices. According to him the dividend policy of a firm is based on the relationship between the internal rate of return (r) earned by it and the cost of capital or required rate of return (Ke). Walter and Myron J. Gordon (see Gordon model), who believe that current cash dividends are less risky than future capital gains. Thus they say that investors prefer those firms which pay regular dividends and such dividends affect the market price of the share. Miller and Modigliani's dividend irrelevance theory is sometimes known as the homemade dividend theory. It suggests that a shareholder can earn as much money as in the case of dividend by selling the shares in the market. Hence, the investors are indifferent to the dividend distribution policy of a company.

Several authors, including M. Gorden, John Linter, James Walter, and Richardson, are associated with the **relevance theory of dividends**. According to these authors, a well-reasoned dividend policy can positively influences a firm's position in the **stock market**. Higher dividends will increase the value of **stock**, whereas low dividends will have the opposite effect. It is increasingly a reality today that dividends provide an indication of an organization's growing profitability over time.

11.2. DIVIDEND PAYMENT POLICIES

Constant dividends: in this approach dividends are predictable but shareholders might be dissatisfied if they see earnings rising but they are stuck will low dividends. If a larger and larger fraction of earnings is retained, shareholders might begin to question whether the company can find enough investment opportunities of the right quality.

Constant growth: again, predictable and very attractive to shareholders. However, the dividend growth rate might not match earnings growth rate.

Constant pay-out ratio: for example, (1 – b) = 25%. A clear and presumably logical link between dividends and earnings. However, in some circumstances this policy might produce signals that are mis-interpreted. Directors know that shareholders prefer predictable dividends and shareholders know that directors know their preference. Therefore, shareholders might interpret the cut as signalling that earnings are poor and will not improve any time soon. If, however, earnings fall yet the directors maintain the dividend, this is often interpreted as signalling that the fall in earnings is temporary and the directors feel sufficiently confident in the company's future to maintain the dividend in absolute terms.

Dividends as residuals: relating back to what was covered in the first section of the article, before paying dividends, directors should first spend earnings on investments in the company that yield: Investments that yield more than the cost of equity (this will increase shareholder value) Investments that yield the cost of equity. Only after these investment opportunities run out should the company pay dividends from the residual earnings, thus allowing shareholders to make the best use they can of their receipts.

No dividend: Microsoft and Apple both went many years without paying a dividend. It is difficult to use the dividend valuation model in these circumstance without making very

contentious assumptions about what future dividends might be. Nevertheless, share values rose dramatically as both companies were immensely successful and, on a P/E approach to valuation, they were plainly very valuable indeed.

11.3. TRADITIONAL THEORY

The traditional theory was expounded by B. Graham and D.L. Dodd. According to them," the stock market is overwhelmingly infamous of liberal dividends as against niggardly dividends."

As per this model the importance attached to liberal current dividends by the shareholders is more. Shareholders give less, importance-to capital gains that may arise in future. Therefore, companies which pay more current· dividends will have higher market value than companies which pay less dividends.

The model is expressed in the following way.

P=M fD+EJ L3 (1) Where
P = market price of share D = Di vidends per share
E = Earnings per share M = Multiplier
In the above model earnings per share (E) is equal to the sum of dividend per share (D) and retained earnings per share (R) .
:. E = D + R , (2)

Substitute this expression in equation. [D (D+R)l P=M + 3 J
On simplification,

i4D+ Rl P=ML3 J (3) ~4 1 1 = 1- D+- RJ L3 3 (4)

The weight attached to dividends is equal to four times the weight attached to retained earnings (R). These weights provided by Graham and Dodd are based on their subjective judgment and not derived from objective analysis. According to their model liberal payout policy has favorable impact on stock price.

11.4. RELEVANCE THEORY OF DIVIDENDS

Relevance theory of dividends states that a well-reasoned dividend policy can positively influences a firm's position in the stock market. Higher dividends will increase the value of stock, whereas low dividends will have the opposite effect. According to one school of thought the dividends are irrelevant and the amount of dividends paid does not affect the value of the firm while the other theory considers that the dividend decision is relevant to the value of the firm. If the company retains earnings and uses those to 'do more of the same' then the share price should not be affected.

If the company retains earnings and uses those to produce higher returns than demanded by investors (and that could be through expanding current operations to become more efficient and cost effective) then dividends should be cut as that will increase shareholder value. If the company retains earnings and uses those to produce lower returns than demanded by investors (and that could be through keeping excess cash in the bank, earning very little) then dividends should be increased to avoid the share price falling. If the company can think of no

good use for its earnings, it should distribute them to shareholders who can then decide for themselves what to do with them.

Some of the major different theories of dividend in financial management are as follows: 1. Walter's model 2.Gordon's model 3.Modigliani and Miller's hypothesis. On the relationship between dividend and the value of the firm different theories have been advanced.

11.5. WALTER'S MODEL

Professor James E. Walter argues that the choice of dividend policies almost always affects the value of the enterprise. His model shows clearly the importance of the relationship between the firm's internal rate of return (r) and its cost of capital (k) in determining the dividend policy that will maximize the wealth of shareholders.

11.5.1. Walter's model is based on the following assumptions:

i. The firm finances all investment through retained earnings; that is debt or new equity is not issued;
ii. The firm's internal rate of return (r), and its cost of capital (k) are constant;
iii. All earnings are either distributed as dividend or reinvested internally immediately.
iv. Beginning earnings and dividends never change. The values of the earnings per share (E), and the divided per share (D) may be changed in the model to determine results, but any given values of E and D are assumed to remain constant forever in determining a given value.
v. The firm has a very long or infinite life.

11.5.2. Walter's formula to determine the market price per share (P) is as follows:

$P = D/K + r(E-D)/K/K$

The above equation clearly reveals that the market price per share is the sum of the present value of two sources of income:
i) The present value of an infinite stream of constant dividends, (D/K) and
ii) The present value of the infinite stream of stream gains. [r (E-D)/K/K]

11.5.3. Walter's Approach

According to James Walter, dividend policy always affects the goodwill of a company. Walter argued that dividend policy reflects the relationship between the firm's return on investment or internal rate of return and the cost of capital or required rate of return.
Suppose that r is the internal rate of return and K is the cost of equity capital. Then, for any given company, we have the following cases:

Case 1: When r > k

Firms with r > k are named **growth firms**. Their optimal dividend policy involves ploughing back the company's entire earnings. Thus, the dividend payment ratio would be zero. This would also maximize the market value of the company's shares.

Case 2: When r < k

Firms with r < k do not offer profitable investment opportunities. For these firms, the optimal dividend policy involves distributing the entire earnings in the form of dividends. Shareholders can use dividends to receive in other channels when they can get a higher rate of dividends. Thus, 100% dividend payout ratio in their case would result in maximizing the value of the equity shares.

Case 3: When r = k

For firms with r = k, it does matter whether the firm retains or distributes its earnings. In their case, the share price would not fluctuate with a change in dividend rates. Thus, no optimal dividend policy exists for such firms.

Formula for Walter's Approach

The market value of a share (P) can be expressed as follows:

$P = (D + r) (E - D) / KE$ or $P = (D + (r / KE) E-D) / KE$

Where

P = Market price of an equity share D = Dividend per share
r = Internal rate of return E = Earnings per share
KE = Cost of equity capital or capitalization rate

11.5.4. Criticisms:

1. Walter's model of share valuation mixes dividend policy with investment policy of the firm. The model assumes that the investment opportunities of the firm are financed by retained earnings only and no external financing debt or equity is used for the purpose when such a situation exists either the firm's investment or its dividend policy or both will be sub-optimum. The wealth of the owners will maximise only when this optimum investment in made.

2. Walter's model is based on the assumption that r is constant. In fact decreases as more investment occurs. This reflects the assumption that the most profitable investments are made first and then the poorer investments are made. The firm should step at a point where r = k. This is clearly an erroneous policy and fall to optimise the wealth of the owners.

3. A firm's cost of capital or discount rate, K, does not remain constant; it changes directly with the firm's risk. Thus, the present value of the firm's income moves inversely with the cost of capital. By assuming that the discount rate, K is constant, Walter's model abstracts from the effect of risk on the value of the firm.

11.5.5. Example:

Required: Based on the table shown below concerning companies A, B, and C, calculate the value of each share using Walter's approach when the dividend payment ratio is 50%, 75%, and 25%.

In addition, D = (50 x 8) / 100 = 4 D = (75 x 8) / 100 = 6 D = (25 x 8) / 100 = 2

	A Ltd.	B Ltd	C Ltd
r	15%	5%	10%
k_e	10%	10%	10%
e	Rs.8	Rs.8	Rs.8

Solution

	A Ltd.	B Ltd	C Ltd
i) When D/P Ratio is 50% P = (D + (r / K_e) E-D) / K_e	(4+(.15/.10) (8-4)/.10 = Rs. 100	(4+(.5/.10) (8-4)/.10 = Rs. 60	(4+(.10/.10) (8-4)/.10 = Rs. 80
ii) When D/P Ratio is 75% P = (D + (r / K_e) E-D) / K_e	(6+(.15/.10) (8-6)/.10 = Rs. 90	(6+(.5/.10) (8-6)/.10 = Rs. 70	(6+(.10/.10) (8-6)/.10 = Rs. 80
iii) When D/P Ratio is 25% P = (D + (r / K_e) E-D) / K_e	(2+(.15/.10) (8-2)/.10 = Rs. 110	(2+(.5/.10) (8-2)/.10 = Rs. 50	(2+(.10/.10) (8-2)/.10 = Rs. 80

Comment: A Ltd. is a growth firm because its internal rate of return exceeds the **cost** of capital. Here, it is better to retain the earnings rather than to distribute them as dividends. As is shown, when the D.P. Ratio is 25%, the share price is $110.

11.5.6. Example:

The following information is obtainable in respect of a firm:
Capitalisation Rate (Ke) = 10% Earning Per Share (E) = Rs. 8
Compute the market price of share under Walter's Model by assuming Rate of Return
(i) 15% (ii) 10% (iii) 5% and
Dividend Payout Ratio
(i) 0% (ii) 25% (iii) 50% (iv) 75% (v) 100%

Solution:-

Dividend Policy and the Value of Share (Walter's Model)

Sr.No	r > k	r=k	r < k
	r= 0.15 k = 0.10 E =Rs. 8	r = 0.10 k =0.10 E =Rs. 8	r = 0.05 k = 0.10 E =Rs. 8
(i)	D/P Ratio = 0% DPS = Rs. 0 (0+(.15/.10) (8-0)/.10 P= Rs. 120	D/P Ratio = 0% DPS = Rs. 0 (0+(.10/.10) (8-0)/.10 P= Rs. 80	D/P Ratio = 0% DPS = Rs. 0 (0+(.05/.10) (8-0)/.10 P= Rs. 40
(ii)	D/P Ratio = 25% DPS = Rs. 2 (2+(.15/.10) (8-2)/.10 P= Rs. 110	D/P Ratio = 25% DPS = Rs. 2 (2+(.10/.10) (8-2)/.10 P= Rs. 80	D/P Ratio = 25% DPS = Rs. 2 (2+(.05/.10) (8-2)/.10 P= Rs. 50

(iii)	D/P Ratio = 50% DPS = Rs. 4 (4+(.15/.10) (8-4)/.10 P= Rs. 100	D/P Ratio =50% DPS = Rs. 4 (4+(.10/.10) (8-4)/.10 P= Rs. 80	D/P Ratio = 50% DPS = Rs. 4 (4+(.05/.10) (8-4)/.10 P= Rs. 60
(iv)	D/P Ratio = 75% DPS = Rs. 6 (6+(.15/.10) (8-6)/.10 P= Rs. 90	D/P Ratio = 75% DPS = Rs. 6 (6+(.10/.10) (8-06)/.10 P= Rs. 80	D/P Ratio =750% DPS = Rs. 6 (6+(.05/.10) (8-6)/.10 P= Rs. 70
(v)	D/P Ratio = 100% DPS = Rs. 8 (8+(.15/.10) (8-8)/.10 P= Rs. 80	D/P Ratio = 100% DPS = Rs. 8 (8+(.10/.10) (8-8)/.10 P= Rs. 80	D/P Ratio = 100% DPS = Rs. 8 (8+(.05/.10) (8-8)/.10 P= Rs. 80

11.6. GORDON'S MODEL (GORDON'S APPROACH)

Gordon proposed a model along the lines of Walter, suggesting that dividends are relevant and that the dividends of a firm influence its value.

The defining feature of Gorden's model is that the value of a dollar in dividend income is greater than the value of a dollar in capital gain. This is due to the uncertainty of the future and the shareholder's discount future dividends at a higher rate. One very popular model explicitly relating the market value of the firm to dividend policy is developed by Myron Gordon.

11.6.1. Assumptions:

Gordon's model is based on the following assumptions.

1. The firm is an all Equity firm
2. No external financing is available
3. The internal rate of return (r) of the firm is constant.
4. The appropriate discount rate (K) of the firm remains constant.
5. The firm and its stream of earnings are perpetual
6. The corporate taxes do not exist.
7. The retention ratio (b), once decided upon, is constant. Thus, the growth rate (g) = br is constant forever.
8. K > br = g if this condition is not fulfilled, we cannot get a meaningful value for the share.

Ac According to Gorden, the market value of a share is equal to the **present value** of the future stream of dividends.

11.6.2. Formula for Gorden's Approach

The formula is given as follows:

$P = E(1 - b) / (K_e - b_r)$ or

$P = D / (K_e - g)$

where

- P = Share price E = Earnings per share b = Retention ratio
- K_e = Cost of equity capital $b_r = g$
- r = Rate of return on investment D = Dividend per share

According to Gordon's dividend capitalisation model, the market value of a share (Pq) is equal to the present value of an infinite stream of dividends to be received by the share. Thus:

$$P_0 = \frac{E_1(1-b)}{K-br}$$

The above equation explicitly shows the relationship of current earnings (E_1), dividend policy, (b), internal profitability (r) and the all-equity firm's cost of capital (k), in the determination of the value of the share (P_0).

11.6.3. Dividend Discount Model

Dividend discount model (DDM) is a stock valuation model in which the intrinsic value of a stock equals the present value of expected cash dividends per share.

Discount model is based on two basic principles of finance: first, the intrinsic value of an investment depends on the future net cash flows it generates and second, a dollar received today is better than a dollar received after one year (i.e. the concept of [time value of money](/325604/tvm">time value of money).

People invest in a stock in expectation of a return, which comes in the form of capital gains and/or dividends. The dividend discount model theorizes that the intrinsic value of a stock should equal the present value of all the future cash dividends the stock is expected to pay (till eternity). Since even the capital gains reflect an expectation of increased dividend due to increased profitability and growth of the company, estimating intrinsic value based on dividend expectations is relevant in many scenarios.

There are different forms of dividend growth model: single-stage model and multi-stage model. The most basic model assumes that the dividend per share grows at a constant rate. Other versions project dividend per share more precisely for near future (say 4 periods) and applies the basic version to estimate the terminal value of the stock (say at the end of 4th year) which is discounted back again to time zero.

11.6.4. Formula

The stable growth dividend discount model assumes that the dividend grows at a constant rate forever. Though this assumption is not very sound for all companies, it simplifies the process of discounting future dividend cash flows. The formula for present value of perpetuity can be used to find intrinsic value:

$$\text{Intrinsic value} = \frac{D1}{r-g}$$

Where

D1 is dividend per share expected to be received at the end of first year. It may be estimated based on current dividend per share projected for 1 year at the prevailing dividend growth rate (i.e. $D1 = D * (1 + g)$).

r is the required return on the stock (i.e. cost of equity)

g is the expected dividend growth rate

Example

11.6.5. Gordon growth model (i.e. stable growth model): Estimate the intrinsic value of a stock which is currently trading at $35 based on the following data:

- Required rate of return (i.e. cost of equity) is 10%.
- Current dividend per share is $2.
- Dividend growth rate forever is 5%.

Is the stock a good investment or not?

Solution:
Dividend per share at the end of Year 1 = Current dividend per share * (1 + growth rate) = $2 * (1+5%) = $2.1
Intrinsic value = $2.1/(10% - 5%) = $2.1/5% = $42
Since the intrinsic value ($42) of the stock is higher than its current price ($35), it is expected to generate positive return and hence it is a good investment.
Gordon growth model should be used to value stocks of companies in mature industries, which have stable capital structure (i.e. proportion of debt and equity), stable earnings and dividend payout ratios. It is not very useful for high-growth companies in fast-paced industries because its assumption of constant moderate growth does not apply there.

11.6.6. What is the Gordon Growth Model?

The Gordon Growth Model – otherwise described as the dividend discount model – is a stock valuation method that calculates a stock's intrinsic value. Therefore, this method disregards current market conditions. Investors can then compare companies against other industries using this simplified model.
Myron J. Gordon (Source: Globe and Mail)

11.6.7. What are the assumptions of the Gordon Growth Model?

The Gordon Growth Model assumes the following conditions:

1. The company's business model is stable; i.e. there are no significant changes in its operations
2. The company grows at a constant, unchanging rate
3. The company has stable financial leverage
4. The company's free cash flow is paid as dividends

11.6.8. What is the Gordon Growth Model formula?

Three variables are included in the Gordon Growth Model formula: (1) D1 or the expected annual dividend per share for the following year, (2) k or the required rate of return, and (3) g or the expected dividend growth rate. With these variables, the value of the stock can be computed as:
Intrinsic Value = D1 / (k – g)

To illustrate, take a look at the following example: Company A's is listed at $40 per share. Furthermore, Company A requires a rate of return of 10%. Currently, Company A pays dividends of $2 per share for the following year which investors expect to grow 4% annually. Thus, the stock value can be computed:
Intrinsic Value = 2 / (0.1 – 0.04)
Intrinsic Value = $33.33
This result indicates that Company A's stock is overvalued since the model suggests that the stock is only worth $33.33 per share.

11.7. MODIGLIANI AND MILLER'S HYPOTHESIS

According to Modigliani and Miller (M-M), dividend policy of a firm is irrelevant as it does not affect the wealth of the shareholders. They argue that the value of the firm depends on the firm's earnings which result from its investment policy.

Thus, when investment decision of the firm is given, dividend decision the split of earnings between dividends and retained earnings is of no significance in determining the value of the firm. M – M's hypothesis of irrelevance is based on the following assumptions.

1. The firm operates in perfect capital market
2. Taxes do not exist
3. The firm has a fixed investment policy
4. Risk of uncertainty does not exist. That is, investors are able to forecast future prices and dividends with certainty and one discount rate is appropriate for all securities and all time periods. Thus, $r = K = K_t$ for all t.

Under M – M assumptions, r will be equal to the discount rate and identical for all shares. As a result, the price of each share must adjust so that the rate of return, which is composed of the rate of dividends and capital gains, on every share will be equal to the discount rate and be identical for all shares.

11.7.1. Thus, the rate of return for a share held for one year may be calculated as follows:

$$r = \frac{D + (P_1 + P_0)}{P_0} = \frac{\text{Dividends + Capital gains (on loss)}}{\text{Purchase price}}$$

Where P^ is the market or purchase price per share at time 0, P, is the market price per share at time 1 and D is dividend per share at time 1. As hypothesised by M – M, r should be equal for all shares. If it is not so, the low-return yielding shares will be sold by investors who will purchase the high-return yielding shares.

This process will tend to reduce the price of the low-return shares and to increase the prices of the high-return shares. This switching will continue until the differentials in rates of return are eliminated. This discount rate will also be equal for all firms under the M-M assumption since there are no risk differences.

From the above M-M fundamental principle we can derive their valuation model as follows:

$$P_0 = \frac{D_1 + P_1}{(1+r)} \qquad P_0 = \frac{D_1 + P_1}{(1+k)} \qquad r = k$$

Multiplying both sides of equation by the number of shares outstanding (n), we obtain the value of the firm if no new financing exists.

$$V = nP_0 = \frac{N(D_1 + P_1)}{(1+k)}$$

If the firm sells m number of new shares at time 1 at a price of P^, the value of the firm at time 0 will be

$$nP_0 = \frac{ND_1 + (n+m)p_1 - mp_1}{(1+k)}$$

The above equation of M – M valuation allows for the issuance of new shares, unlike Walter's and Gordon's models. Consequently, a firm can pay dividends and raise funds to undertake the optimum investment policy. Thus, dividend and investment policies are not confounded in M – M model, like waiter's and Gordon's models.

11.7.2. Criticism:

Because of the unrealistic nature of the assumption, M-M's hypothesis lacks practical relevance in the real world situation. Thus, it is being criticised on the following grounds.

1. The assumption that taxes do not exist is far from reality.
2. M-M argue that the internal and external financing are equivalent. This cannot be true if the costs of floating new issues exist.
3. According to M-M's hypothesis the wealth of a shareholder will be same whether the firm pays dividends or not. But, because of the transactions costs and inconvenience associated with the sale of shares to realise capital gains, shareholders prefer dividends to capital gains.
4. Even under the condition of certainty it is not correct to assume that the discount rate (k) should be same whether firm uses the external or internal financing.

If investors have desire to diversify their port folios, the discount rate for external and internal financing will be different.

5. M-M argues that, even if the assumption of perfect certainty is dropped and uncertainty is considered, dividend policy continues to be irrelevant. But according to number of writers, dividends are relevant under conditions of uncertainty.

11.8. PRACTICAL CONSIDERATIONS

As so often occurs, theoretical outcomes do not always match practical considerations. So too with dividend irrelevancy. Perhaps this is because investors do not understand or believe the theory or perhaps it is because, to derive the theory, simplifying assumptions have to be made, such as the existence of perfect markets with no transaction costs and perfect information. The practical matters are:

i. Signaling : The announcement of a dividend is the release of a piece of publically available information. The semi-strong form of the efficient market hypothesis says that the share price will react to this information. The problem is: what signal does a change in dividend give out and therefore how should share prices move? For example, does a cut in dividend mean that the company is conserving cash because it expects hard times or does it mean that the company sees a great investment opportunity? There is inevitably information asymmetry as the directors will almost certainly be in possession of information that is not in the public domain. Almost always shareholders will be unsettled by abrupt changes in dividend policy.

ii. Lack of trust in directors' forecasts: Lack of trust in directors' forecasts or justifications for dividend cuts. Really, this point follows on from above. Directors might have been very open about a dividend policy but if investors do not share directors' optimism about the future success of the company, the share price will be affected.

iii. Preference for current consumption: Investors' preference for current consumption rather than future promises (the 'bird in the hand' argument). Here, it is argued that a current dividend means that investors have safely received cash. Whereas, if the dividend were deferred they are at the mercy of future events and risks. This argument is very persuasive, but it is incorrect. Market forces should mean that a share price has been correctly set for the level of risk and returns made. If more cash is paid out as dividend the investor has to decide how to invest that cash. It could be spent on another investment which has higher returns and higher risk or on one where both returns and risks are lower. In either case, diversified investors should be happy with the deal because the capital asset pricing model states that extra risk is correctly compensated for by extra returns.

iv. The clientele effect: This idea suggests that investors buy shares that 'suit' their needs. So, a pension fund will base much of its investment portfolio on its need to produce income to pay to pensioners. It will therefore invest heavily in shares that pay regular, relatively predictable dividends. Similarly, tax can affect investment decisions if gains are taxed less severely than income. If a company abruptly changes its dividend policy it will disturb investors' carefully constructed portfolios and investors will have to adjust their mix of shares incurring transaction costs. It is sometimes argued that if a cut in dividend reduces an investor's income, the investor can sell some shares to manufacture 'income'. Of course, this will again incur transaction costs and different tax treatment.

v. Company liquidity: Irrespective of all the potential share price movements that a change in dividend policy might cause, companies have to ensure that their liquidity is sound and might have dividend reductions forced on them if they are to stay solvent.

vi. Borrowing covenants: Sometimes lenders put clauses in loan agreements which limit dividend payments, for example to a certain fraction of earnings. This is the lender trying to ensure that the loan is more secure. If less cash is paid as dividends, liquidity might be better (though, of course, cash can still be consumed on the purchase of non-current assets).

vii. Legal constraints: No distributable reserves means no dividends. Here is perhaps a good place to mention scrip dividends. These allow shareholders to choose to receive shares as full or partial replacement of a cash dividend. The number of shares received is linked to the dividend and the market price of the shares so that roughly equivalent value is received. This choice allows investors to acquire new shares (if they don't need the cash dividend) without transactions costs and the company can conserve its cash and liquidity. There can also be beneficial tax effects in some countries.

Conclusion

Dividends and dividend policy will be a continuing cause of debate and comment. The theoretical position is clear: provided retained earnings are reinvested at the cost of equity, or higher, shareholder wealth is increased by cutting dividends. However, in the real world, where not necessarily all investors are logical and where transaction costs and other market imperfections intervene, determining a successful and popular dividend policy is rather more difficult.

11.9. SUMMARY:

After studying this lesson you should be able to: Know the Dividend Theories and understand the case studies on dividend theories. It is consisting of eleven aspects such as: 11.1.Introduction 11.2.Dividend Payment Models, 11.3.Traditional Theory, 11.4. Relevance Theory of Dividend, 11.5. Walter's Model, 11.6. Garden's Model, 11.7. M.M. Hypotheses, 11.8. Summary, 11.9.Technical terms 11.10.Self Assessment Questions 11.11. Suggested Readings

11.10. TECHNICAL TERMS:

Rinvestment : Reinvestment is when income distributions received from an investment are plowed back into that investment instead of receiving cash. Reinvestment works by using

dividends received to purchase more of that stock, or interest payments received to buy more of that bond.

Cost of equity : Cost of equity is the return that a company requires for an investment or project, or the return that an individual requires for an equity investment. The formula used to calculate the cost of equity is either the dividend capitalization model or the CAPM.

Theory : A theory is a carefully thought-out explanation for observations of the natural world that has been constructed using the scientific method, and which brings together many facts and hypotheses.

Trust : The main purpose of a trust is to transfer assets from one person to another. Trusts can hold different kinds of assets. Investment accounts, houses and cars are examples. One advantage of a trust is that it usually avoids having your assets (and your heirs) go through probate when you die.

Hypotheses : A hypothesis is an assumption, an idea that is proposed for the sake of argument so that it can be tested to see if it might be true. In the scientific method, the hypothesis is constructed before any applicable research has been done, apart from a basic background review.

Model : A model is a person with a role either to promote, display or advertise commercial products (notably fashion clothing in fashion shows) or to serve as a visual aid for people who are creating works of art or to pose for photography.

Conclusion : The conclusion basically asks us to do a few things: Restate the main idea of the paper (why you wrote this entire long piece to begin with). Summarize all the key points you made throughout the body of the paper (things that proved your thesis statement).

Summarize : To summarize, you must read a passage closely, finding the main ideas and supporting ideas. Then you must briefly write down those ideas in a few sentences or a paragraph. It is important to understand the difference between a summary and a paraphrase. A paraphrase is simply a rewriting of a passage in your own words.

11.11. SELF ASSESSMENT QUESTIONS:

1. How much dividend should a company distribute to its shareholders?
2. What will be the impact of dividend decision on the share prices of the company?
3. What is the consequential impact of inability to maintain dividend year after year?
4. Discuss various types of dividend theories.
5. Explain Walter's model dividend theory.
6. Explain Gordon's model dividend theory.
7. Explain M.M.Hypothesis dividend theory.

11.12. SUGGESTED READINGS:

1. I.M. Panday: "Financial Management " Vikas Publishing House (P) Ltd

2. Chandra, Prasanna "Financial Management " Tata Publishing House Ltd, New Delhi

3. S.N. Maheswari : "Principles of Financial Management " Sultan Chand, Delhi

4. Sheeba Kapil : "Financial Management " Pearson, 2011

5. P.V. Kulakarni: "Financial Management " Himalaya Publishing House Bombay

6. Khan & Jain : Cases in "Financial Management " Tata Publishing House Ltd, Delh

7. Van Horne, James C. : Financial Management

8. Bhalla V.K. : Finanacial Management, S. Chand & Company Pvt. Ltd. New Delhi.

LESSON-12
TYPES, FACTORS & POLICIES OF WORKING CAPITAL MANAGEMENT

Aims and Objectives

After studying this lesson you should be able to:

- Understand the Types of Working Capital
- Analyze the Factors Determining Working Capital
- Know the concept of Working Capital Financing Policies

Structure

12.1. INTRODUCTION

Working capital:, Working capital is needed to pay for planned and unexpected expenses, meet the short-term obligations of the business, and to build the business. It is also a good measure of the short and medium-term financial health of a company.

i. Working capital indicates the liquidity levels of businesses for managing day-to-day expenses and covers inventory, cash, accounts payable, accounts receivable and short-term debt. It is an indicator of the short-term financial position of an organisation and is also a measure of its overall efficiency.

ii. Working capital affects many aspects of your business, from paying your employees and vendors to keeping the lights on and planning for sustainable long-term growth. In short, working capital is the money available to meet your current, short-term obligations.

iii. Working capital is the money used to cover all of a company's short-term expenses, which are due within one year. Working capital is the difference between a company's current assets and current liabilities. Working capital is used to purchase inventory, pay short-term debt, and day-to-day operating expenses. Working capital is the cash a business needs to run its operations successfully, including paying salaries, suppliers, rent and other overheads.

iv. Working capital, also known as net working capital (NWC), is the difference between a company's current assets—such as cash, accounts receivable/customers' unpaid bills, and

inventories of raw materials and finished goods—and its current liabilities, such as accounts payable and debts. A business uses working capital in its daily operations; working capital is the difference between a business's current assets and current liabilities or debts. Working capital serves as a metric for how efficiently a company is operating and how financially stable it is in the short-term.

12.1.1. Working capital management:

i. Working capital management is essentially the efforts and strategies that ensure that companies are leveraging both their assets and liabilities in order to keep things running smoothly. This often involves careful management across multiple departments within a company, and may include revenue collection, inventory management, debt management, and accounts payable. It is, simply put, the difference between a business's current assets and its current debt and financial liabilities. In this case, your assets are anything that can readily be converted into liquid cash within a 12-month period, which often includes accounts receivable, cash, and inventory.

ii. Efficient working capital management focuses heavily on ensuring that the business is able to maintain the liquidity needed to keep business running while hopefully leveraging assets as investments. This means having enough cash flow to be able to pay all short-term expenses and debts that could otherwise jeopardize the business or its operational status, while trying to have funds set aside to potentially invest in the advancement of the business itself.

iii. Working Capital Management: Why Does Working Capital Management Matter?
Cash flow issues are a major concern for businesses of all sizes, and can be a particularly detrimental problem to run into. One study even found that 82% of small businesses who had to close up shop had failed because of cash flow problems. No one wants to run out of money, even if that just means that your funds are tied up in other assets. A mechanic who uses up all of their funds getting a new car lift, for example, will suddenly have no funds left over to order in new parts, pay for marketing campaigns, maintain yearly licensing fees, or even pay their employees. They haven't lost the money they put into the car lift, but it's tied up, they can't use it, and now they have nowhere to go. This is an overly simplified example, but it's a common problem for businesses of all sizes to run into. Working capital management can help you avoid cash flow problems that could pose a major financial risk to your business, but it's also crucial to help you grow. When executed well, it can help you achieve a higher rate of return on your capital, increasing profitability, value appreciation, and liquidity all at once.

iv. It has been often observed that the shortage of working capital leads to the failure of a business. The proper management of working capital may bring about the success of a business firm. The management of working capital includes the management of current assets and current liabilities. A number of companies for the past few years have been finding it difficult to solve the increasing problems of adopting seriously the management of working capital. A firm may exist without making profits but cannot survive without liquidity. The function of working capital management in an organization is similar that of the heart in a human body. Also it is an important function of financial management. The financial manager must determine the satisfactory level of working capital funds and also the optimum mix of current assets and current liabilities. He must ensure that the appropriate sources of funds are used to finance working capital and should also see that short term obligation of the

business are met well in time. Working capital management is a business strategy designed to ensure that a company operates efficiently by monitoring and using its current assets and liabilities to their most effective use. The efficiency of working capital management can be quantified using ratio analysis.

v. What is the importance of working capital management?

Working capital management can help you avoid cash flow problems that could pose a major financial risk to your business, but it's also crucial to help you grow. When executed well, it can help you achieve a higher rate of return on your capital, increasing profitability, value appreciation, and liquidity all at once. Working Capital Management is Essential to a Healthy Business. There's no denying that running a business is an exhausting and complex task. There's so much to keep up with, including peaks and falls in the market, shifting consumer behaviors, and new developments in the industry. At any one point there's so much to keep up with that it's not uncommon for things to start to slip.

One thing that you never, ever want to slip, however, is your cash flow and your capital management. It is even more important to manage your cash flow and your capital management now as more companies are extending their Days Payable Outstanding. Both can do serious (and potentially irreparable) harm to your business that can be difficult to recover from, so let's take a look at how working capital management can protect your business and help you thrive all at once.

12.2. CONCEPT OF WORKING CAPITAL MANAGEMENT

There are two concepts of working capital viz .quantitative and qualitative. Some people also define the two concepts as gross concept and net concept. According to quantitative concept, the amount of working capital refers to 'total of current assets'. Current assets are considered to be gross working capital in this concept. The qualitative concept gives an idea regarding source of financing capital. According to qualitative concept, the amount of working capital refers to "excess of current assets over current liabilities." The concept of working capital, also known as net working capital (NWC), does not apply to banks since financial institutions do not have typical current assets and liabilities, such as inventories and accounts payable (AP).

L.J. Guthmann defined working capital as "the portion of a firm's current assets which are financed from long–term funds." The excess of current assets over current liabilities is termed as 'Net working capital'. In this concept "Net working capital" represents the amount of current assets which would remain if all current liabilities were paid. Both the concepts of working capital have their own points of importance. "If the objectives is to measure the size and extent to which current assets are being used, 'Gross concept' is useful; whereas in evaluating the liquidity position of an undertaking 'Net concept' becomes pertinent and preferable. It is necessary to understand the meaning of current assets and current liabilities for learning the meaning of working capital, which is explained below.

i. Current assets – It is rightly observed that "Current assets have a short life span. These type of assets are engaged in current operation of a business and normally used for short–term operations of the firm during an accounting period i.e. within twelve months. The two important characteristics of such assets are, (i) short life span, and (ii) swift transformation into other form of assets. Cash balance may be held idle for a week or two; account

receivable may have a life span of 30 to 60 days, and inventories may be held for 30 to 100 days.

ii. Current liabilities – The firm creates a Current Liability towards creditors (sellers) from whom it has purchased raw materials on credit. This liability is also known as accounts payable and shown in the balance sheet till the payment has been made to the creditors. The claims or obligations which are normally expected to mature for payment within an accounting cycle (1 year) are known as current liabilities. These can be defined as "those liabilities where liquidation is reasonably expected to require the use of existing resources properly classifiable as current assets, or the creation of other current assets, or the creation of other current liabilities."

12.2.1.Three Ratios for Working Capital Management: When it comes to working capital management, there are three ratios you need to stay on top of things. Cash flow management can be challenging, but Raistone Capital is here to help.

i. Working capital ratio, which is calculated by your current assets divided by your current liabilities. This can be an indicator of financial health and liquidity, particularly in terms of whether or not you can meet all your short-term debt and financial obligations. While the ideal working capital ratio varies heavily by industry, keeping your ratio above 1.0 is a good sign, and ratios of up to 2.0 are considered ideal.

ii. Inventory turnover ratio. This is calculated by dividing the cost of goods sold in a set period of time by the average inventory cost of that period. Average inventory is typically used because most companies' inventory fluctuates wildly throughout the year, so this will give you a better big-picture view.

Your inventory turnover ratio can help you ensure that you're not having too much of your capital stuck in inventory that isn't moving, which could potentially cause cash flow issues. For this, you want your ratio to be pretty middle of the ground; low ratios may indicate that you're inventory is using too much capital, while higher ratios may mean that you don't have enough inventory to keep your customers happy.

iii. Collection ratio, which is calculated as "the product of the number of days in an accounting period" multiplied by "the average amount of outstanding accounts receivables" which is then divided by "the total amount of net credit sales during the accounting period."

This ratio measures how efficiently your business is measuring your accounts receivables, and it looks at how many days it takes on average to receive payment after invoicing or transactions. You want this ratio to be as low as possible because a low collection ratio means much better cash flow for your business. Companies whose customers typically pay promptly and on time will do well here.

12.2.2. Leveraging Your Working Capital Correctly: Striking the Balance

There's a lot to consider when you're looking at working capital management, and the right balance will be different for every business. It's not uncommon for newer businesses to need to invest more, for example, and to have lower assets overall while they get started. Look at your industry, your direct competition, and consider what you feel comfortable with. When it comes down to it, you'll find that there are three commonly-used policies of working capital management approaches. These are:

Working Capital Management Approaches

i. A relaxed, conservative approach, where a high level of assets are maintained in order to balance out the existing liabilities. Liquidity is high, but unfortunately, this can impact your profitability negatively. It's safe but may not yield as a big of a payoff.

ii. A restricted, aggressive approach, which maintains a lower level of current assets than the conservative approach. Liquidity is typically very low here, which is risky, but profitability can also be higher.

iii.A right-down-the-middle, moderate approach, which seeks to find a balance right between the two. This is sometimes easier to do once your business is up and running for at least a short period of time so you have more flexibility. Need assistance managing your cash flow thanks to extended days payable? Contact us here to learn more about how we can help you address these problems.

12.3. TYPES OF WORKING CAPITAL

Different Types of Working Capital: Temporary Working Capital. Permanent Working Capital. Gross & Net Working Capital. Negative Working Capital. Reserve Working Capital. Regular Working Capital. Seasonal Working Capital. Special Working Capital.

According to the needs of business, the working capital may be classified into following two basis:1) On the basis of periodicity, 2) On the basis of concept

1. On the basis of periodicity: The requirements of working capital are continuous. More working capital is required in a particular season or the peck period of business activity. On the basis of periodicity working capital can be divided under two categories as under: A. Permanent working capital, B. Variable working capital

(A) Permanent working capital: This type of working capital is known as Fixed Working Capital. Permanent working capital means the part of working capital which is permanently locked up in the current assets to carry out the business smoothly. The minimum amount of current assets which is required to conduct the business smoothly during the year is called permanent working capital. For example, investments required to maintain the minimum stock of raw materials or to cash balance. The amount of permanent working capital depends upon the size and growth of company. Fixed working capital can further be divided into two categories as under:

i. Regular Working capital: Minimum amount of working capital required to keep the primary circulation. Some amount of cash is necessary for the payment of wages, salaries etc.

ii. Reserve Margin Working capital: Additional working capital may also be required for contingencies that may arise any time. The reserve working capital is the excess of capital over the needs of the regular working capital is kept aside as reserve for contingencies, such as strike, business depression etc.

(B) Variable or Temporary Working Capital: The term variable working capital refers that the level of working capital is temporary and fluctuating. Variable working capital may change from one assets to another and changes with the increase or decrease in the volume of

business. The variable working capital may also be subdivided into following two sub-groups.

i. Seasonal Variable Working capital: Seasonal working capital is the additional amount which is required during the active business seasons of the year. Raw materials like raw-cotton or jute or sugarcane are purchased in particular season. The industry has to borrow funds for short period. It is particularly suited to a business of a seasonal nature. In short, seasonal working capital is required to meet the seasonal liquidity of the business.

ii. Special variable working capital: Additional working capital may also be needed to provide additional current assets to meet the unexpected events or special operations such as extensive marketing campaigns or carrying of special job etc.

Difference Between Permanent and Variable Working Capital: The distinction between permanent or fixed working capital and variable working capital or temporary working capital is of great importance in operating cycle and raising the funds. However, there is always a minimum level of current assets which is continuously required by the firm to carry on its business operations. This minimum level of current assets is referred to as permanent or fixed working capital and is permanent in the same way as the firm's fixed asset. Depending on the change in production and sales, the need of working capital, over and above the permanent working capital, will fluctuate. It is shown in below figure that permanent working capital is stable over time, while temporary working capital is fluctuating-sometimes increasing and sometimes decreasing. However, the permanent working capital line need not be horizontal if the firm's requirement for permanent capital is increasing or decreasing over period. For a growing firm, the difference between permanent and temporary working capital can be depicted the figure as under.

2) On the basis of concept:
on the basis of concept working capital is divided into two categories as under:

(A) Gross Working Capital: Gross working capital refers to total investment in current assets. The current assets employed in business give the idea about the utilization of working capital and idea about the economic position of the company. Gross working capital concepts is popular and acceptable concept in the field of finance.

(B) Net Working Capital: Net working capital means current assets minus current liabilities. The difference between current assets and current liabilities is called the net working capital. If the net working capital is positive, business is able to meet its current liabilities. Net working capital concept provides the measurement for determining the creditworthiness of company.

12.4. FACTORS DETERMINING WORKING CAPITAL

The working capital need of a business depends a great deal on its nature and size & Business Cycle. Business cycle too has a significant impact on the working capital needs of a business. ...Production Cycle. ...Seasonal Fluctuations. ...Operational Efficiency. The following factor determine the amount of working capital

1. Nature of Companies: The composition of an asset is a function of the size of a business and the companies to which it belongs. Small companies have smaller proportions of cash,

receivables and inventory than large corporation. This difference becomes more marked in large corporations. A public utility, for example, mostly employs fixed assets in its operations, while a merchandising department depends generally on inventory and receivable. Needs for working capital are thus determined by the nature of an enterprise.

2. Demand of Creditors: Creditors are interested in the security of loans. They want their obligations to be sufficiently covered. They want the amount of security in assets which are greater than the liability.

3. Cash Requirements: Cash is one of the current assets which are essential for the successful operations of the production cycle. A minimum level of cash is always required to keep the operations going. Adequate cash is also required to maintain good credit relation.

4. Nature of Business: The type of business, firm is involved in, is the next consideration while deciding the working capital. In case of trading concern or retail shop the requirement of working capital is less because length of operating cycle is small. The wholesalers as compared to retail shop require more working capital as they have to maintain large stock and generally sell goods on credit which increases the length of operating cycle. The manufacturing company requires huge amount of working capital because they have to convert raw material into finished goods, sell on credit, maintain the inventory of raw material as well as finished goods.

5. Nature and Size of Business: The working capital requirements of a firm are basically influenced by the nature of its business. Trading and financial firms have a very less investment in fixed assets, but require a large sum of money to be invested in working capital. Retail stores, for example, must carry large stocks of a variety of goods to satisfy the varied and continues demand of their customers. Some manufacturing business, such as tobacco manufacturing and construction firms also have to invest substantially in working capital and a nominal amount in the fixed assets.

6. Volume of Sales: This is the most important factor affecting the size and components of working capital. A firm maintains current assets because they are needed to support the operational activities which result in sales. They volume of sales and the size of the working capital are directly related to each other. As the volume of sales increase, there is an increase in the investment of working capital-in the cost of operations, in inventories and receivables.

7. Terms of Purchases and Sales: If the credit terms of purchases are more favourable and those of sales liberal, less cash will be invested in inventory. With more favourable credit terms, working capital requirements can be reduced. A firm gets more time for payment to creditors or suppliers. A firm which enjoys greater credit with banks needs less working capital

8. Business Cycle Fluctuation: Business expands during periods of prosperity and declines during the period of depression. Consequently, more working capital required during periods of prosperity and less during the periods of depression. During boom period the market is flourishing so more demand, more production, more stock, and more debtors which mean more amount of working capital is required. Whereas during depression period low demand less inventories to be maintained, less debtors, so less working capital will be required. The working capital requirement is constant for the companies which are selling goods throughout the season whereas the companies which are selling seasonal goods require huge amount

during season as more demand, more stock has to be maintained and fast supply is needed whereas during off season or slack season demand is very low so less working capital is needed.

9. Production Cycle: The time taken to convert raw materials into finished products is referred to as the production cycle or operating cycle. The longer the production cycle, the greater is the requirements of the working capital. An utmost care should be taken to shorten the period of the production cycle in order to minimize working capital requirements. In case of production cycle, if production cycle is long then more working capital will be required because it will take long time for converting raw material into finished goods whereas when production cycle is small lesser funds are tied up in inventory and raw materials so less working capital is required.

10. Technology and Production Cycle: If a company is using labour intensive technique of production then more working capital is required because company needs to maintain enough cash flow for making payments to labour whereas if company is using machine-intensive technique of production then less working capital is required because investment in machinery is fixed capital requirement and there will be less operative expenses.

11. Liquidity and Profitability: If a firm desires to take a greater risk for bigger gains or losses, it reduces the size of its working capital in relation to its sales. If it is interested in improving its liquidity, it increase the level of its working capital. However, this policy is likely to result in a reduction of the sales volume, and therefore, of profitability. A firm, therefore, should choose between liquidity and profitability and decide about its working capital requirements accordingly.

12. Seasonal Fluctuations: Seasonal fluctuations in sales affect the level of variable working capital. Often, the demand for products may be of a seasonal nature. Yet inventories have got to be purchased during certain seasons only. The size of the working capital in one period may, therefore, be bigger than that in another.

13.Operating Efficiency: The firm having high degree of operating efficiency requires less amount of working capital as compared to firm having low degree of efficiency which requires more working capital. Firms with high degree of efficiency have low wastage and can manage with low level of inventory also and during operating cycle also these firms bear less expense so they can manage with less working capital also.

14. Time: The level of working capital depends upon the time required to manufacturing goods. If the time is longer, the size of working capital is great. Moreover, the amount of working capital depends upon inventory turnover and the unit cost of the goods that are sold. The greater this cost, the bigger is the amount of working capital.

15. Length of Operating Cycle: The amount of working capital directly depends upon the length of operating cycle. Operating cycle refers to the time period involved in production. It starts right from acquisition of raw material and ends till payment is received after sale. The firms operating at large scale need to maintain more inventory, debtors, etc. So they generally require large working capital whereas firms operating at small scale require less working capital. The working capital is very important for the smooth flow of operating cycle. If operating cycle is long then more working capital is required whereas for companies having short operating cycle, the working capital requirement is less.

16. Credit Allowed: Credit policy refers to average period for collection of sale proceeds. It depends on number of factors such as creditworthiness, of clients, industry norms etc. If company is following liberal credit policy then it will require more working capital whereas if company is following strict or short term credit policy, then it can manage with less working capital also.

17.Credit Avail: Another factor related to credit policy is how much and for how long period company is getting credit from its suppliers. If suppliers of raw materials are giving long term credit then company can manage with less amount of working capital whereas if suppliers are giving only short period credit then company will require more working capital to make payments to creditors.

18. Availability of Raw Materials: If raw materials are easily available and there is ready supply of raw materials and inputs then firms can manage with less amount of working capital also as they need not maintain any stock of raw materials or they can manage with very less stock. Whereas if the supply of raw materials is not smooth then firms need to maintain large inventory to carry on operating cycle smoothly. So they require more working capital.

19. Level of Competition: If the market is competitive then company will have to adopt liberal credit policy and to supply goods on time. Higher inventories have to be maintained so more working capital is required. A business with less competition or with monopoly position will require less working capital as it can dictate terms according to its own requirements.

20.Inflation: If there is increase or rise in price then the price of raw materials and cost of labour will rise, it will result in an increase in working capital requirement. Inflation Image Courtesy : static.guim.co.uk/sys-images/Guardian/Pix/pictures/2012/7/agricultura-001.jpg But if company is able to increase the price of its own goods as well, then there will be less problem of working capital. The effect of rise in price on working capital will be different for different businessmen.

21. Growth Prospects: Firms planning to expand their activities will require more amount of working capital as for expansion they need to increase scale of production which means more raw materials, more inputs etc. so more working capital also.

12.5. OPERATING CYCLE

The duration of time required to complete the sequence of events right from purchase of raw material / goods for cash to the realization of sales in cash is called the operating cycle, working capital cycle or cash cycle.

12.5.1. Operating Cycle of Manufacturing Cycle: The above operating cycle in figure relates to a manufacturing firm where cash is needs to purchase raw materials and convert raw materials into work-in-process is converted into finished goods. Finished goods will be sold for cash or credit and ultimately debtors will be realized.

12.5.2. Operating Cycle of Non-Manufacturing Firm:The non-manufacturing firms, such as whole sellers and retailers, will not have the manufacturing phase; they will have rather direct

conversion of cash into finished stock, into accounts receivables and then into cash. The operating cycle of a non-manufacturing firm is shown as under.

12.5.3. Operating Cycle of Service and Financial Firms: In addition to this, some service and financial concerns may not have any inventory at all. Such firm have the shorter operating cycle.

12.5.4. Liquidity Versus Profitability: Risk-Return Tangle: The firm would make just enough investment in current assets, if it were possible to estimate working capital needs exactly. Under perfect certainty, the current assets holdings would be at the minimum level. A ledger investment in current assets under certainty would mean a low rate or return investment for the firm, as excess investment in current assets will not earn enough return. A smaller investment in current assets, on the other hand, would mean interrupted production and sales, because of frequent stock-outs and inability to creditor in time to restrictive credit policy. As it is not possible to estimate working needs accurately, the firm must decide about the levels of current assets to be carried. The current assets holdings of the firm will depend upon its working capital policy. It may follow a conservative or an aggressive policy. These polices have different risk-return implications. A conservative policy means lower return and risk, while an aggressive policy produces higher return and risk.

The two important aims of the working capital management are: profitability and solvency. Solvency, used in the technical sense, refers to the firm's continuous ability to meet maturing obligations. Lenders and creditors expected prompt settlement of their claims as and when due. To ensure solvency, the firm maintains a relatively large investment in current assets holdings. If the firm maintains a relatively large investment in current assets, it will have no difficulty in paying the claims of the creditors when they become due and will be able to fill all sales orders and ensure smooth production. Thus, a liquid firm has less risk of insolvency; that is, it will hardly experiences a cash shortage or stock-outs. However, there is a cost associated with maintaining a sound liquidity position. A considerable amount of the firm's funds will be tied up in current assets. And to the extent this investment is idle, the firm's profitability will suffer.

To have high profitability, the firm may sacrifice solvency and maintain a relatively low level of current assets. When the firm does so, its profitability will improve as less funds are tied up in idle current assets, but its solvency would be threatened and would be exposed to greater risk of cash shortage and stock-outs. Therefore, the firm should balance the profitability solvency tangle by minimizing the total cost of liquidity and cost of illiquidity.

12.5.5. The Cost Trade-off: A different way of looking into the risk-return trade of is in terms of the cost of maintaining a particular level of current assets. There are two different kinds of costs involved. First there is the cost of liquidity. If the firm carries too much liquidity, the firm's rate of return will be low. Funds tied up in idle cash and excess inventory earn nothing, and receivables levels that are too large also reduce the firm's profitability. Thus, the cost of liquidity increases with the level of current assets. There is the cost of liquidity, which is the cost of having too little invested in current assets. If the firm carries too little cash, it may not be able to pay bills promptly at they mature. This may force the firm to borrows at high rates of interest. This will also adversely affect the creditworthiness of the firm and it will face difficulties in obtaining funds in future. This all may force the firm into insolvency. If the firm's inventory level too low, sales may be lost and customers may shift to competitors. Also, low level of book debts may be due to tight credit policy, which would impair sales

further. Thus, the low level of current assets involves cost which increases as this level falls.

12.6. DIFFERENT WORKING CAPITAL FINANCING POLICIES

Working capital is a significant factor in a company's operational competency. Proper management of working capital ensures sufficient availability of funds to finance the day-to-day operations of an organisation, as well as, to fulfill growth and expansion targets. Thus, experts often consider it to be a precursor to a business's success or failure. To that end, several businesses opt for working capital financing options. However, the poFlicy a business undertakes to finance its working capital is of utmost significance. With an inept policy, an organisation's funds may remain underutilised, its growth may be hindered, or worse, it could face immense losses. Thus, it requires a clear understanding of different working capital financing strategies to produce the most optimal results

In general, working capital policies involve determining the sources of finance. It also determines the allocation of these finances towards current assets and liabilities. Broadly, three strategies can help optimise working capital financing for a business, namely, hedging, aggressive, and conservative, as per the risk levels involved.

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Working Capital Investment Policies (Explained With Diagram): Working capital financing policy basically deals with the sources and the amount of working capital that a company should maintain. A firm is not only concerned about the amount of current assets but also about the proportions of short-term and long-term sources for financing the current assets. There are several working capital investment policies a firm may adopt after taking into account the variability of its cash inflows and outflows and the level of risk.

12.6.1. Hedging Policy: One of the policies by which a firm finances its working capital needs is the hedging policy, also known as matching policy. This policy works in an arrangement where the current assets of the business are used perfectly to match the current liabilities. As per this approach, fixed and permanent current assets are financed through long-term sources and fluctuating current assets are financed through short-term sources. This policy is a medium risk proposition and requires a good amount of attention. For example, if a bank loan is due to be paid after six months, the company will ensure that sufficient amount of cash will be available to repay the loan on the date of maturity even though it may or may not currently have sufficient cash. In case of a growth firm, the amount of fixed assets and permanent current asset go on increasing with the passage of time but the volume of fluctuating current assets change with the change in production level. In Figure 8.1, Line A and Line B is upward slopped indicating that they go on increasing with the passage of time and as per hedging principle they are financed through long-term sources like equity and long-term debt.

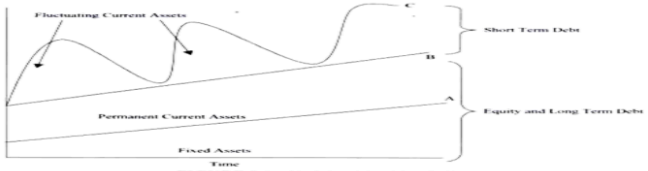

FIGURE 8.1 Hedging/Matching Policy

Fluctuating current assets, which are shown by the curved Line C, should be financed through short term sources. Also known as matching policy, adopting this strategy ensures that the current assets of a company are always in sync with short-term liabilities. In essence, this working capital financing policy aims to balance the two extreme strategies, both in terms of risk and growth potential. Most organisations observing this strategy use long-term sources of finance to invest in fixed current assets and resort to short-term funding options for current asset financing

12.6.2. Conservative Policy: As the name suggests, this policy tries to avoid the risk involved in financing of current assets. Here, relatively high proportions of long-term sources are to be used for financing current assets. The firm not only matches the current assets with current liabilities but also keeps some excess amount to meet any uncertainty.
This is the lowest risk working capital policy and fails to ensure optimum utilization of funds. Hence it cuts down the expected returns of the shareholders. This policy is illustrated in Figure 8.2. Line A denotes the fixed assets and Line B denotes the permanent working capital, which is financed through long-term sources. Certain portion of fluctuating current assets, which is shown by dashed Line C, is also financed by long-term sources. Under this policy some part of fluctuating current assets is financed through short-term sources.

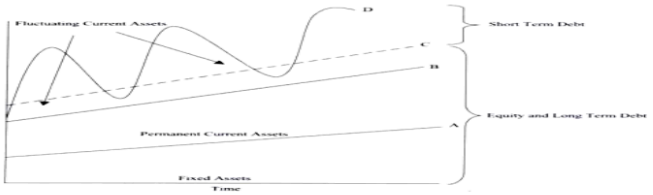

FIGURE 8.2 Conservative Policy

An organisation undertakes this strategy only when it requires minimising risk to the furthest. Under this policy, the management regulates the credit limits stringently to ensure low risk. Moreover, current assets are always above par against the current liabilities to ascertain sufficient availability of funds. Organisations majorly utilise long-term funding options to finance fixed and fluctuating current assets. The use of short-term sources is kept to a minimum for low-risk. Observing a conservative working capital financing policy, hence, leads to underutilisation of funds, thus cutting down on returns and compromising growth.

12.6.3. Aggressive Policy: Aggressive working capital financing policy is a risky policy that requires maximum amount of investment in current assets. Fluctuating as well as permanent current assets under this policy will be financed through short-term debt. In this policy debt is collected on time and payments to the creditors are made as late as possible.

This policy has been illustrated in Figure 8.3. According to this approach long-term sources are used to finance the fixed assets, which are shown by Line A; but a portion of permanent current assets, shown by the dotted Line B, is also financed through long-term sources. The remaining part of permanent current assets, depicted by Line C, and the entire amount of fluctuating current assets, shown by the curved Line D, are financed by short-term debt.

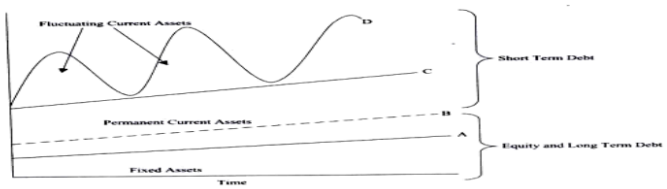

FIGURE 8.3 Aggressive Policy

As the name may suggest, aggressive policies involve the maximum risk, and thus, also bring the potential for multiplied growth. When observing this strategy, companies ensure their current assets, such as the value of debtors, are minimised by ensuring timely payments or minimum credit sales. At the same time, management also maintains that payments to creditors are delayed to the furthest. Organisations aiming at accelerated growth can opt for this working capital policy. However, since it involves immense risk, strong business acumen, and deft handling of finances are critical.

12.6.4. Comparison of Working Capital Financing Policies

When considering an ideal financing strategy for your organisation, taking into account the following parameters may benefit:

i. Liquidity: While following an aggressive strategy, liquidity is usually low since short-term funds are primarily used to finance both fixed and fluctuating current assets. A company is thus left with minimal idle funds. Conversely, in the case of a conservative strategy, liquidity is usually high. It is because companies mainly use long-term sources of finance, which leaves them with sufficient idle funds to address emergencies. Hedging strategy involves moderate liquidity, ensuring a balance between idle funds and their cost.

ii. Profitability: In a conservative approach, interest cost is higher compared to the other two working capital policies. Thus, naturally, it lowers profits. In general, aggressive policies offer the highest returns since the cost involved is kept to a minimum. As you can guess, in observing the matching strategy, profits generated are moderate.

iii. Working Capital Requirement: Under a conservative approach, the working capital you need to maintain is substantial as it involves the provision of idle capital for exigencies. Under an aggressive strategy, the working capital requirement is notably low, which speaks to high risk, but the cost is saved. When considering the hedging policy, this factor is neither too high, nor too low.

12.7.SUMMARY:

After studying this lesson you should be able to: i. Know the concept of Working Capital Policies , ii. Understand the Types of Working Capital, iii. Analyze the Factors Determining Working Capital. The present lesson structure is as follows: 12.1. Introduction 12.2. Concept Of Working Capital Management 12.3. Types of Working Capital 12.4. Factors Determining Working Capital 12.5. Operating Cycle 12.6. Liquidity Versus Profitability: Risk-Return Tangle 12.7. Summary 12.8. Technical terms 12.9.Self Assessment Questions 12.10. Suggested Readings

12.8. TECHNICAL TERMS:

Working capital : Working capital, also known as net working capital (NWC), is the difference between a company's current assets—such as cash, accounts receivable/customers' unpaid bills, and inventories of raw materials and finished goods—and its current liabilities, such as accounts payable and debts.

Working Capital Management: Working capital management is a business strategy designed to ensure that a company operates efficiently by monitoring and using its current assets and liabilities to their most effective use. The efficiency of working capital management can be quantified using ratio analysis.

operating cycle :An operating cycle refers to the time it takes a company to buy goods, sell them and receive cash from the sale of said goods. In other words, it's how long it takes a company to turn its inventories into cash. The length of an operating cycle is dependent upon the industry.

Liquidity : Liquidity refers to the ease with which an asset, or security, can be converted into ready cash without affecting its market price. Cash is the most liquid of assets, while tangible items are less liquid. The two main types of liquidity include market liquidity and accounting liquidity.

Profitability : Profitability is a measure of an organization's profit relative to its expenses. Organizations that are more efficient will realize more profit as a percentage of its expenses than a less-efficient organization, which must spend more to generate the same profit.

12.9.SELF ASSESSMENT QUESTIONS:

1. Define working capital? Explain the concept of working capital.
2. What is working capital management? Types of Working Capital-Explain.
3. What are the determinants of working capital? Discuss.
4. What are the working capital financial policies? Explain.

12.10. SUGGESTED READINGS:

1. I.M. Panday: "Financial Management " Vikas Publishing House (P) Ltd
2. Chandra, Prasanna "Financial Management " Tata Publishing House Ltd, New Delhi
3. S.N. Maheswari : "Principles of Financial Management " Sultan Chand, Delhi
4. Sheeba Kapil : "Financial Management " Pearson, 2011
5. P.V. Kulakarni: "Financial Management " Himalaya Publishing House Bombay
6. Khan & Jain : Cases in "Financial Management " Tata Publishing House Ltd, Delh
7. Bhalla V.K. : Financial Management, S. Chand & Company Pvt. Ltd. New Delhi.

LESSON-13
WORKING CAPITAL CONTROL AND BANKING POLICY
(Management of Loans and Advances)

Aims and Objectives

After studying this lesson you should be able to:

- Know the concept of Working Capital control
- Understand the Management of Loans and Advances
- Awareness about banking policy on Working Capital

Structure

13.1. INTRODUCTION

Working capital finance provided by the banks to trade and industry was regulated by the Reserve Bank of India through a series of guidelines/instructions issued. There were various quantitative and qualitative restrictions on bank's lending. The banks were also expected to ensure conformity with the basic financial disciplines prescribed by the RBI from time to time under Credit Authorisation Scheme (CAS). However, consistent with the policy of liberalisation and financial sector reforms, several indirect measures to regulate bank credit such as exposure norms for lending to individual/group borrowers, prudential norms for income recognition, asset classification and provisioning for advances, capital adequacy ratios, etc. were introduced by RBI and greater operational freedom has been provided to banks in dispensation of credit. Banks are now are expected to lay down, through their boards, transparent policies and guidelines for credit dispensation, in respect of each broad category of economic activity, keeping in view the credit exposure norms and various other guidelines issued by the Reserve Bank of India from time to time. Some of the currently applicable guidelines are detailed in the following paragraphs.

13.1.1 Working Capital requirements up to Rs. 1 crore

The assessment of working capital requirement of borrowers, other than SSI units, requiring fund based working capital limits upto Rs.1.00 crore and SSI units requiring fund based working capital limits upto to Rs.5.00 crore from the banking system may be made on the basis of their projected annual turn over. In accordance with these guidelines, the working

capital requirement is to be assessed at 25% of the projected turnover to be shared between the borrower and the bank, viz. borrower contributing 5% of the turnover as net working capital (NWC) and bank providing finance at a minimum of 20% of the turnover.

The banks may, at their discretion, carryout the assessment based on projected turnover basis or the traditional method. If the credit requirement based on traditional production/processing cycle is higher than the one assessed on projected turnover basis, the same may be sanctioned, as borrower must be financed upto the extent of minimum 20 per cent of their projected annual turnover. The banks may satisfy themselves about the reasonableness of the projected annual turnover of the applicants, both for new as well as existing units, on the basis of annual statements of accounts or any other documents such as returns filed with sales-tax/revenue authorities and also ensure that the estimated growth during the year is realistic.

The borrowers would be required to bring in 5 per cent of their annual turnover as margin money. In other words, 25 per cent of the output value should be computed as working capital requirement, of which at least four-fifth should be provided by the banking sector, the balance one-fifth representing the borrower's contribution towards margin for the working capital. In cases, where output exceeds the projections or where the initial assessment of working capital is found inadequate, suitable enhancement in the working capital limits should be considered by the competent authority as and when deemed necessary. For example, in case, annual turnover of a borrower is projected at Rs. 60.00 lakh, the working capital requirement will be computed at Rs. 15.00 lakh (i.e. 25%) of which Rs. 12 lakh (i.e. 20%) may be provided by the banking system, while Rs. 3.00 lakh (i.e. 5 %) should be borrower's contribution towards margin money.

Drawals against the limits should, however, be allowed against the usual safeguards so as to ensure that the same are used for the purpose intended. Banks will have to ensure regular and timely submission of monthly statements of stocks, receivables, etc., by the borrowers and also periodical verification of such statements vis-à-vis physical stocks by their officials. In regard to the above, few clarifications to some of the issues raised by banks are given below:

13.1.2. Working Capital Requirements above Rs. 1 crore

A. Method of Assessment

i. The revised guidelines in respect of borrowers other than SSI units, requiring working capital limits above Rs.1 crore and for SSI units requiring fund based working capital limits above Rs.5 crore, from the banking system bestow greater level of flexibility to the primary (urban) co-operative banks in their day-to-day operations without diluting the prudential norms for lending as prescribed by Reserve Bank of India.

ii. The earlier prescription regarding Maximum Permissible Bank Finance (MPBF), based on a minimum current ratio of 1.33:1, recommended by Tandon Working Group has been withdrawn. Banks are now free to decide on the minimum current ratio and determine the working capital requirements according to their perception of the borrowers and their credit needs.

iii. Banks may evolve an appropriate system for assessing the working capital credit needs of borrowers whose requirement are above Rs.1 crore. Banks may adopt any of the under-noted methods for arriving at the working capital requirement of such borrowers.

a) The turnover method, as prevalent for small borrowers may be used as a tool of assessment for this segment as well,

b) Since major corporates have adopted cash budgeting as a tool of funds management, banks may follow cash budget system for assessing the working capital finance in respect of large borrowers.

c) The banks may even retain the concept of the MPBF with necessary modifications.

B. Norms for Inventory/Receivables

i. In order to provide flexibility in the assessment of credit requirements of borrowers based on a total study of borrowers' business operations, i.e., taking into account the production/processing cycle of the industry as well as the financial and other relevant parameters of the borrower, the banks have also been permitted to decide the levels of holding of each item of inventory as also of receivables, which in their view would represent a reasonable build-up of current assets for being supported by bank finance.

ii. Reserve Bank of India no longer prescribes detailed norms for each item of inventory as also of receivables.

iii. Classification of Current Assets and Current Liabilities

iv. With the withdrawal of MPBF, inventory norms and minimum current ratio, the classification of current assets and current liabilities ceases to be mandatory. The banks may decide on their own as to which items should be included for consideration as current assets or current liabilities.

v. Banks may also consider evolving suitable internal guidelines for accepting the projections made by their borrowers relating to the item 'Sundry Creditors (Goods)' appearing as an item under 'Other Current Liabilities' in the balance sheet.

C. Bills Discipline

In respect of borrowers enjoying fund-based working capital credit limits of Rs. 5 crore and more from the banking system, the banks are required to ensure that the book-debt finance does not exceed 75 per cent of the limits sanctioned to borrowers for financing inland credit sales. The remaining 25 per cent of the credit sales may be financed through bills to ensure greater use of bills for financing sales.

D. Grant of Ad hoc Limits

To meet the contingencies, banks may decide on the quantum and period for granting ad hoc limits to the borrowers based on their commercial judgement and merits of individual cases. While granting the ad hoc limits the banks must ensure that the aggregate credit limits (inclusive of ad hoc limits) do not exceed the prescribed exposure ceiling.

E. Commitment Charge

The levy of commitment charge is not mandatory and it is left to the discretion of the financing banks/ consortium/syndicate. Accordingly, banks are free to evolve their own guidelines in regard to commitment charge for ensuring credit discipline.

F. Consortium Arrangement

The mandatory requirement of formation of consortium for extending working capital finance under multiple banking arrangements has been withdrawn.

G. Syndication of Credit

The syndication of loans is an internationally practised model for financing credit requirements. The banks are free to adopt syndication route, irrespective of the quantum of credit involved, if the arrangement suits the borrower and the financing banks.

13.2. LOAN SYSTEM FOR DELIVERY OF BANK CREDIT

In order to bring about an element of discipline in the utilisation of bank credit by large borrowers, instill efficiency in funds management, loan system for delivery of bank credit was been introduced for borrowers enjoying working capital credit limits of Rs.10 crore and above from the banking system and the minimum level of loan component for such borrowers was fixed at 80 per cent. These guidelines have been revised by RBI, in the light of current environment of short-term investment opportunities available to both the corporate and the banks. In case any primary (urban) co-operative bank is having borrowers with MPBF of Rs. 10 crore and above where it has participated under consortium/syndication, it should ensure strict compliance with the under-noted guidelines.

13.2.1. Loan Component and Cash Credit Component

(i) Banks may change the composition of working capital by increasing the cash credit component beyond 20 per cent or to increase the loan component beyond 80 per cent, as the case may be, if they so desire.

(ii) Banks are expected to appropriately price each of the two components of working capital finance, taking into account the impact of such decisions on their cash and liquidity management.

(iii) If a borrower so desires, higher loan component can be granted by the bank; this would entail corresponding pro-rata reduction in the cash credit component of the limit.

(iv) In the case of borrowers with working capital (fund based) credit limit of less than Rs. 10 crore, banks may persuade them to go in for the Loan System by offering an incentive in the form of lower rate of interest on the 'loan component' as compared to the 'cash credit component' The actual percentage of 'loan component' in these cases may be settled by the bank with its borrower clients.

(v) In respect of certain business activities which are cyclical and seasonal in nature or have inherent volatility, the strict application of loan system may create difficulties for the

borrowers. Banks, may with the approval of their respective Boards, identify such business activities which may be exempt from the loan system of credit delivery.

13.2.2. Ad hoc Credit Limit

The ad hoc/additional credit for meeting temporary requirements may be considered by the financing bank only after the borrower has fully utilised/exhausted the existing limit.

13.2.3. Sharing of Working Capital Finance

The ground rules for sharing of cash credit and loan components may be laid down by the consortium, wherever formed, subject to the stipulations contained in Para. 3.9.2 above.

The level of individual bank's share shall be governed by the norm for single / group borrowers credit exposure.

13.2.4. Rate of Interest

Banks are allowed to fix separate lending rates for 'loan component' and 'cash credit component'.

13.2.5. Period of Loan

The minimum period of the loan for working capital purposes may be fixed by banks in consultation with borrowers. Banks may decide to split the loan component according to the need of the borrower with different maturity bases for each segment and allow roll over.

13.2.6. Security

In regard to security, sharing of charge, documentation, etc., banks may themselves decide on the requirements, if necessary, in consultation with the other participant banks.

13.2.7. Export Credit

Export credit limit would be allowed in the form hitherto granted. The bifurcation of the working capital limit into loan and cash credit components, as stated in paragraph 3.9.2 (i) above, would be effected after excluding the export credit limits (pre-shipment and post-shipment).

13.2.8. Bills Limit

Bills limit for inland sales may be fully carved out of the 'loan component'. Bills limit also includes limits for purchase of third party (outstation) cheques/bank drafts. Banks must satisfy themselves that the bills limit is not mis-utilised.

13.2.9. Renewal/Roll-over of Loan Component

The loan component , may be renewed/rolled over at the request of the borrower. However, banks may lay down policy guidelines for periodical review of the working capital limit and the same may be scrupulously adhered to.

13.2.10. Provision for Investing Short Term Surplus Funds of Borrowers

The banks, at their discretion, may permit the borrowers to invest their short term/temporary surpluses in short-term money market instruments like Commercial Paper (CP), Certificates of Deposit (CDs) and in Term Deposit with banks, etc.

13.2.11. Applicability

The loan system would be applicable to borrowal accounts classified as 'standard' or 'sub-standard'.

13.3. CREDIT ADMINISTRATION

13.3.1. No Objection Certificate

The primary (urban) co-operative banks should not finance a borrower already availing credit facility from another bank without obtaining a 'No Objection Certificate' from the existing financing bank.

13.3.2. Opening of Current Accounts

Before permitting the parties to open current accounts/sanctioning post-sale limits, the banks should invariably obtain the concurrence of the banks which have sanctioned main limits.

13.3.3. Certification of Accounts of Non-Corporate Borrowers by Chartered Accountants

As per the Income Tax Act, 1961, filing of audited balance sheet and profit & loss account is mandatory for certain types of non-corporate entities. Therefore, the banks must insist on the audited financial statements from the borrowers enjoying large limits; since such borrowers would, in any case, be submitting audit certificate to the income-tax authorities, based on audit of their books of accounts by a Chartered Accountant.

13.3.4. Defaults in Payment of Statutory Dues by Borrowers

It has been observed that many of the borrowers enjoying credit facilities from primary (urban) co-operative banks default in payment of Provident Fund, Employees State Insurance and other statutory dues. Despite this, such borrowers continue to carry on operations with the assistance of bank finance without meeting their statutory, obligations.

13.3.5. In the case of insolvency/winding up of a borrowing employer, under the law, there are certain priorities in regard to the recovery of statutory dues e.g., employees contribution towards provident fund deducted from wages of the employee members for a period of more than six months and not paid to the Commissioner, are a first charge on the assets of borrowers.

13.3.6. In the circumstances, the banks should safeguard their interest vis-à-vis such statutory dues and, therefore, it would be desirable for the banks to ensure that provident funds and similar other dues are paid by the borrowers promptly. For the purpose, the banks should incorporate an appropriate declaration in their application forms for grant/renewal/

enhancement of credit facilities so as to ensure that the position regarding the statutory dues is disclosed therein.

13.3.7. Where warranted, banks should satisfy themselves about genuineness of the party's declaration in this regard. Thus, the sanction/renewal/ enhancement of credit facilities can be utilised by banks as a leverage for enforcing necessary discipline on the part of their borrowers.

13.3.8. In respect of the corporate borrowers and non-corporate borrowers, the amount of statutory dues should normally be reflected in their annual accounts which should be duly certified by the auditors, and hence, the banks should have no difficulty in ascertaining the position of their statutory dues. Nonetheless, in addition to duly audited annual accounts, banks should also obtain a specific certificate from the Chartered Accountant as regards the position of statutory dues, if the audited accounts do not clearly indicate the position.

13.3.9. After ascertaining the quantum of statutory dues, the banks should ensure that these are cleared by the borrowers within a reasonable period and that too through internal generation of funds. The non-payment of statutory dues is one of the symptoms of incipient sickness of an industrial unit. Therefore, it is in the interest of both the lender and borrower to give high priority to the clearance of these dues. Apart from insisting the borrowers to indicate a definite programme for clearance of arrears, banks may consider suitable restrictions on the outflow of funds by way of dividends, repayment of loans from promoters or their friends, relatives or inter-corporate borrowings etc., till the overdue statutory liabilities are cleared.

13.4. SANCTION OF ADVANCES

13.4.1. Irregularities/ Deficiencies in Credit Sanction

Banks should, take suitable precautions to avoid irregular practices such as sanctioning of advances beyond discretionary powers and/or without proper credit appraisal in order to minimise chances of frauds.

13.4.2. Delegation of Powers

(i) The Board of Directors should delegate specific powers to the Branch Managers and other functionaries at the Head Office level as also to the Chairman in the matter of sanction of advances and expenditure. A system should also be introduced to ensure that powers are exercised within the limits prescribed and any transgressions are immediately reported to Head Office.

(ii) The internal inspectors should examine during the course of inspection of branches whether powers have been exercised properly and any unauthorised exercise of powers should immediately be brought to the notice of Head Office. Similarly, sanctions beyond discretionary powers by the Chairman, Chief Executive Officer and other executives at the Head Office should also be reported to the Board of Directors.

13.4.3. Oral Sanction

The higher authorities at various level should desist from the unhealthy practice of conveying sanction of advances orally or on telephone.

13.4.4. Proper Record of Deviations

(i) Only in exigencies, where sanctions are made on telephone/oral instructions of higher functionaries or sanctions beyond discretionary powers have to be resorted to, the following steps should be taken:

(a) Record of such instructions/sanctions should be maintained by the sanctioning/disbursing authorities explaining the circumstances under which sanctions were made.

(b) Written confirmation of the competent sanctioning authority should be obtained by the disbursing authority / official within a week/fortnight.

(c) Sanctions within discretionary powers should also be reported to Head Office within a stipulated time and Head Office should meticulously follow up receipt of such returns.

(d) Head Office should diligently scrutinise the statements/ returns and should initiate stringent action against erring functionary(ies) if he/they is/are found to have indulged in unauthorised sanctioning.

(ii) Officials should exercise powers delegated to them judiciously and should not exceed their discretionary powers for granting loans and advances. Violation, if any, in this regard should be viewed seriously and the guilty should be punished suitably.

13.5. MONITORING OPERATIONS IN LOAN ACCOUNTS

13.5.1. Diversion of Funds

Some of the bank clients are known to be making large cash withdrawals. It is quite possible that such cash withdrawals may be used by the account holders for undesirable or illegal activities. While cash withdrawals cannot be refused, banks should keep a proper vigil over requests of their clients for cash withdrawals from their accounts for large amounts.

13.5.2. Post-Sanction Monitoring

(i) It is the primary responsibility of banks to be vigilant and ensure proper end use of bank funds /monitor the funds flow. It is, therefore, necessary for banks to evolve such arrangements as may be considered necessary to ensure that drawals from cash credit/overdraft accounts are strictly for the purpose for which the credit limits are sanctioned by them. There should be no diversion of working capital finance for acquisition of fixed assets, investments in associate companies/subsidiaries, and acquisition of shares, debentures, units of Unit Trust of India and other mutual funds, and other investments in the capital market. This has to be so, even if there is sufficient drawing power/undrawn limit for the purpose of effecting drawals from the cash credit account.

(ii) Post sanction follow-up of loans and advances should be effective so as to ensure that the security obtained from borrowers by way of hypothecation, pledge, etc. are not tampered with in any manner and are adequate.

(iii) Drawals against clearing cheques should be sanctioned only in respect of first class customers and even in such cases the extent of limits and the need therefor should be subjected to thorough scrutiny and periodical review. Banks should not issue banker's cheques/pay orders/demand drafts against instruments presented for clearing, unless the proceeds thereof are collected and credited to the account of the party. Further, banker's cheques /pay orders/ demand drafts, should not be issued by debit to cash credit /over draft accounts which are already overdrawn or likely to be overdrawn with the issue of such instruments.

(iv) Drawals against clearing instruments should be normally confined to bank drafts and government cheques and only to a limited extent against third party cheques.

(v) Cheques against which drawals are allowed should represent genuine trade transactions and strict vigilance should be observed against assisting kite-flying operations.

(vi) Drawals against cheques of allied /sister concerns should not be permitted and the facility of drawal against clearing cheques should normally be of temporary nature and should not be allowed on a regular basis without proper scrutiny and appraisal.

(vii) Bills of accommodation nature should never be purchased and the officials responsible for purchase of such bills should be punished suitably.

(viii) In case a borrower is found to have diverted finance for the purposes, other than for which it was granted, banks must recall the amounts so diverted. In addition, banks may charge penal interest on the amount diverted.

(ix) Where borrowers fail to repay the amounts diverted from cash credit accounts for uses other than for which the limit was sanctioned, banks should reduce the limits to the extent of amount diverted. The above aspects relating to safe guards are only illustrative in nature and not exhaustive.

13.5.3. Responsibility

(i) The primary responsibility for preventing misuse of funds rests with the management of banks. For the purpose, highest standards of integrity and efficiency are imperative in urban banks which are the trustees of public money. The banks should, therefore, take appropriate steps to review and tighten their internal administration and control measures so as to eliminate the scope for misuse/diversion of funds and malpractices.

(ii) Banks should take serious view of instances of misuse of power, corruption and other malpractices indulged by the members of staff and erring staff members should be given punishments befitting the seriousness of the irregularity. Light punishments such as issue of warning, stoppage of increments, transfer, etc. may not prove a deterrent in all cases. Quick disposal of enquiries by the banks and award of deterrent punishment would be necessary in all such cases, The Board should take more active interest in these matters.

13.6. MONITORING OF WILLFUL DEFAULTERS

13.6.1 Collection and dissemination of information on cases of wilful default of Rs. 25.00 lakh and above

13.6.1.1 Pursuant to the instructions of the Central Vigilance Commission for collection of information on wilful defaulters by RBI and dissemination to the reporting banks and financial institutions, a scheme has been framed under which the banks and financial institutions will be required to submit the details of the wilful defaulters. The scheduled primary (urban) co-operative banks have also been brought within the ambit of the scheme.

13.6.1.2 The details of the scheme are given below:

(i) The scheme has come into force with effect from 1st April 1999. Accordingly, scheduled primary (urban) co-operative banks are required to report on a quarterly basis, all cases of wilful defaults which occurred, or are detected after 31st March 1999 in the proforma given in Annexure IV.

(ii) The scheme covers all non-performing borrowal accounts with outstanding (funded facilities and such non-funded facilities which are converted into funded facilities) aggregating to Rs. 25.00 lakh and above.

13.6.2 Wilful Default

'A willful default would be deemed to have occurred, if :

(a) The unit has defaulted in meeting its payment / repayment obligations to the lender even when it has the capacity to honour the said obligations. OR

The unit has defaulted in meeting its payment / repayment obligations to the lender and has not utilised the finance from the lender for the specific purposes for which finance was availed of but has diverted the funds for other purposes. OR

(c) The unit has defaulted in meeting its payment / repayment obligations to the lender and has siphoned off the funds so that the funds have not been utilised for the specific purpose for which finance was availed of, nor the funds are available with the unit in the form of other assets.

13.6.3. Diversion and siphoning of funds

13.6.3.1 Diversion of funds would be construed to include any one of the under-noted occurrences:

(a) utilisation of short-term working capital funds for long-term purposes not in conformity with the terms of sanctions;

(b) deploying borrowed funds for purposes / activities or creation of assets other than those for which the loan was sanctioned;

(c) transferring funds to the subsidiaries / group companies or other corporates by whatever modalities;

(d) routing of funds through any bank other than the lender bank or members of consortium without prior permission of the lender;

(e) investment in other companies by way of acquiring equities / debt instruments without approval of lenders;

(f) short fall in deployment of funds vis-à-vis the amounts disbursed / drawn and the difference not being accounted for.

6.3.2 Siphoning of funds should be construed to have occur if any funds borrowed are utilised for purposes unrelated to the operations of the borrower, to the detriment of the financial health of the entity or of the lender. The decision as to whether a particular instance amounts to siphoning of funds would have to be a judgement of the lenders based on objective facts and circumstances of the case.

13.6.4 Cut-off limits

While the penal measures normally be attracted by all the borrowers identified as wilful defaulters or the promoters involved in diversion / siphoning of funds, keeping in view the present limit of Rs.25 lakh fixed by the Central Vigilance Commission for reporting of cases of wilful default by scheduled banks to RBI, any wilful defaulter with an outstanding balance of Rs.25 lakh or more would attract the penal measure stipulated at para 6.6 below. The limit of Rs.25 lakh may also be applied for the purpose of taking congnisance of the instances of `siphoning '/ `diversion' of funds.

13.6.5 End-use of Funds

In cases of project financing, banks should seek to ensure end use of funds by, inter alia, obtaining certification from the Chartered Accountants for the purpose. In case of short-term corporate / clean loans, such an approach ought to be supplemented by `due diligence' on the part of lenders themselves, and to the extent possible, such loans should be limited to only those borrowers whose integrity and reliability were above board. Scheduled pcbs, therefore, should not depend entirely on the certificates issued by the Chartered Accountants but strengthen their internal controls and the credit risk management system to enhance the quality of their loan portfolio. Needless to say, ensuring end-use of funds by banks should form a part of their loan policy document for which appropriate measures should be put in place.

13.6.5.1 The following are the illustrative measures that could be taken by the lenders for monitoring and ensuring end-use of funds :

(a) Meaningful scrutiny of quarterly progress reports / operating statements / balance sheets of the borrowers ;

(b) Regular inspection of borrowers' assets charged to the lenders as security;

(c) Periodical scrutiny of borrowers' books of accounts and the no-lien accounts maintained with other banks;

(d) Periodical visits to the assisted units;

(e) System of periodical stock audit, in case of working capital finance;

(f) Periodical comprehensive management audit of the `Credit' function of the lenders, so as to identify the systemic weaknesses in the credit-administration.

13.6.6 Penal measures

In order to prevent the access to the capital markets by the wilful defaulters, a copy of the list of wilful defaulters is forwarded by RBI to SEBI as well. It has also been decided that the following measures should be initiated by schedule pcbs against the wilful defaulters

(i) No additional facilities be granted to the listed wilful defaulters. In addition, the entrepreneurs / promoters of companies where banks have identified siphoning / diversion of funds, misrepresentation, falsification of accounts and fraudulent transactions should be debarred from institutional finance for floating new ventures for a period of 5 years from the date the name of the wilful defaulter is published in the list of wilful defaulters by the RBI.

(ii) The legal process, where warranted, against the borrowers/guarantors and foreclosure of loans should be initiated expeditiously. The lenders may also initiate criminal proceedings against wilful defaulters, wherever necessary.

(iii) Wherever possible, the banks should adopt a proactive approach for a change of management of the wilfully defaulting borrower unit. It would be imperative on the part of the banks to put in place a transparent mechanism for the entire process so that the penal provisions are not misused and the scope of such discretionary powers is kept to the barest minimum. It should be ensured that a solitary or isolated instance is not made the basis for imposing the penal action.

13.6.7 Treatment of Group

While dealing with wilful default of a single borrowing company in a group, the banks should consider the track record of the individual company, with reference to its repayment performance to its lenders. However, in cases where a letter of comfort and/or the guarantees furnished by the companies within the group on behalf of the wilfully defaulting units are not honoured when invoked by scheduled banks, such group companies should also be reckoned as wilful defaulters.

13.6.8 Role of Auditors

13.6.8.1 In case any falsification of accounts on the part of the borrowers is observed by banks, they should lodge a formal complaint against the auditors of the borrowers, with Institute of Chartered Accountant of India (ICAI) if it is observed that the auditors were negligent or deficient in conducting the audit to enable the ICAI to examine and fix accountability of the auditors.

13.6.8.2 With a view to monitoring the end-use of funds, if the lenders desire a specific certification from borrowers' auditors regarding diversion / siphoning of funds by the borrower, the lender should award a separate mandate to the auditors for the purpose. To facilitate such certification by the auditors scheduled pcbs will also need to ensure that appropriate covenants in the loan agreements are incorporated to enable award of such a mandate by the lenders to the borrowers / auditors.

13.6.9 Filing of Suits to Recover Dues from Wilful Defaulters

13.6.9.1 There are few cases where the amount outstanding is substantial but the banks have not initiated any legal action against the defaulting borrowers. It may be noted that the cases of wilful defaults have an element of fraud and cheating and therefore, should be viewed differently.

13.6.9.2 Scheduled pcbs should examine all cases of wilful defaults of Rs. 1.00 crore and above and file suits in such cases, if not already done. Banks should also examine whether in such cases of wilful defaults, there are instances of cheating/fraud by the defaulting borrowers and if so, they should also file criminal cases against those borrowers. In other cases involving amounts below Rs. 1.00 crore, banks should take appropriate action, including legal action, against the defaulting borrowers.

13.7. SUMMARY

After studying this lesson you should be able to: i.Know the concept of Working Capital control,Understand the Management of Loans and Advances ,iii. Awareness about banking policy on Working Capital. This lesson is presented into ten parts including suggested readings such as: 13.1. Introduction 13.2. Loan System for Delivery of Bank Credit 13.3. Credit Administration 13.4. Sanction of Advances 13.5. Monitoring Operations in Loan Accounts 13.6. Monitoring of Willful Defaulters 13.7. Summary 13.8. Technical terms 13.9.Self Assessment Questions 13.10. Suggested Readings.

13.8. TECHNICAL TERMS

Loan System : A loan management system is a digital platform that helps automate every stage of the loan lifecycle, from application to closing. The traditional loan management process is meticulous, time-consuming, and requires collecting and verifying information about applicants, their trustworthiness, and their credibility.

Sanction : Definition of Sanction. give official permission or approval. Examples of Sanction in a sentence. 1. Because of the school's behavioral problems, the principal is unlikely to sanction a school dance this year.

Monitoring :Monitoring is the regular observation and recording of activities taking place in a project or programme. It is a process of routinely gathering information on all aspects of the project. To monitor is to check on how project activities are progressing. It is observation; ─ systematic and purposeful observation.

Operations : Define Operations: Operation means The actions and decisions made by participants and members of a business that affect the production, distribution, service,

management, etc. needed for a company to function that requires the use of resources and assets.

Loan Accounts : Loan account is a representative personal account, as it represents the person from whom the loan is obtained or to whom the loan is given. Hence, it is classified as a personal account.

13.9. SELF ASSESSMENT QUESTIONS

1. What is Loan System? Explain about Loan System for Delivery of Bank Credit.
2. What is the role of Credit Administration of banks for loan sanction to the business concerns - discuss.
3. Sanction of Advances for working capital to the firms by bank loans – explain.
4. How to Monitoring Operations in Loan Accounts for providing working capital?

13.10. SUGGESTED READINGS

1. I.M. Panday: "Financial Management " Vikas Publishing House (P) Ltd

2. Chandra, Prasanna "Financial Management " Tata Publishing House Ltd, New Delhi

3. S.N. Maheswari : "Principles of Financial Management " Sultan Chand, Delhi

4. Sheeba Kapil : "Financial Management " Pearson, 2011

5. P.V. Kulakarni: "Financial Management " Himalaya Publishing House Bombay

6. Khan & Jain : Cases in "Financial Management " Tata Publishing House Ltd, Delh

7. Bhalla V.K. : Financial Management, S. Chand & Company Pvt. Ltd. New Delhi.

LESSON - 14
ESTIMATING WORKING CAPITAL NEEDS

Aims and Objectives

After studying this lesson you should be able to:

- Know the concept of Working Capital control
- Understand the Management of Loans and Advances
- Awareness about banking policy on Working Capital

Structure

14.1. INTRODUCTION

"The fact that cash inflows are not matched in both timing and amount by cash outflows, provides us with an operating cycle and rationale for investing in working capital. In any analysis of working capital, a distinction is made between temporary and permanent working capital requirements. The latter are a function of secular and cyclical trends in sales and operating expenses. The former depend on seasonal factors. In a proforma projection of working capital requirements, management must forecast the maximum level of current assets required to support an expected volume of sales and maximum level of short term credit it can anticipate to finance these assets." The efficiency of the planning and management is subject to the correct estimate of the working capital requirement. Irrespective of the planning exercise made and control mechanism adopted, the correct estimation of working capital requirement is the fundamental necessity of a good and efficient working capital management. The present article looks into the steps and calculations required to estimate the working capital requirement for a firm.

14.1.1. Loan System for Delivery of Bank Credit

In respect of borrowers having aggregate fund based working capital limit of ₹1500 million and above from the banking system, a minimum level of 'loan component' of 40 percent shall be effective from April 1, 2019. In this system, the borrowers are allowed to draw funds from the account to the extent of the value of inventories and receivables less stipulated margin within the maximum permissible credit limit granted by the bank. The term bank credit refers to the amount of credit available to a business or individual from a banking institution in the form of loans. As at present, ad hoc/additional credit for meeting temporary requirements can be considered by the financing bank only after the borrower has fully utilised/exhausted the existing limit. Cash credit is a short-term business loan. It is meant for entrepreneurs wanting

to get quick working capital. An overdraft facility, on the other hand, is a long-term financial assistance.

Working Capital Demand Loan (WCDL) is provided to meet working capital requirements. It shall be within the assessed working capital limits. It can be available as a sub limit of funded working capital limit. Period of the loan is upto 12 months.

Types of secured loans: 1.Home loan. 2.Loan against property (LAP) 3.Loans against insurance policies. 4. Gold loans.5. Loans against mutual funds and shares. 5. Loans against fixed deposits. The process of assessing whether or not to lend to a particular entity is known as the credit process. It involves evaluating the mindset of the potential borrower, underwriting of the risk, the pricing of the instrument and the fit with the lenders portfolio.

14.1.2. Credit Administration

Credit administration is a department in a bank or lending institution that is tasked with managing the entire credit process. Credit administrators are responsible for conducting background checks on potential customers to determine their ability to pay back the principal and interest. Credit management is important because it reinforces a company's liquidity. If done correctly it will improve cash flow and lower the rate of late payments. It's the difference between a high or low DSO, amount of bad debt a financial portfolio presents and even negative or positive customer relations. Loan administration is a broad topic in banking that generally involves determining loan eligibility, tracking loan documentation, and generating reports. Typically, a loan administrator is part of the loan operations team and supports or oversees the bank's loan administration processes.
The 7Cs credit appraisal model: character, capacity, collateral, contribution, control, condition and common sense has elements that comprehensively cover the entire areas that affect risk assessment and credit evaluation. The following are the main types of credit risks: Credit default risk. i. Credit default risk occurs when the borrower is unable to pay the loan obligation in full or when the borrower is already 90 days past the due date of the loan repayment. ii. Concentration risk.

The Credit Information Bureau (India) Limited (CIBIL) is the most popular of the four credit information companies licensed by Reserve Bank of India. There are three other companies also licensed by the RBI to function as credit information companies. They are Experian, Equifax and Highmark. CIBIL Score

The Credit Information Bureau (India) Ltd, better known as CIBIL, is the premier agency for providing credit reports and scores pertaining to individuals. CIBIL sources financial data of individuals such as loan and credit card information from leading banks and other financial institutions in India. This data is then presented in the form of a CIBIL credit report, also known as a Credit Information Report (CIR). CIBIL was incorporated in 2000 and has continued to expand its presence throughout the country. It is backed by TransUnion International and Dun and Bradstreet, which are major global credit bureaus and agencies Tips to have a great CIBIL ScoreHow to Improve CIBIL Score CIBIL Score Range

The Credit Information Bureau (India) Ltd, popularly known as CIBIL is a Reserve Bank of India (RBI) authorised credit agency. It offers CIBIL scores and CIBIL reports for individuals. A CIBIL score is generated by the bureau after considering an individual's detailed credit information. The agency also offers credit report services to the banks and other NBFC (Non-banking financial companies). A CIBIL score is a three-digit number

between 300-900, 300 being the lowest, that represents an individual's credit worthiness. A higher CIBIL score suggests good credit history and responsible repayment behavior. CIBIL scores are calculated on the basis of at least 6 months of historical financial data of an individual. The data is fed into an algorithm with 258 different variables; each with a different weightage.

14.1.3.Why a Good CIBIL Score is Important for Loans

A CIBIL score is considered as good if it lies between 700 and 900. This will be taken into account by banks and NBFCs when considering a loan application for most retail loans, whether it is a home loan or a vehicle loan. A high CIBIL score, also called a credit score, has many benefits during the loan application process such as: i.Quicker and faster loan application process ii.Easier loan documentation process iii. Lower interest rates on the loan iv. A higher quantum of loan y. Longer or more flexible repayment tenure

Choice between multiple lenders so that you can select the loan that's best for you In addition, such a score will lead to a quicker and easier documentation process. When it comes to a home loan, you can expect up to 80% of the total cost of the property if you have a CIBIL score between 700 and 900.

14.2. ESTIMATION PROCESS OF WORKING CAPITAL UNDER DIFFERENT APPROACHES

A firm must estimate in advance as to how much net working capital will be required for the smooth operations of the business. Only then, it can bifurcate this requirement into permanent working capital and temporary working capital. This bifurcation will help in deciding the financing pattern i.e., how much working capital should be financed from long term sources and how much be financed from short term sources. There are different approaches available to estimate the working capital requirements of a firm as follows :

14.2.1. Working Capital as a Percentage of Net Sales

This approach to estimate the working capital requirement is based on the fact that the working capital for any firm is directly related to the sales volume of that firm. So, the working capital requirement is expressed as a percentage of expected sales for a particular period. The working capital estimation is thus, solely dependent on the sales forecast. This approach is Based on the assumption that higher the sales level, the greater would be the need for working capital. There are three steps involved in the estimation of working capital. (a) To estimate total current assets as a % of estimated net sales. (b) To estimate current liabilities as a % of estimated net sales, and (c) The difference between the two above, is the net working capital as a % of net sales.

So, the firm has to find out on the basis of past experience, or on the basis of other firm's experience in the same competitive environment, as to how much total current assets and total current liabilities should be maintained for a given level of expected sales. The step (a) above i.e., total current assets as a % of net sales will give the gross working capital requirement and step (b) above i.e., current liabilities as a % of net sales will give the funds provided by current liabilities. The difference between the two is the net working capital which the firm has to arrange for.

14.2.2. Working Capital as a Percentage of Total Assets or Fixed Assets

This approach of estimation of working capital requirement is based on the fact that the total assets of the firm are consisting of fixed assets and current assets. On the basis of past experience, a relationship between (i) total current assets i.e., gross working capital; or net working capital i.e., Current assets – Current liabilities, and (ii) total fixed assets or total assets of the firm is established. For example, a firm is maintaining 20% of its total assets in the form of current assets and expects to have total assets of Rs. 50,00,000 next year. Thus, the current assets of the firm would be Rs. 10,00,000 (i.e., 20% of Rs. 50,00,000).

In this approach, the working capital may also be estimated as a % of fixed assets. The firm basically plans the future level of fixed assets in terms of capital budgeting decisions. In order to use these fixed assets in an efficient and optimal way, the firm must have sufficient working capital. So, the working capital requirement depend upon the planned level of fixed assets. The estimation of working capital therefore, depends upon the estimation of fixed capital which depends upon the capital budgeting decisions. It has already been noted in Chapter 8 that the investment decisions of a firm are consisting of capital budgeting decisions (relating to fixed assets) and working capital management (relating to current assets and current liabilities). So, the working capital estimation, being a part of the investment decisions, should be made together with the capital budgeting decisions.

Both the above approaches to the estimation of working capital requirement are relatively simple in approach but difficult in calculation. The main shortcoming of these approaches is that these require to establish the relationship of current assets with the net sales or fixed assets, which is quite difficult. The past experience either may not be available, or even if available, may not help much in correct estimation. There is yet another approach to estimate the working capital requirement based on the concept of operating cycle. Working capital requirement of a firm depends upon two variables :(a) Time Factor (b) Value Factor

14.2.3. Working Capital based on Operating Cycle

The concept of operating cycle, as discussed in the preceding chapter, helps determining the time scale over which the current assets are maintained. The operating cycle for different components of working capital gives the time for which an assets is maintained, once it is acquired. However, the concept of operating cycle does not talk of the funds invested in maintaining these current assets. The concept of operating cycle can definitely be used to estimate the working capital requirements for any firm.

In this approach, the working capital estimate depends upon the operating cycle of the firm. A detailed analysis is made for each component of working capital and estimation is made for each of these components. The different components of working capital may be enumerated as follows : Current Assets: Cash and Bank Balance Inventory of Raw Material Inventory of Work-in-progress Inventory of Finished Goods Receivables Current liabilities Creditors for Expenses

Different components of current assets require funds depending upon the respective operating cycle and the cost involved. The current liabilities, on the other hand, provide financing depending upon the respective operating cycle or the lag period in payment.

14.2.4. The estimation of working capital requirement can now be made as follows:

(a) Need for Cash and Bank Balance : Every firm must maintain some minimum cash and bank balance (i.e., immediate liquidity) to meet day to day requirement for petty expenses,

general expenses and even for cash purchases. The minimum cash requirement for these transactions can be estimated on the basis of past experience. The need or motives for holding cash and bank balance have been discussed in detail in the next chapter. However, it must be noted, at this stage that the cash and bank balance must be estimated correctly for two reasons : (i) That the cash and bank balance is the least productive of all the current assets, hence a minimum balance be maintained, and (ii) The cash and bank balance provide liquidity to the firm, which is of utmost importance to any firm. The minimum cash and bank balance is also considered while preparing the cash budget for the firm (Chapter 14).

(b) Need for Raw Materials : Every manufacturing firm has to maintain some stock of raw material in stores in order to meet the requirements of the production process. The number of units to be kept in stores for different types of raw materials depend upon various factors such as raw material consumption rate, time lag in procuring fresh stock, contingencies and other factors. For example, if it takes 5 days to procure fresh stock of raw materials, and 50 units are used daily, then there should be a minimum of 250 units in stock. The firm may also like to have a safety stock of 20 units. Thus, the total units to be maintained in stores would be 270 units. If the cost per unit of this item of raw material is Rs. 10 per unit, then the working capital requirement is Rs. 2,700 (i.e., 270 × Rs. 10).

(c) Need for Work-in-progress : In any manufacturing firm, the production process is continuous and is generally consisting of several stages. At any particular point of time, there will be different number of units in different stages of production. Some of these units may be 10% complete, some may be 60% complete and some may be even 99% complete. These units, which can neither be defined as raw material nor as finished goods, are known as work-in-progress or semi-finished goods. The value of raw material, wages and other expenses locked up in these semi-finished units is the working capital requirement for work-in-progress.

It may be noted that all the units are not equally completed and hence valuation of all these units is a difficult job. For this purpose, certain assumptions may be made as follows :

(i) The production process starts with the intake of full raw material. So, the value of raw material locked up in work-in-progress will be equal to full cost of number of units of raw material being represented in work-in-progress.

(ii) The units in work-in-progress may be unfinished with respect to labour expenses and overhead expenses only. Some of these units may be 10% complete, some may be 75% complete and some may be even 80% complete and so on. It is assumed for simplification, that all work-in-progress units are on an average 50% complete with respect to labour and overhead expenses. However, if some other information is given, then the valuation of work-in-progress may be made accordingly.

(d) Need for Finished Goods : In most of the cases, be it a trading concern or a manufacturing concern, the goods are not immediately sold after purchase/procurement/completion of production process. The goods in fact, remain in stores for some times before they are sold. The cost which is already incurred in purchasing, procuring or production of these units is locked up and hence working capital is required for them. It may be noted that these finished goods are valued on the basis of cost of these units. The carriage inward ofcourse, is included.

(e) Need for Receivables : The term receivables include the debtors and the bills. When the goods are sold by a firm on cash basis, the sales revenue is realized immediately and no

working capital is required for after sale period. However, in case of credit sales, there is a time lag between sales and collection of sales revenue. For example, a firm makes a credit sale of Rs. 1,50,000 per month and a credit of 15 days given to customers. The working capital locked up in receivables is Rs. 75,000 (Rs. 1,50,000 × 1/2 month).

However, an important point is worth noting here. The calculation of Rs. 75,000 is based upon the selling price, whereas the actual funds locked up in receivables are restricted to the cost of goods sold only. There is no investment in profit element as such. Therefore, it is better to calculate the working capital locked up in receivables on the cost basis. Thus, if the firm is selling goods at a gross profit of 20% then the working capital requirement in the above case, for receivables would be Rs. 60,000 only (i.e., Rs. 75,000 × 80%).

The total of working capital requirement for all the above elements is also known as the gross working capital of the firm. At any particular point of time every firm requires this gross working capital as there will be some units of raw materials in stores, some units in work-in-progress, some units as finished goods and there will be some debtors yet to be collected.

(f) Creditors for the Purchases : Likewise a firm sells goods and services on credit it may procure/purchases raw materials and finished goods on credit basis. The payment for these purchases may be postponed for the period of credit allowed by suppliers. So, the suppliers of the firm in fact provide working capital to the firm for the credit period. For example, a firm makes credit purchases of Rs. 60,000 per month and the credit allowed by the suppliers is two month, then the working capital supplied by the creditors is Rs. 1,20,000 (i.e., Rs. 60,000×2 months). It means that the firm would be getting the supplies without however, making the payment for two months. The postponement of the payment to the creditors makes the firm to utilize this money elsewhere or help the firm to sell on credit without blocking its own funds.(g) Creditors for Expenses and Wages : Usually, the expenses and wages are paid at the end of a month. However, these wages and expenses accumulate in the work-in-progress and finished goods on a regular basis. The time lag in payment of wages and other expenses also provide some working capital to the firm. It may be noted that these wages and expenses are considered for the valuation of work-in-progress and finished goods, but are paid usually at the end of the month, providing a working capital to the firm for that period.

The working capital estimation as per the method of operating cycle, is the most systematic and logical approach. In this case, the working capital estimation is made on the basis of analysis of each and every component of the working capital individually. As already discussed, the working capital, required to sustain the level of planned operations, is determined by calculating all the individual components of current assets and current liabilities. There are different steps required for estimation of working capital based on operating cycle. These steps are :

(i) Identify the current assets and current liabilities to be maintained. Estimation of each element of current assets and current liability is required.

(ii) Determine the average operating cycle (or holding period) for each of these elements. Calculation of different holding periods has been explained in the previous chapter.

(iii) Find out the rate per unit for each of these elements. For example, the rates of raw materials, work in progress, finished goods are to be ascertained.

(iv) Find out the amount (funds) expected to be blocked in each of these elements. For example, in raw materials, the funds blocked are : Av. holding period × No. of units required

Per Period × Rate per unit. (v) Prepare the working capital estimation sheet and find out the working capital requirement.

14.2.5. The calculation of net working capital may also be shown as follows :

Working Capital = Current Assets – Current Liabilities
= (Raw Material Stock + Work-in- progress Stock + Finished Goods Stock + Debtors + Cash Balance) – (Credi- tors + Outstanding Wages + Outstanding Overheads), where,
Raw Material Stock = Cost (Average) of Materials in Stock.
Work-in-progress Stock = Cost of Materials + Wages + Overhead of Work-in-progress.
Finished Goods Stock Creditors for Material = Cost of Materials + Wages + Overhead of Finished Goods. Creditors for Materials = Cost of Average Outstanding Creditors.
Creditors for Wages = Average Wages Outstanding.
Creditors for Overhead = Average Overheads Outstanding.
Thus, Working Capital = Cost of Materials in Stores, in Work-in-progress, in Finished Goods and in Debtors.
Less : Creditors for Materials
Plus : Wages in Work-in-progress, in Finished Goods and in Debtors.
Less : Creditors for Wages.
Plus : Overheads in Work-in-progress, in Finished Goods and in Debtors. Less : Creditors for Overheds.
The work-sheet for estimation of working capital requirements under the operating cycle method may be presented as follows :

14.3. METHODS FOR ESTIMATING WORKING CAPITAL REQUIREMENT

There are broadly three methods of estimating or analyzing the requirement of working capital of a company, viz. percentage of revenue or sales, regression analysis, and operating cycle method. Estimating working capital means calculating future working capital. It should be as accurate as possible because the working capital planning would be based on these estimates, and banks and other financial institutes finance the working capital needs to be based only on such estimates.

Estimating Working Capital Requirement: Top 5 Methods | Financial Analysis : The following points highlight the top five methods for estimating working capital requirements, i.e., 1. Percentage of Sales Method 2. Regression Analysis Method 3. Cash Forecasting Method 4. Operating Cycle Method 5. Projected Balance Sheet Method.

14.3.1. Percentage of Sales Method

Percentage of Sales Method is the easiest of the methods for calculating the working capital requirement of a company. This method is based on the principle of 'history repeats itself.' For estimating, a relationship of sales and working capital is worked out for, say last 5 years. If it is constantly coming near, say 40%, i.e., working capital level is 40% of sales, the following year's estimation is done based on this estimate. If the expected sales are 500 million dollars, 200 million dollars would be required as working capital. This method of estimating working capital requirements is based on the assumption that the level of working capital for any firm is directly related to its sales value. If past experience indicates a stable

relationship between the amount of sales and working capital, then this basis may be used to determine the requirements of working capital for future period.

Thus, if sales for the year 2007 amounted to Rs 30,00,000 and working capital required was Rs 6,00,000; the requirement of working capital for the year 2008 on an estimated sales of Rs 40,00,000 shall be Rs 8,00,000; i.e. 20% of Rs 40,00,000. The individual items of current assets and current liabilities can also be estimated on the basis of the past experience as a percentage of sales. This method is simple to understand and easy to operate but it cannot be applied in all cases because the direct relationship between sales and working capital may not be established.

The advantage of this method is that it is very simple to understand and calculate also. The disadvantage includes its assumption, which is difficult to be true for many organizations. So, this method is not useful where there is no linear relationship between the revenue and working capital. In new startup projects, this method is not applicable because there is no past.

14.3.2. Regression Analysis Method
(Average Relationship between Sales and Working Capital)

This method of forecasting working capital requirements is based upon the statistical technique of estimating or predicting the unknown value of a dependent variable from the known value of an independent variable. It is the measure of the average relationship between two or more variables, i.e.; sales and working capital, in terms of the original units of the data. Regression Analysis Method is a statistical estimation tool utilized by mass for various types of estimation. It tries to establish a trend relationship. We will use it for working capital estimation. This method expresses the relationship between revenue & working capital in the form of an equation (Working Capital = Intercept + Slope * Revenue). The slope is the rate of change of working capital with one unit change in revenue. Intercept is the point where regression line and working capital axis meet (Will not go deeper into statistical details). At the end of the statistical exercise with past revenue and working capital data, we will get an equation like the below:

Working Capital = -6.34 + 0.46 * Revenue
To calculate working capital, just put the targeted revenue figure in the above equation, say 200 million dollars.
Working Capital = -6.34 + 0.46 * 200 = -6.34 + 92 = 85.66 ~ 86 Million Dollar.
Therefore, we need 86 million dollars of working capital to achieve a revenue of 200 million dollars.

14.3.3. Cash Forecasting Method

This method of estimating working capital requirements involves forecasting of cash receipts and disbursements during a future period of time. Cash forecast will include all possible sources from which cash will be received and the channels in which payments are to be made so that a consolidated cash position is determined.

This method is similar to the preparation of a cash budget. The excess of receipts over payments represents surplus of cash and the excess of payments over receipts causes deficit of cash or the amount of working capital required.

The following illustration explains the cash forecasting method of estimating working capital requirements:
Texas Manufacturing Company Ltd. is to start production on 1st January, 2009. The prime cost of a unit is expected to be Rs 40 out of which Rs 16 is for materials and Rs 24 for labour. In addition, variable expenses per unit are expected to be 7 & Rs 8 and fixed expenses per month Rs 30,000.

Payment for materials is to be made in the month following the purchases. One-third of sales will be for cash and the rest on credit for settlement in the following month. Expenses are payable in the month in which they are incurred. The selling price is fixed at Rs 80 per unit.

14.3. 4. Operating Cycle Method

The operating cycle method is probably the best of the methods because it considers the actual business or industry situation while giving an estimate of working capital. A general rule can be stated in this method. The longer the working capital operating cycle, the higher the requirement for working capital and vice versa. We would agree on the point also. This method of estimating working capital requirements is based upon the operating cycle concept of working capital. The cycle starts with the purchase of raw material and other resources and ends with the realization of cash from the sale of finished goods.
It involves purchase of raw materials and stores, its conversion into stock of finished goods through work-in-process with progressive increment of labour and service costs, conversion of finished stock into sales, debtors and receivables, realization of cash and this cycle continues again from cash to purchase of raw material and so on. The speed/time duration required to complete one cycle determines the requirement of working capital – longer the period of cycle, larger is the requirement of working capital and vice-versa.

The following formula can be used to estimate or calculate the working capital

Working Capital = Cost of Goods Sold (Estimated) * (No. of Days of Operating Cycle / 365 Days) + Bank and Cash Balance.
If the cost of goods sold (estimated) is $35 million and the operating cycle is 75 days, the bank balance required is 1.25 million. Therefore, Working Capital = 35 * 75/365 + 1.25 = $8.44 Million. In this method, each component can also be calculated. It means a bifurcation of $8.44 million can be done in inventory, cash, accounts receivable, accounts payable, etc.
For proper computation of working capital under this method, a detailed analysis is made for each individual component of working capital. The value of each individual item of current assets and current liabilities is determined on the basis of estimated sales or budgeted production or activity level as follows:

(a) Stock of Raw Material:
The amount of working capital funds to be invested in holding stock of raw material can be estimated on the basis of budgeted units of production, estimated cost of raw material per unit and the average duration for which the raw material is held in stock by using the following formula: (Note. 360 days in a year may. be assumed in place of 365 to simplify calculations in some cases)

(b) Stock of Work-in-Process:
In manufacturing/processing industries the production is carried on continuous basis. At the end of the period, some work remains incomplete even though all or some expenses have

been incurred, this work is known as work-in-progress or partly completed or semi-finished goods. The work-in-process consists of direct material, direct labour and production overheads locked up in these semi-finished goods. (i) 360 days a year may be assumed to simplify calculations.

(ii) In the absence of information about stage of completion of WIP with regard to material labour and overheads, 100% of material cost, and 50% of labour and production overheads cost may be assumed as the estimated cost of work-in-process.

(iii) In case cash cost approach' is followed for estimation of working capital, then depreciation should be excluded from production overheads while calculating cost of work-in-process. However, under the total approach, depreciation is also included.

(c) Stock of Finished Goods: The amount of funds to be invested in holding stock of finished goods can be estimated on the basis of annual budgeted units of production, estimated cost of production per unit and the average holding period of finished goods stock by using the following formula:

(i) Cost of production consist of 100% of material, labour and production overheads costs.

(ii) Under the total cost approach, depreciation is included in the cost of goods produced.

However, depreciation is to be excluded under the cash cost approach.

(d) Investment in Debtors/Receivables. When the sales are made by a firm on cash basis, the amount is realized immediately and no funds are blocked for after sale period. However, in case of credit sales, there is a time lag between sales and realization of cash. Thus, funds are to be invested in receivables, i.e. debtors and bills receivables.

However, actual amount of funds locked up in receivables is only to the extent of cost of sales and not the actual sales which include profit. It would, therefore, be more appropriate to ascertain the amount of funds to be invested in debtors/receivables at cost of sales and not the selling price. But in case, total approach is followed for estimation of working capital then receivables may be computed on the basis of selling price.

(i) Cost of sales = Cost of goods produced/sold + Office and administrative overheads + Selling and distribution overheads

(ii) Selling price per unit should be considered in place of cost of sales per unit in case total approach is to be followed for estimation of working capital. Under the total approach, all costs including depreciation and profit margin are included.

(e) Cash and Bank Balance:

Cash is one of the current assets of a business. It is needed at all times to keep the business going. A business firm has to always keep sufficient cash to meet its obligations. Thus, a minimum desired cash and bank balance to be maintained by a firm should be considered as an important component of current assets while estimating the working capital requirements.

(f) Prepaid Expenses:

Some of the expenses like wages, manufacturing overheads, office and administrative expenses and selling and distribution expenses etc. may have to be paid in advance. Such

prepayment of expenses should also be estimated while computing working capital requirements of a firm.

(g) Trade Creditors:
The term trade creditor refers to the creditors for purchase of raw material, consumables, stores etc. The suppliers of goods, generally, extend some period of credit in the normal course of business. The trade credit arrangement of a firm with its suppliers is an important source of short-term finance. It reduces the amount of net working capital required by a firm.

(h) Creditors for Wages and Other Expenses:
Wages and salaries are usually paid on monthly, fortnightly or weekly basis for the services already rendered by employees. The longer the payment – period, the greater is the amount of current liability towards employees or the funds provided by them. In the same manner, other expenses may also have to be paid after the lag of a certain period. The amount of such accrued or outstanding expenses reduces the level of net working capital requirements of a firm.

(i) The creditors for wages and each of the overheads may be calculated separately.

(ii) In case of selling overheads, budgeted annual sales in units should be considered in place of budgeted production units,

Approaches to Estimation of Working Capital Requirements:

While studying the valuation of each individual item of current assets or current liabilities under the operating cycle method, that there are two approaches which are followed in the estimation of working capital requirements: (a) Total Approach (b) Cash Cost Approach

(a) Total Approach:
Under this approach of estimation of working capital requirements, all costs including depreciation and profit margin are included. Thus, production overhead inclusive of depreciation is considered for calculation of the cost of work-in-progress. In the same manner, cost of goods produced includes depreciation. Further, the computation of funds invested in debtors is done on the basis of selling price including profit margin.

(b) Cash Cost Approach:
Under this approach, the amount of working capital is estimated on the basis of only cash costs incurred. Thus, depreciation being non-cash is excluded while calculating the cost of work-in-process, cost of goods produced and cost of goods sold. In the same manner, debtors are computed on the basis of cash cost of sales excluding profit margin.

14.3.5. Projected Balance Sheet Method

Under this method, projected balance sheet for future date is prepared by forecasting of assets and liabilities by following any of the methods stated above. The excess of estimated total current assets over estimated current liabilities, as shown in the projected balance sheet, is computed to indicate the estimated amount of working capital required.

The company enjoys one month's credit from suppliers of raw materials and maintains 2 months stock of raw materials and one and a half months finished goods. Cash balance is

maintained at Rs 1, 00,000 as a precautionary balance. Assuming a 10% margin, find out the working capital requirements of ABC Ltd. Cost of sales for computation of debtors and stock of finished goods may be taken at sales minus gross profit as per rate of gross profit given.

Profits have been ignored while preparing working capital requirements for the following reasons:
(i) Profits may or may not be used for working capital.
(ii) Even if profits have to be used for working capital, they have to be reduced by the amount of income tax, dividends, etc.

14.4.SUMMARY

The present lesson no-14 is required to establish the title that "Estimating working capital needs". After studying this lesson you should be able to: Know the concept of Working Capital control, Understand the Management of Loans and Advances , & Awareness about banking policy on Working Capital. It is established seven aspects to reach the said above objectives. Such established aspects are as follows: 14.1. Introduction 14.2. Working Capital Estimating approaches 14.3. Working Capital Estimating Methods 14.4. Summary 14.5. Technical terms 14.6.Self Assessment Questions 14.7. Suggested Readings.

14.5. TECHNICAL TERMS

Methods :1 : a procedure or process for attaining an object: such as. a(1) : a systematic procedure, technique, or mode of inquiry employed by or proper to a particular discipline or art. (2) : a systematic plan followed in presenting material for instruction the lecture method.

Liabilities : A liability is something a person or company owes, usually a sum of money. Liabilities are settled over time through the transfer of economic benefits including money, goods, or services.

Estimated : 1a : a rough or approximate calculation. b : a numerical value obtained from a statistical sample and assigned to a population parameter. 2 : a statement of the cost of work to be done. 3 : an opinion or judgment of the nature, character, or quality of a person or thing had a high estimate of his abilities.

Finished goods : Finished goods are goods that have been completed by the manufacturing process, or purchased in a completed form, but which have not yet been sold to customers. Goods that have been purchased in completed form are known as merchandise.

Operating Cycle: The operating cycle is the average period of time required for a business to make an initial outlay of cash to produce goods, sell the goods, and receive cash from customers in exchange for the goods.

Projected balance sheet : A projected balance sheet is also referred to as a pro forma balance sheet. It shows the estimation of the total assets and total liabilities of any business. A pro forma balance sheet is a tabulation of future projections. As a result, it will help your business manage your assets now for better results in the future.

14.6. SELF ASSESSMENT QUESTIONS

1. What is the meaning of working capital requirements? Discuss.
2. What are the estimated process working capital approaches? Discuss.
3. What are the working capital methods? How can these methods are useful in estimation of working capital needs?
4. What is projected balance sheet method? Explain
5. What is operating cycle method? Explain.
6. What is Credit Administration?

14.7. SUGGESTED READINGS

1. I.M. Panday: "Financial Management " Vikas Publishing House (P) Ltd
2. Chandra, Prasanna "Financial Management " Tata Publishing House Ltd, New Delhi
3. S.N. Maheswari : "Principles of Financial Management " Sultan Chand, Delhi
4. Sheeba Kapil : "Financial Management " Pearson, 2011
5. P.V. Kulakarni: "Financial Management " Himalaya Publishing House Bombay
6. Khan & Jain : Cases in "Financial Management " Tata Publishing House Ltd, Delh
7. Bhalla V.K. : Financial Management, S. Chand & Company Pvt. Ltd. New Delhi.

LESSON - 15
ASSESSING GLOBAL LIQUIDITY OF WORKING CAPITAL

Aims and Objectives

After studying this lesson you should be able to:

- Know the Global Liquidity Concept, Measurement & Policy Implications
- Understand the Drivers and transmission mechanisms in global liquidity.

Structure

15.1. INTRODUCTION

Liquidity refers to how easily an investment can be sold for cash. T-bills and stocks are considered to be highly liquid since they can usually be sold at any time at the prevailing market price. On the other hand, investments such as real estate or debt instruments and illiquid assets trade at a discount. The pyramid shows that: half of the world's net wealth belongs to the top 1%, top 10% of adults hold 85%, while the bottom 90% hold the remaining 15% of the world's total wealth, top 30% of adults hold 97% of the total wealth. The minimum net worth of the top 1% is roughly $11.1 million. A person would need to earn an average of $823,763 per year in order to join the top 1%. Transforming illiquid assets into assets than can be readily sold on a market thereby increases liquidity. For example, a bank can use securitization to convert a portfolio of mortgages (which individually are illiquid assets) into cash (a very liquid asset).

i. **International Monitory Fund:** The IMF was established in 1944 in the aftermath of the Great Depression of the 1930s. 44 founding member countries sought to build a framework for international economic cooperation. Today, its membership embraces 190 countries, with staff drawn from 150 nations. The IMF is governed by and accountable to those 190 countries that make up its near-global membership.

International Monitory Fund (IMF) and International Liquidity the primary component of international liquidity that a country possesses is its international reserves which are made up of gold holdings and foreign exchange assets in US dollars and pound sterling. The subsidiary resources of international liquidity are provided by IMF. Nonetheless, Special

Drawing Rights (SDR) allocations can play a role in providing liquidity and supplementing member countries' official reserves, as was the case amid the global financial crisis.

At the top of its organizational structure is the Board of Governors. The day-to-day work of the IMF is overseen by its 24-member Executive Board, which represents the entire membership and supported by IMF staff. The Managing Director is the head of the IMF staff and Chair of the Executive Board. S/he is assisted by four Deputy Managing Directors. The IMF's resources mainly come from the money that countries pay as their capital subscription (quotas) when they become members. Each member of the IMF is assigned a quota, based broadly on its relative position in the world economy. Countries can then borrow from this pool when they fall into financial difficulty.

ii. Special Drawing Right: The Special Drawing Right (SDR) is an interest-bearing international reserve asset created by the IMF in 1969 to supplement other reserve assets of member countries. The SDR is based on a basket of international currencies comprising the U.S. dollar, Japanese yen, euro, pound sterling and Chinese Renminbi.The SDR serves as the unit of account of the IMF and other international organizations. The SDR is neither a currency nor a claim on the IMF. The IMF's resources mainly come from the money that countries pay as their capital subscription (quotas) when they become members. Each member of the IMF is assigned a quota, based broadly on its relative position in the world economy. Countries can then borrow from this pool when they fall into financial difficulty.

The measures of monetary liquidity include base money and broader money aggregates, central bank assets, foreign exchange reserves, and official foreign exchange reserves as a percentage of the GDP. The current ratio (also known as working capital ratio) measures the liquidity of a company and is calculated by dividing its current assets by its current liabilities. The term current refers to short-term assets or liabilities that are consumed (assets) and paid off (liabilities) is less than one year.

iii. Bank for International Settlements (BIS):

The term global liquidity is used by the Bank for International Settlements (BIS) to mean the ease of financing in global financial markets. Credit is among the key indicators of global. Traditionally, global liquidity has been defined. as the sum of narrow money created by central banks and international reserves within. advanced economies. Such a monetary liquidity. For a company, liquidity essentially measures its ability to pay off its bills when they are due, or how easily and effectively a company can access the money it needs to cover its debts. Working capital reflects the liquid assets a company utilizes to make such debt payments. Working capital affects both the liquidity as well as profitability of a business. As the amount of working capital increases liquidity of the business increases. However since current assets offer low return with the increase in working capital the profitability of the business falls. Within Global Liquidity and Cash Management (GLCM), we enable clients to make payments, receive funds and have visibility of their cash balances across the world, ultimately supporting their growth by helping them make smarter business decisions There is around $40 trillion in physical money present globally. This amount can touch a quadrillion if cryptocurrencies, broad money (M2 and M3) and investments and derivatives are added to that total. What is liquidity with example?

15.2. MEASUREMENT OF GLOBAL LIQUIDITY

The real interest rates are calculated by subtracting the annual rate of inflation from the individual economies' policy rates. These rates are then aggregated together using GDP weights. This type of indicator is one tool for gauging global liquidity conditions. Global liquidity has become a key focus of international policy debates over recent years. This reflects the view that global liquidity and its drivers are of major importance for international financial stability. The concept of global liquidity, however continues to be used in a variety of ways and this ambiguity can lead to unfounded and potentially destabilising policy initiatives. In a world of high capital mobility, global liquidity cannot be approached as it used to be a few decades ago.

It has both an official and a private component. The official component can be defined as "the funding that is unconditionally available to settle claims through monetary authorities." It can be accessed through various instruments, such as foreign exchange reserves and swap lines between central banks. Ultimately, only central banks can create official liquidity. IMF programmes and SDRs, in turn, are vehicles for mobilising official liquidity, but are not tools for liquidity creation.

Private global liquidity displays both an increasing trend and a strong cyclical component. The increasing trend is a result of deeper financial integration between countries and financial innovation (spurred, among other things, by regulatory changes). But private global liquidity is also highly cyclical because it is driven by divergences in growth rates, monetary policies and, above all, risk appetite. Private liquidity can give rise to international spillovers as many financial institutions provide liquidity both domestically and in other countries.

The creation and destruction of private liquidity is closely related to leveraging and deleveraging by private institutions. Hence, globally, private liquidity is linked to the dynamics of gross international capital flows, including cross-border banking or portfolio movements. This international component of liquidity can be a potential source of instability, because of its own dynamics or because it amplifies cyclical movements in domestic financial conditions and intensifies domestic imbalances.

There is some interaction between official and private liquidity. In normal times and particularly in boom periods, the supply of global liquidity will be largely determined by international banks (either directly or through financial markets). In times of stress, the supply of global liquidity will depend crucially on the private sector's access to official liquidity. Global liquidity, and especially its private component, is best assessed on the basis of a combination of both price and quantity measures. Price indicators tend to provide information about the conditions at which liquidity is provided, while quantity measures capture how far such conditions translate into Policy responses to global liquidity call for a consistent framework that considers all phases of global liquidity cycles, countering both surges and shortages.

In order to manage the firm's liquidity effectively, corporate treasury and finance teams need to have a clear view of the company's cash position, as this will help them identify any liquidity gaps that need to be addressed. This means carrying out real-time cash modeling and forecasting.

International liquidity problem is the problem of inadequacy of international reserves. Reserves are said to be inadequate when their availability is insufficient to ensure the smooth functioning of the international monetary system and to meet the expanding world trade.

15.3. POLICY RESPONSES TO GLOBAL LIQUIDITY

This provides the first line of defence, even though additional policy action will be needed at both the domestic and international levels to better deal with both surges and disturbances of global liquidity provision. This implies a key role for central banks as macroprudential and monetary policymakers and through their involvement in financial regulation and supervision. Specifically, while country-specific or regional shocks may be addressed through self-insurance and existing arrangements for the international distribution of liquidity, such as IMF programmes and similar facilities, global liquidity shocks will require interventions by institutions with the ability to supply official liquidity in an elastic manner and in potentially very sizeable amounts to break downward liquidity spirals. Only central banks have this ability.

Policy responses to global liquidity call for a consistent framework that considers all phases of global liquidity cycles, countering both surges and shortages. Such a framework should rest on three lines of defense.

I. First line of defence: The first line of defense is the prevention of excessive liquidity surges through strengthened regulatory frameworks. The current reform agenda clearly goes in the right direction. It will limit the probability and frequency of liquidity disruptions by increasing the resilience of global financial intermediation. It will also dampen the amplitude of global liquidity cycles by limiting the intrinsic procyclicality of our financial systems.

ii. Second line of defence : Domestic policies are a second line of defense. They include, inter alia, macroprudential measures and central bank liquidity provision. One issue is the extent to which individual countries will want to insure themselves against liquidity shocks by building sufficiently large stocks of foreign reserves. The accumulation of reserves, which has been on an increasing trend, entails some negative externalities as well as operational challenges. The report notes, however, the complexity of drivers behind

iii. **Third line of defence:** Cooperative measures for the provision of liquidity in crisis situations provide the third line of defence**.** Central banks have a key role to play in all these policy areas. The established cooperative Basel process ensures that central banks understand each others' reaction functions and economic outlooks. This provides the context within which they can set their own policies in a manner consistent with their domestic policy principles and financial and price stability objectives. Working through this process, central banks remain well placed to address future surges and shortages in global liquidity.

There is a well known tradeoff between ex ante clarity and the risk of moral hazard. Existing IMF precautionary facilities have worked well, but it is important to preserve the current level of conditionality. Swap arrangements between central banks have played a crucial role in the crisis, which has shown that truly global liquidity shocks necessitate direct interventions in amounts large enough to break downward liquidity spirals. Central banks' ability to elastically supply potentially very sizeable amounts of foreign currency liquidity at short notice can thus successfully assure credibility among financial market participants. This

advantage has to be balanced, however, by the necessity of avoiding moral hazard, preserving monetary policy autonomy, and controlling financial risks for the liquidity-providing central bank.

15.4. GLOBAL LIQUIDITY – CONCEPT, MEASUREMENT AND POLICY IMPLICATIONS

Global liquidity has become a key focus of international policy debates over recent years. This reflects the view that global liquidity and its drivers are of major importance for international financial stability, both in the build-up phase for vulnerabilities and when any resulting financial imbalances unwind. This is for at least four reasons:

(i) with increasing financial integration, global financial conditions have a growing impact on domestic economic conditions in each country, affecting international capital flows and the dynamics of credit, financial asset and property prices in all major economies;

(ii) global liquidity can contribute to the build-up of financial system vulnerabilities in the form of large mismatches across currencies, maturities and countries;

(iii) shortages of global liquidity can have important implications for economic growth, as experienced in 2008–09; and

(iv) policy responses to these shortages, such as the accumulation of precautionary reserves, can affect capital flow patterns and financial markets more broadly. Given these observations, and against the backdrop of ongoing work at the G20 on the International Monetary System and Global Liquidity Management, in May 2011 BIS Governors asked the Committee on the Global Financial System (CGFS) to investigate the measurement, drivers and policy implications of global liquidity.

In response, the Committee decided to establish an Ad-hoc Group to analyse global liquidity, primarily from a financial stability perspective. The Group's deliberations are summarised in this report. It argues that the policy implications of global liquidity are best approached in the context of two distinct liquidity concepts. One is private (or private sector) liquidity and is closely associated with liquidity surges and related build-ups of risk in expansionary policy environments. Hence, responses to private liquidity are tightly linked with microand macroprudential policies as well as the financial reform agenda, which will help reduce the vulnerabilities associated with global liquidity cycles. The second concept is official (or public sector) liquidity and relates to situations of liquidity shortage or disruptions in the private provision of liquidity.

Policy considerations in this area are primarily related to discussions about precautionary foreign exchange reserve holdings, central bank swap lines and other tools for the international distribution of liquidity. Central banks have a key role to play in both policy areas.

15.4.1. Global liquidity and its drivers

Even with increased attention to global liquidity in recent years, a precise definition is still missing. Liquidity is a multifaceted concept and, if anything, "ease of financing" (or perceptions thereof) appears to be the common element.

i. Official liquidity – From a global perspective, an essential distinction to be introduced from the start is between official liquidity – which is created by the public sector – and private (or private sector) liquidity. For the purposes of this report, official (or public sector) liquidity is defined as the funding that is unconditionally available to settle claims through monetary authorities. Central banks create official liquidity in their domestic currency. They do so through their regular monetary operations and, in periods of stress, emergency liquidity support. Official liquidity can also be created as a consequence of other central bank actions, for instance changes in the terms under which standing facilities can be accessed. Various instruments can provide access to official liquidity in foreign currency.

a. The first and most traditional form is foreign exchange reserves, which can be mobilised to provide official liquidity at the discretion of the reserve-accumulating central bank.

b. Second, official liquidity can be accessed through swap lines between central banks.

c. A third possibility is dedicated facilities, such as IMF programmes or Special Drawing Rights (SDR).

Ultimately, all these instruments provide access to official liquidity created by foreign central banks, though subject to different degrees of friction and conditionality. SDR, for example, can be used (ie sold against usable currencies) only in limited quantities, with any increase in the global supply of liquidity entirely at the discretion of the reserve-providing central bank. Thus, SDR – and similar instruments – should best be seen as vehicles for mobilising official liquidity, but not as a tool for liquidity creation.

ii. Private liquidity. In a world of capital mobility and internationally integrated financial markets, the concept of global liquidity has come to cover also private liquidity. Nowadays, a key determinant of the funding conditions for the broader international economy is the behaviour of the financial sector, and its willingness to provide cross-border and/or foreign currency financing. Financial institutions provide market liquidity to securities markets, for instance through market-making activity, or provide funding liquidity through, for example, interbank lending. The conditions under which these intermediaries can fund their balance sheets, in turn, depend on the willingness of other private sector participants to provide funding or market liquidity.

This interdependence underlines the endogenous character of private liquidity. At the macroeconomic level, private liquidity is thus closely related to monetary liquidity or funding conditions, as reflected in various monetary and credit aggregates or measures of the cost of funding. From a financial stability perspective, two broad points can be made regarding private liquidity: First, private liquidity can give rise to international spillovers. Many financial institutions provide liquidity both domestically and in other countries, with the latter involving relationships between residents in different jurisdictions and/or in different currencies. While the same forces may drive domestic and global private liquidity dynamics, they can have quite different implications for domestic

15.5. DRIVERS AND TRANSMISSION MECHANISMS

Global liquidity – seen from a financial stability perspective – is based in large part on international financial flows (eg cross-border credit provision and foreign currency lending), which are determined by choices made in both source and recipient economies and by the

official as well as private sectors. Global liquidity conditions are the result of interactions among three major categories of drivers:

(i) macroeconomic factors, including economic growth, the stance of monetary policy, exchange rate regime choice, capital account policies and the way they affect global imbalances;

(ii) other public sector policies, including financial regulation; and

(iii) financial factors that guide the behaviour of financial market participants and intermediaries, such as financial innovation and risk appetite. Both macroeconomic and financial factors change and interact in complex ways, blurring any distinction between driving factors (as the source of impulses) and their associated transmission or amplification mechanisms. This section provides a broad description of the main drivers and their interactions.

15.5.1 Macroeconomic factors

Macroeconomic factors influence global liquidity through actual funding costs, return expectations, and market participants' perceptions of economic risks for individual markets, economies and the world economy as a whole. As a result, macroeconomic policies have a major influence on both the supply of and demand for global liquidity, even though, in practice, a broad host of private sector factors will be important as well. Monetary policy and interest rate differentials. The stance of monetary policy determines domestic short-term interest rates and influences risk-free (nominal) yield curves through expectations about the future path of policy rates. Interbank market rates and those for other financial assets are set on the basis of these risk-free rates, with risk premia added to reflect market-specific liquidity and counterparty risks as well as risk appetite.

The level of interest rates, in turn, affects the growth rate of private credit and overall funding and liquidity conditions throughout the economy. At the same time, it is important to note that monetary policies are themselves endogenous and move in response to macroeconomic factors (real growth and inflation) that can drive risk-taking and global credit. Also, longer-term interest rates, especially real ones, are driven by more than simply monetary policy, and can be affected by factors such as global savings and investment patterns.

Easy monetary conditions or low longer-term interest rates may also increase private liquidity by inducing search for yield behaviour in financial markets, for example through incentives for carry trades and similar cross-currency investment strategies. Hence, periods with low policy rates or elevated interest rate differentials across currency areas can be associated with over-optimistic risk perceptions and elevated risk tolerance, leading to a mispricing of assets and excessive easing of lending standards (see also Section 2.2.3 below).

Exchange rate policies. One factor in the transmission of monetary stimuli across currency areas is exchange rate regimes. Allowing the exchange rate to adjust can help to mitigate the transmission of policy spillovers and reduce capital flows induced by currency misalignments or other macroeconomic factors. A country pegging its exchange rate, in turn, effectively adopts a foreign currency's monetary policy stance if capital movements are fully liberalised and will accumulate or reduce official reserve holdings as external adjustment pressures translate into exchange rate intervention (see Section 4.2 below). In addition, a commitment

to maintain a peg may be perceived as an implicit guarantee and can create powerful incentives for unhedged foreign currency borrowing and lending. This can be a source of systemic risk if the currency peg is abandoned, unless appropriately addressed by prudential measures.

Yet, even flexible exchange rates do not fully insulate a country from the spillover effects of foreign macroeconomic conditions. 7 This is shown by the existence of strong international asset market linkages among advanced countries with floating currencies, as illustrated by the global crisis. As a result, for both flexible and fixed exchange rate regimes, surges in capital inflows can affect domestic credit and asset prices. They may also help to trigger or exacerbate financial boom-bust cycles. In this context, the strength and propagation of the effects of cross-border flows on credit and liquidity creation in recipient countries will depend on the degree of exchange rate flexibility as well as on factors such as the financial structure of the recipient economy.

Empirical evidence establishes strong links between global monetary policy spillovers and official reserve accumulation as well as portfolio flows. Specifically, rising exchange rate flexibility in receiving economies seems to be associated with smaller monetary policy spillovers into domestic asset returns, though without insulating recipient countries altogether. At the same time, causal relationships may go in both directions, suggesting that global as well as domestic policy influences are determinants of asset returns. See eg IMF (2010).

15.5.2. Other public sector policies

Central bank liquidity policies. The characteristics of central bank liquidity facilities (including collateral policies) can have important effects on the availability and allocation of liquidity. During the recent financial crisis, the introduction of extraordinary (temporary) liquidity facilities helped to support the functioning of funding markets under conditions of illiquid global capital markets and elevated financial stress. The expansion of central bank collateral frameworks countered deteriorating private liquidity conditions as many assets were no longer accepted as collateral in private transactions. Given the significant reliance of financial institutions on market sources of funding, these policies had more general effects on liquidity and financial conditions throughout the financial system Financial regulation. Banks and other intermediaries will deploy available funds globally according to portfolio allocation decisions that seek out the most profitable use of such funds. The ability to extend liquidity cross-border thus depends on the availability of markets, instruments and infrastructures (including cross-border payment and settlement systems) for cross-border financing and the way that financial intermediaries organise their international business.8 These factors, in turn, importantly reflect incentives created by prudential regulation, which will constrain the choices made by financial intermediaries and their counterparties (including any constraints on foreign exchange borrowing or lending applying in recipient countries). Differences in regulation and supervision across market participants and jurisdictions can play a key role. While banks tend to face rather stringent capital and liquidity requirements, non-bank financial intermediaries may not. This, together with different business models, implies that non-bank entities may affect global liquidity conditions in ways that are largely beyond the scope of regulatory policies.
However, coordinated efforts to reduce the scope for regulatory arbitrage could help mitigate these risks.

15.5.3. Financial factors

Financial integration. Financial integration promotes greater cross-border financing flows and facilitates access to new financial products across jurisdictions. The degree of financial integration therefore has a bearing on global liquidity by affecting any spillovers of domestic liquidity into other economies. Apart from global banks, other highly active participants, such as global investment funds, have taken on a more active role in international markets. These developments have increased the number and diversity of market participants, and hence added to market liquidity. At the same time, and consistent with the endogeneity of liquidity, there has been a positive feedback effect as the increase in market liquidity itself attracted new participants. Financial innovation. Financial innovation often leads to the development of instruments that create new means of payment or enhance market or funding liquidity. A first example for the liquidityenhancing effect of financial innovation is securitisation, which involves the transformation of illiquid assets into more liquid ones via the pooling and transfer of assets to bankruptcy-remote special purpose vehicles, which may then issue tranched claims against the assets. The large cross-border investments of international banks in securitised products illustrate how this innovation may have contributed to global liquidity. Another example is more widespread use of collateralised funding. It has been argued that repo contracts, which served as a major pre-crisis source of short-term financing for many financial institutions, represented an important form of money creation, since the collateral received in repo transactions could be re-hypothecated. Again, to the extent that such markets are international, there will be effects on global liquidity. Third, derivatives affect market liquidity. On the one hand, derivatives that are sufficiently standardised facilitate position-taking and hedging due to their low cost and high flexibility – in both the domestic and international contexts. On

15. 5.4 Interactions and dynamics

Taking into account the drivers and transmission mechanisms described above, the dynamics of global liquidity are perhaps most easily summarised by way of reference to two broad types of interactions: between risk and liquidity; and between private and official liquidity. These, in turn, affect shock transmission across economies and financial systems.

Risk and liquidity. Liquidity, no matter how defined, is widely understood to follow a cyclical pattern, reflecting the self-reinforcing interaction between risk appetite and liquidity. At a broad level, risk appetite is influenced by liquidity conditions, while liquidity depends on the ability and propensity of 9 See Section 3.3 below and McGuire and von Peter (2009) for an example in the context of cross-currency funding activities by European banks.

Central banks receiving foreign currency, in turn, may wish to consider adjusting their collateral policies in order to make their lending more effective. Specifically, they could consider whether expanding the range of assets eligible for central bank loans to include instruments denominated in the foreign currency might usefully broaden the base for central bank lending in that currency, without compromising risk management.

Concerns over global liquidity have increased over recent years. At the same time, conceptual ambiguities run the risk of leading to unfounded and potentially destabilising policy initiatives. What is needed is a consistent policy framework for addressing global liquidity. The financial reform agenda and evolving macroprudential policy frameworks clearly work in the direction of reducing vulnerabilities associated with global liquidity cycles, through both enhanced financial sector resilience and reduced procyclicality.

Central banks, working cooperatively through the Basel Process, thus remain well placed to address future surges and shortages in global liquidity. The established cooperative process ensures that central banks understand each other's reaction functions and economic outlooks, and develop and discuss their own views on how the monetary stance in individual economies can have spillover effects across jurisdictions. This provides the context within which they can set their own policy in a manner consistent with their financial and price stability objectives. It also provides a proven and effective forum for cooperation between central banks in times of crisis and in their role as lenders of last resort.

15.6. MANDATE OF THE CGFS AD-HOC GROUP ON GLOBAL LIQUIDITY

A financial system consists of institutional units and markets that interact, typically in a complex manner, for the purpose of mobilizing funds for investment, and providing facilities, including payment systems, for the financing of commercial activity. The Global Financial Stability Report (GFSR) replaced two previous reports by the IMF, the annual International Capital Markets Report and the quarterly Emerging Market Financing Report. Central banks are responsible for economic and monetary policy and they make sure the soundness of the financial system. These institutions set interest rates and control the money supply of a country. The U.S. Federal Reserve is one of the most powerful central banks in the world.

Committee on the Global Financial System (CGFS), which is chaired by Philip Lowe, Governor of the Reserve Bank of Australia. The Committee on the Global Financial System (CGFS) is one of the central banks' committees at the Bureau of Indian Standards: BIS is the National Standard Body of India established under the BIS Act 2016. BIS . It assists central banks in recognising, analysing and responding to threats to the stability of financial markets and the global financial system.

Background and objective Progress on reforming the International Monetary System is a priority for the G20 in 2011, including improvement in the management of global liquidity. In this context, Governors have asked the CGFS to investigate the measurement, drivers and policy implications of global liquidity. The Committee's work will inform discussions among Governors of policy implications with a view to providing input into the G20 deliberations.
Mandate The Ad-hoc Group on Global Liquidity will analyse global liquidity primarily from a financial stability perspective. Specifically, the group will (i) articulate how the concept of global liquidity can be defined and identify measures/indicators that can be used to monitor global liquidity, (ii) identify key drivers of global liquidity and (iii) discuss the policy implications of the analysis. The Group would proceed in two stages as follows:

15.6.1. Stage 1: Concept, assessment and drivers

i. Discuss alternative definitions of global liquidity and how they are related, taking a financial stability perspective: o Propose appropriate measures/indicators for these various liquidity concepts. o Consider ways for assessing global liquidity on the basis of these measures.
ii. Identify and discuss key drivers of global liquidity (eg monetary policy stance, financial regulation, financial innovation (including derivatives), risk appetite over the cycle): o Discussion of "equilibrium"/"excess" liquidity concepts. o The evolution of global liquidity over time.

15.6.2. Stage 2: Policy implications of global liquidity-

i. On the basis of Stage 1 conclusions: i. Consider potential mechanisms for dealing with global liquidity surges and shortages (eg reserve holdings, central bank swap lines, financial safety nets, SDRs and IMF lending capacity).

ii. Identify implications of the financial reform agenda for global liquidity (eg macro and micro regulation, macroprudential policy, evolution of shadow banking). Process The Group will be chaired by Jean-Pierre Landau (Banque de France). Governors would receive an interim report on stage 1 results in late June, which would also form the basis for an interim input into the G20 discussion in July. A final draft report would be prepared for the CGFS meeting in September 2011. The Group's work would also form the basis for a discussion at the September Governors' meetings. Based on these discussions, Governors could decide to submit the report (with amendments if necessary) to the G20 in mid-Octob

15.7. SUMMARY

The title of the present lesson-15 is "Assessing the global liquidity of working capital" is covered different aspects such as: 15.1. Introduction 15.2. Measurement of global liquidity 15.3.Policy responses to global liquidity 15.4. Global Liquidity – Concept, Measurement and Policy Implications 15.5. Drivers and transmission mechanisms 15.6. Mandate of the CGFS Ad-hoc Group on Global Liquidity 15.7.Summary 15.8.Technical Terms 15.9. Self Assessment Questions 15.10. Suggested Readings

15.8. TECHNICAL TERMS

Global Liquidity : The term global liquidity is used by the BIS mean the ease of financing in global financial markets. Credit is among the key indicators of global .

CGFS The Committee on the Global Financial System (CGFS), which is chaired by Philip Lowe, Governor of the Reserve Bank of Australia, monitors developments in ...

IMF : The International Monetary Fund (IMF) works to achieve sustainable growth and prosperity for all of its 190 member countries. It does so by supporting economic policies that promote financial stability and monetary cooperation, which are essential to increase productivity, job creation, and economic well-being.

SDR : The Special Drawing Right (SDR) is an interest-bearing international reserve asset created by the IMF in 1969 to supplement other reserve assets of member countries. The SDR is based on a basket of international currencies comprising the U.S. dollar, Japanese yen, euro, pound sterling and Chinese Renminbi.

GFSR : The Global Financial Stability Report (GFSR) is a semiannual report by the International Monetary Fund (IMF) that assesses the stability of global financial markets and emerging-market financing.

15.9. SELF ASSESSMENT QUESTIONS

1. What is liquidity? How is it different from global liquidity?
2. What is global liquidity? How is it measured?

3. What are the Policy responses to global liquidity? Explain it.
4. How the Drivers and transmission mechanisms are useful to estimate working capital ?

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