MBA II SEMESTER

CORPORATE FINANCE

SYLLABUS

CORPORATE FINANCE

UNIT – I INDUSTRIAL FINANCE

Indian Capital Market – Basic problem of Industrial Finance in India. Equity – Debenture financing – Guidelines from SEBI, advantages and disadvantages and cost of various sources of Finance - Finance from international sources, financing of exports – role of EXIM bank and commercial banks. – Finance for rehabilitation of sick units.

UNIT – II SHORT TERM-WORKING CAPITAL FINANCE

Estimating working capital requirements – Approach adopted by Commercial banks, Commercial paper- Public deposits and inter corporate investments.

UNIT – III ADVANCED FINANCIAL MANAGEMENT

Appraisal of Risky Investments, certainty equivalent of cash flows and risk adjusted discount rate, risk analysis in the context of DCF methods using Probability information, nature of cash flows, Sensitivity analysis; Simulation and investment decision, Decision tree approach in investment decisions.

UNIT – IV FINANCING DECISION

Simulation and financing decision - cash inadequacy and cash insolvency- determining the probability of cash insolvency- Financing decision in the Context of option pricing model and agency costs- Inter-dependence of investment- financing and Dividend decisions.

UNIT – V CORPORATE GOVERNANCE

Corporate Governance - SEBI Guidelines- Corporate Disasters and Ethics- Corporate Social Responsibility- Stakeholders and Ethics- Ethics, Managers and Professionalism.

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CORPORATE FINANCE

Unit-I

Define corporate finance.

Corporate Finance is the specific area of finance dealing with the financial decisions corporations make, and the tools and analysis used to make the decisions. The discipline as a whole may be divided between long term, capital investment decisions, and short term, working capital management.

Corporate finance has two basic functions:-

Acquisition of Resources

Acquisition of resource means fund generation at lowest possible cost. Resource generation can be done through:-

- Equity --- It includes proceeds obtained from stock selling, retained earnings, and investment returns.
- Liability **---** It includes bank loans, warranties of products and payable account.

• **Allocation of Resources**

Investment of funds for profit maximization motive is known as allocation of resources. Investment can be categorized into two groups:-

- **Fixed Asset ---** Land, Machinery, buildings, etc.
- **Current Asset ---** Inventory, cash, receivable accounts, etc.

Corporate or **business finance** is all about raising and allocation of funds for increasing profit. Senior management chalks out long-term plan for fulfilling future objectives. Value of the company's stock is a very important issue for the management because it is directly related to the wealth of the share-holders of the company.

Functions of Corporate Finance are:-

- Raising of Capital or Financing
- Budgeting of Capital
- Corporate Governance
- Financial management
- Risk Management

All the above functions are interrelated and interdependent. For example, in order to materialize a project a company needs to raise capital. So, budgeting of capital and financing are interdependent.

Decisions making of the corporate finance are basically of two types based on the time period for the same, namely, Long term and Short term.

i . **Long term decisions:-**

It is basically concerned with the capital investment decisions such as viability assessment of the project, financing it through equity or debt, pay dividend or reinvest out of the profit.

Long term corporate finance which is generally related to fixed assets and capital structure are called Capital Investment Decisions. Senior managements always target to maximize the value of the firm by investing in positive NPV (Net Present Value) projects. If such opportunities don't arise then reinvestment of profits should be stalled and the excess cash should be returned to the shareholders in the form of dividends. Hence, Capital Investment Decisions constitute three decisions:-

You might get confused to know how to get the best Car Financing Option. However, you are able to

- **Decision on Investment**
- **Decision on Financing**
- **Decision on Dividend**

ii. **Short term decisions:-**

These are also known as working capital management which tries to strike a balance between current assets (cash, inventories, etc.) and current liabilities (a company's debts or obligations impending for less than one year).

Principle of Corporate Finance

Principles of Corporate Finance constitute the theories and their implementations by the managers of the companies in the practical field for maximization of profit.

Corporate Finance deals with a company's financial or monetary activity (promotion, financing, investment, organization, capital budgeting etc.).

All these activities are accomplished with the sole objective of profit maximization.

For meeting the fund requirements for any project of a corporation, a company can get it from various sources such as internal, external or equities at the lowest cost possible. This fund is then used for investment purposes for the production of the desirable asset.

Principle of Corporate Finance shows how the different corporate financial theories help to formulate the policies for the growth of a company.

Finance is a science of managing money and other assets. It is the process of canalizations of funds in the form of invested capital, credits, or loans to those economic agents who are in need of funds for productive investments or otherwise. Eg. On one hand, the consumers, business firms, and governments need funds for making their expenditures, pay their debts, or complete other transactions. On the other hand, savers accumulate funds in the form of savings deposits, pensions, insurance claims, savings or loan shares, etc which becomes a source of investment funds. Here, finance comes to the fore by channeling these savings into proper channels of investment.

Broadly, finance can be classified into three fields:-

- **Public Sector Finance:** Financing in the government or public level is known as **public sector finance.** Government meets its expenditures mainly through taxes. Government budget generally don't balance, hence it has to borrow for these deficits which in turn gives rise to public debt.
- **Corporate or Business Finance:** It tries to optimize the goals (profit, sales, etc.) of a corporation or other business organization by estimating future asset requirements and then allocating funds in accordance to the availability of funds.
- **Personal Finance** :

It basically deals with the optimization of finances in the individual (single consumer, family, personal savings, etc.) level subjected to the budget constraint. Eg. A consumer can finance his/her purchase of a car by taking a loan from any bank or financial institutions.

Corporate or **business finance** is all about raising and allocation of funds for increasing profit. Senior management chalks out long-term plan for fulfilling future objectives. Value of the company's stock is a very important issue for the management because it is directly related to the wealth of the share-holders of the company.

Some of the terms important in principle of Corporate finance are:-

Net Present Value (NPV)

Net Present Value = (Present Value of Inflow of Cash) – (Present Value of

Outflow of Cash)

NPV helps to measure the value of a currency today with that of the future, after taking into consideration returns and inflation.

Positive **Net Present Value** for a project means that the project is viable because cash flows will be positive for the same.

Senior managements always target to maximize the value of the firm by investing in positive NPV (Net Present Value) projects. If such opportunities don't arise then

reinvestment of profits should be stalled and the excess cash should be returned to the shareholders in the form of dividends.

Financial Risk management

According to Financial Economics, that project which increases the value of the shareholders wealth should be taken on. Financial Risk Management is the creation of value of the shareholders of a firm by managing the exposure to risk by the use of financial instruments (loans, deposits, bonds, equity stocks, future and options, etc.). Financial risk management involves:-

- Identification of the source of risk
- Risk measurement
- Chalking out of plans to manage the risks

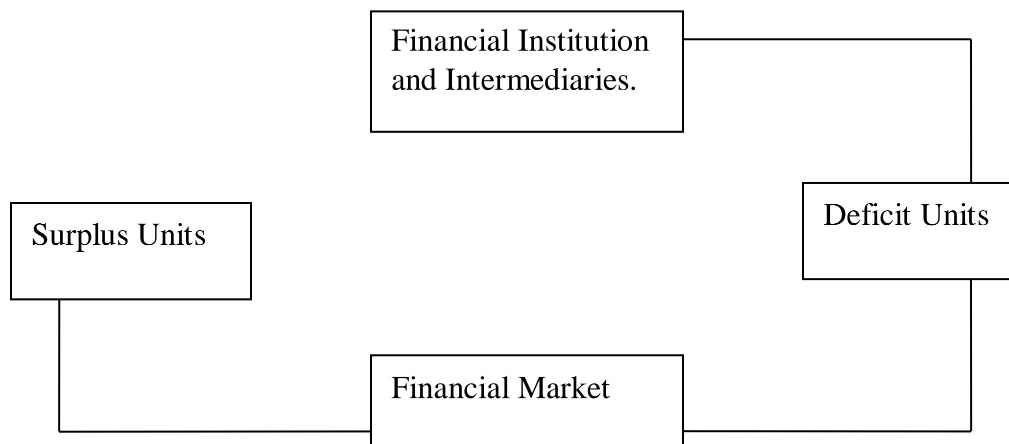
Financial Risk Management always tries to find out viable opportunity to hedge the costly risk exposures by using financial instruments.

Indian capital market

A market in which individuals and institutions trade financial securities. Organizations/institutions in the public and private sectors also often sell securities on the capital markets in order to raise funds. Thus, this type of market is composed of both the primary and secondary markets.

Indian financial system:

Financial system is the system which consists of variety of institutions, markets and instruments. It provides means by which savings are transferred in to investments.



Functions of financial system

1. Payment system
2. Pooling of funds
3. Transfer of resources
4. Risk management
5. Price information

Objectives of financial system

1. Speeding up economic growth
2. Rapid industrialization
3. Support to agriculture
4. Support to trade
5. Rural / Backward development
6. Project finance
7. Entrepreneurship development
8. Housing education and health
9. Infrastructure
10. Liquidity
11. Price control
12. Human development.

Financial market

1. Capital market
2. Money market
3. Forex market

Capital market:

Capital market compresses various channels which make the individuals and community savings available for public trade, business and industry. Capital market is defined as a market which constitutes all long term lending by banks and financial institutions, ling term borrowings from foreign markets and rising of capital by new issue markets.

Therefore capital market is the mechanism which provides long term finance like shares, debentures and ling term borrowings and not the short term finance.

Elements of capital Market:

Equity share:

Equity share is a share which is not a preference share i.e., no priority given to share holders. All the share holders are treated alike.

Types

1. Growth Share
2. Income Share
3. defensive share
4. Cyclic Share.

Preference Shares:

Preference share is a share, where the holder of the share will be given preference in paying dividends and settlement during liquidation.

Types

1. Cumulative preference share
2. Non cumulative preference share
3. Participating preference share
4. Non participating preference share
5. Convertible preference share
6. Non convertible share
7. Redeemable preference share
8. Irredeemable preference share
9. Cumulative convertible preference share

Debenture and Bonds:

Both the instruments are documents acknowledging the debt of the company. The difference between bond and debenture is bond unsecured where as debenture secured

Types

1. Registered debenture / Bond
2. Bearer/ unregistered debenture /Bond
3. Fully convertible debenture
4. Partly convertible debenture
5. Non convertible debenture
6. Redeemable debenture
7. Sinking fund bonds—Installment
8. Serial bonds – serial 3 to 4 times in a year
9. Collateral bonds – floating charge
10. Secured debenture /bond – fixed charge
11. Non secured debenture/ bond
12. Guaranteed bonds
13. Joint bonds
14. Income bonds—payment of the rest will be made only when there is a profit

Mutual fund:

Mutual fund is collection of funds from small investors and investing large amounts out of collections in equalities and other securities.

Types

By structure

1. Open ended
2. closed ended
3. Interval schemes.

By investment objective

1. Growth schemes
2. Income schemes
3. Balanced schemes
4. Money market schemes

Other schemes

1. Tax saving schemes (ELSS)
2. Industry specific / sector specific
3. Index schemes
4. Load funds
5. No load fund
6. Theme fund
7. Children fund

Non Tradable Securities

1. Post office / Govt securities
2. term loan from bank and financial institution
3. Feed capture by financial institutions

Capital Market—Types

1. Primary market
2. Secondary market

Primary Market:

It is also called as new issue market. It deals with securities issued for the first time in the market. Corporate organizations are willing to raise the funds through primary market only. They raise funds through the issue equity and preference shares and debentures.

There are two methods of raising funds in primary market they are.

1. Public issue: In this method the company will to the general public and raises the funds by issue of securities. It involves advertising in newspapers etc and equity subscription.
2. Rights issue: In this method the funds are raised by the money contributed by the equity share holders of the company.

Secondary Market:

Secondary Market is a market for trading existing securities of the companies. Stock market is an organized market through which the securities are bought and sold in an orderly manner. Since the securities market is called as secondary market it is also been known as stock exchange.

Money Market:

Money Market is the market deals with short term securities. It is a marker to provide short term finance for the organizations.

1. **Call money market:**
   Amount borrowed or lent on demand for a very shout period of 1 to 14 days. Interring holidays and Sundays are excluded for the purpose.
2. **Bill market:**
   The documents of bill of exchange will be issued by the passes which can be negotiable and will mature in a shout period of time.
3. **Certificate deposits:**
   A certificate of deposits is a marketable receipt of fund which is having a maturity period of up to one year. It is issued by bands in the form of promissory notes.

4. Commercial paper:

Commercial paper is a short term negotiable instrument issued by the companies. The maturity period range from 30 to 364 days. Compulsory credit is also required.

5. Treasury bills:

The lowest risk category instrument is Treasury bill which is issued by RBI. The maturity period ranges from 14 to 364 days.

6. Money market Mutual fund:

Money market Mutual fund is introduced here to provide additional short term avenue through which the small investor could actually take part in the money market.

Forex Market:

Forex market is the market deals with the trading of foreign currencies. It is also considered as one of the important avenue of investment.

Advantages, Disadvantages of various instruments

Equity shares:

Advantages:

1. Command and control
2. No fixed cost
3. No charge over assets
4. Permanent capital
5. Public issue

Disadvantages:

1. Control /management by equity share holders
2. Market price- If it is low further raising can be possible
3. High dividend
4. Excessive capitalization of equity shares will affect the company's profit.

Preference share:

Advantages:

1. Assured return
2. Fixed return
3. Maturity period
4. Chance of convertibility
5. Preference right

Disadvantages:

1. Not a permanent capital
2. Rigid capital structure

   Not able to alter the returns
3. Cost of capital higher than debenture
4. No tax benefits

Debenture:

Advantages:

1. Assured return

2. Less risky and secured
3. Tax benefit
4. Flexibility/ convertibility

Disadvantages:

1. Charge on assets
2. Not a permanent capital
3. More of debenture will affect the profit of the organization.

Problems of Industrial finance:

1. High cost
2. Difficulty in information transfer
3. Less response from house hold (10% of investment)
4. Prevalence of unorganized market
5. Inability of the poor to approach organized market
6. No integration between various segments of financial market
7. Pricing and allocation of resources is not efficient
8. Participation is not uniform
9. More amount of brokerage and underwriting exchanges
10. difficulty in attaining minimum subscription
11. Problem of repaying the amount of the minimum subscription is not attained
12. Gap between functional and institutional setup. Merchant banking is absent.
13. Due to risk aversion of investor they prefer less risky securities
14. the cost of flotation is very high
15. the Existing companies with sound track record can raise funds very easily but the new organization can't do it very easily.

Problems other View:

1. Applicant submitting window dressed annual report
2. Unrealizable accounting creates non performing assets
3. Difficulty in assessing capital finance
4. Diluting the loan other than original purpose
5. Relevant norms not framed so it leads to failure
6. Poor projects appraisal
7. Double or multiple financing
8. Improper monitoring of borrower by lender
9. Undue delay in sanctioning loans.

"Debt Financing vs. Equity Financing

Financing your new business can be categorized into two different types: debt financing and equity financing.

Debt Financing:
In basic terms, this is a loan. Money that you borrow from another source with the understanding that you will pay it back in a fixed amount of time. As the name suggests, this type of financing means that you have "debt" -- money that you owe to someone. The person who lends you money does not have any liberties or ownership over your business. Your relationship continues as long as you owe the money and once it is paid

back, your relationship with the lender ends. Debt financing can be short-term (one year or less for repayment) or long-term (repayment over more than one year). This type of financing occurs with banks and the SBA (Small Business Administration).

Advantages to Debt Financing:

- You retain maximum control over your business
- The interest on debt financing is tax deductible

Disadvantages to Debt Financing:

- Too much debt can cause problems if you begin to rely on it and do not have the revenue to pay it back.
- Too much debt will make you unattractive to investors who will view you as "high risk."

Equity Financing:
This type of financing is an exchange of money (from a lender) for a piece of ownership in the business. This appears to be "easy money" because it involves no debt. This type of financing normally occurs with venture capitalists and angel investors.

Advantages to Equity Financing:

- You don't have to worry about repayment in the traditional way. As long as your business makes a profit, the lenders will be repaid.
- With the help of investors, your business becomes more credible and may win new attention from the lenders' networks.

Disadvantages to Equity Financing:

- As the business owner, you lose your complete control and autonomy. Now, investors have a say in the decisions that are made.
- Too much may indicate to potential funders that you are willing to take the necessary personal risks, which could signify a lack of belief in your own business venture.

When a banker, venture capitalist, or angel investor is considering giving you money, they will look at your ***debt to equity ratio***. This is the amount of debt you have compared to the amount of equity you have. To lenders, this ratio is important because it tells the amount of money available for repayment in the case of default. It also shows if your business is being run in a sensible way, without too much dependence on any one source.

When considering what type of financing you want or need, take some time to think about your business motives. How much control do you want? What are your long-term goals? With equity financing, you and your investors may come to disagree on important business decisions. When this happens, it is often best for you to "cash in" and let your

investors take the business into the future without you. To some entrepreneurs who believe in their business idea and want to see it through, selling is not an option. If this describes you, equity financing is not for you. Instead, you should explore debt financing and retain control over the direction of your business venture.

SEBI Guide Lines

Equity

1. Price band is free for existing companies but at par for fresh issue
2. The prospectus must contain the net asset value.
3. Proper justification of price should be given.
4. Promoter's contribution 20 to 25 % on the issue.
5. Minimum No of share application and application money
   For at par 200 shares face value of 10 each
   For premium minimum application money is not less than Rs.2000
   25% on face value of shares and not less than 5% on face value
6. Securities issued should be fully paid up with in 12 months.
7. 12 months elapsed between two issues.
8. Period of subscription
   10 working days at least for 3 working says.
   Rights issue- 30 days not mare than 60 days.
9. Retention of oversubscription:
   10% of the net offer for rounding off to the nearest multiple of 100
10. Underwriting optional but the underwriter has to give commit money for 5% of issue amount or 25 lakh which ever is less.
11. Merchant banker are also responsible for prospectus.
12. Promoters lock in period 5 years
13. For premium 3 years track record is needed and promoters contribution 25%. If not promoters contribution is 50%.
14. If the issue amount goes beyond Rs 500 crores the issuer has to arrange for monitoring by financial institution.

SEBI Guide lines for debenture:

1. Conversion period not more than 36 months.
2. Compulsory credit rating
3. No restriction on fixing interest
4. Creation of Redemption reserves.
5. Premium can be collected for the company which has 3 years sound track record.
6. Disclose of loan certificate
7. If interest rate is less than bank rate, proper disclosure has to be made about it.
8. After interest dividend has to be paid.
9. Redemption can be made after 5 years.
10. Protection of interest of debenture holder.
    - Monitor the progress financial institution
    - Adjust certificate for utilization of fund
    - Appointing trustees for debentures

- Filing of encumbrance certificate with SEBI and NOC from banks.
- Supervising by trustees.

Commercial banks

An institution which accepts deposits, makes business loans, and offers related services. Commercial banks also allow for a variety of deposit accounts, such as checking, savings, and time deposit. These institutions are run to make a profit and owned by a group of individuals, yet some may be members of the Federal Reserve System. While commercial banks offer services to individuals, they are primarily concerned with receiving deposits and lending to businesses.

Functions of Commercial Banks

The functions of commercial banks are divided into two categories:
i) Primary functions, and
ii) Secondary functions including agency functions.

i) Primary functions:

The primary functions of a commercial bank include:
a) Accepting deposits; and
b) Granting loans and advances;

a) Accepting deposits

The most important activity of a commercial bank is to mobilize deposits from the public. People who have surplus income and savings find it convenient to deposit the amounts with banks. Depending upon the nature of deposits, funds deposited with bank also earn interest. Thus, deposits with the bank grow along with the interest earned. If the rate of interest is higher, public are motivated to deposit more funds with the bank. There is also safety of funds deposited with the bank.

b) Grant of loans and advances

The second important function of a commercial bank is to grant loans and advances. Such loans and advances are given to members of the public and to the business community at a higher rate of interest than allowed by banks on various deposit accounts. The rate of interest charged on loans and advances varies depending upon the purpose, period and the mode of repayment. The difference between the rate of interest allowed on deposits and the rate charged on the Loans is the main source of a bank's income.

i) Loans

A loan is granted for a specific time period. Generally, commercial banks grant short-term loans. But term loans, that is, loan for more than a year, may also be granted. The borrower may withdraw the entire amount in lump sum or in installments. However, interest is charged on the full amount of loan. Loans are generally granted against the security of certain assets. A loan may be repaid either in lump sum or in installments.

ii) Advances

An advance is a credit facility provided by the bank to its customers. It differs from loan in the sense that loans may be granted for longer period, but advances are normally granted for a short period of time. Further the purpose of granting advances is to meet the day to day requirements of business. The rate of interest charged on advances varies from bank to bank. Interest is charged only on the amount withdrawn and not on the sanctioned amount.

Modes of short-term financial assistance

Banks grant short-term financial assistance by way of cash credit, overdraft and bill discounting.

a) Cash Credit

Cash credit is an arrangement whereby the bank allows the borrower to draw amounts up to a specified limit. The amount is credited to the account of the customer. The customer can withdraw this amount as and when he requires. Interest is charged on the amount actually withdrawn. Cash Credit is granted as per agreed terms and conditions with the customers.

b) Overdraft

Overdraft is also a credit facility granted by bank. A customer who has a current account with the bank is allowed to withdraw more than the amount of credit balance in his account. It is a temporary arrangement. Overdraft facility with a specified limit is allowed either on the security of assets, or on personal security, or both.

c) Discounting of Bills

Banks provide short-term finance by discounting bills that is, making payment of the amount before the due date of the bills after deducting a certain rate of discount. The party gets the funds without waiting for the date of maturity of the bills. In case any bill is dishonored on the due date, the bank can recover the amount from the customer.

ii) Secondary functions

Besides the primary functions of accepting deposits and lending money, banks perform a number of other functions which are called secondary functions. These are as follows:-

a) Issuing letters of credit, travellers cheques, circular notes etc.

b) Undertaking safe custody of valuables, important documents, and Securities by providing safe deposit vaults or lockers;

c) Providing customers with facilities of foreign exchange.

d) Transferring money from one place to another; and from one branch to another branch of the bank.

e) Standing guarantee on behalf of its customers, for making payments for purchase of goods, machinery, vehicles etc.

f) Collecting and supplying business information;

g) Issuing demand drafts and pay orders; and,

h) Providing reports on the credit worthiness of customers.

Difference between Primary and Secondary Functions of Commercial Banks

Primary Functions	Secondary Functions
1. These are the main activities of the bank.	1. These are the secondary activities of the bank.
2.These are the main sources of Income of the bank.	2. These are not the main sources of income of the banks.
3. These are obligatory on the part of bank to perform.	3. These are not obligatory on the part of bank to perform. But generally all commercial banks perform these activities.

Different modes of Acceptance of Deposits

Banks receive money from the public by way of deposits. The following types of deposits are usually received by banks:

i) Current deposit
ii) Saving deposit
iii) Fixed deposit
iv) Recurring deposit
v) Miscellaneous deposits

i) Current Deposit

Also called 'demand deposit', current deposit can be withdrawn by the depositor at any time by cheques. Businessmen generally open current accounts with banks. Current accounts do not carry any interest as the amount deposited in these accounts is repayable on demand without any restriction.

The Reserve bank of India prohibits payment of interest on current accounts or on deposits up to 14 Days or less except where prior sanction has been obtained. Banks usually charge a small amount known as incidental charges on current deposit accounts depending on the number of transaction.

ii) Savings deposit/Savings Bank Accounts

Savings deposit account is meant for individuals who wish to deposit small amounts out of their current income. It helps in safe guarding their future and also earning interest on the savings. A saving account can be opened with or without cheque book facility. There are restrictions on the withdrawals from this account. Savings account holders are also allowed to deposit cheques, drafts, dividend warrants, etc. drawn in their favour for collection by the bank. To open a savings account, it is necessary for the depositor to be introduced by a person having a current or savings account with the same bank.

iii) Fixed deposit

The term 'Fixed deposit' means deposit repayable after the expiry of a specified period. Since it is repayable only after a fixed period of time, which is to be determined at the time of opening of the account, it is also known as time deposit. Fixed deposits are most useful for a commercial bank. Since they are repayable only after a fixed period, the bank may invest these funds more profitably by lending at higher rates of interest and for relatively longer periods. The rate of interest on fixed deposits depends upon the period of deposits. The longer the period, the higher is the rate of interest offered. The rate of interest to be allowed on fixed deposits is governed by rules laid down by the Reserve Bank of India.

iv).Recurring Deposits

Recurring Deposits are gaining wide popularity these days. Under this type of deposit, the depositor is required to deposit a fixed amount of money every month for a specific period of time. Each installment may vary from Rs.5/- to Rs.500/- or more per month and the period of account may vary from 12 months to 10 years. After the completion of the specified period, the customer gets back all his deposits along with the cumulative interest accrued on the deposits.

v).Miscellaneous Deposits

Banks have introduced several deposit schemes to attract deposits from different types of people, like Home Construction deposit scheme, sickness Benefit deposit scheme, Children Gift plan, Old age pension scheme, Mini deposit scheme, etc.

Different methods of Granting Loans by Bank

The basic function of a commercial bank is to make loans and advances out of the money which is received from the public by way of deposits. The loans are particularly granted to businessmen and members of the public against personal security, gold and silver and other movable and immovable assets. Commercial bank generally lends money in the following form:

i) Cash credit

ii) Loans

iii) Bank overdraft, and

iv) Discounting of Bills

i) Cash Credit:

A cash credit is an arrangement whereby the bank agrees to lend money to the borrower up to a certain limit. The bank puts this amount of money to the credit of the borrower. The borrower draws the money as and when he needs. Interest is charged only on the amount actually drawn and not on the amount placed to the credit of borrower's account. Cash credit is generally granted on a bond of credit or certain other securities. This very popular method of lending in our country.

ii) Loans:

A specified amount sanctioned by a bank to the customer is called a 'loan'. It is granted for a fixed period, say six months, or a year. The specified amount is put on the credit of the borrower's account. He can withdraw this amount in lump sum or can draw cheques against this sum for any amount. Interest is charged on the full amount even if the borrower does not utilize it. The rate of interest is lower on loans in comparison to cash credit. A loan is generally granted against the security of property or personal security. The loan may be repaid in lump sum or in installments. Every bank has its own procedure of granting loans. Hence a bank is at liberty to grant loan depending on its own resources. The loan can be granted as:

a) Demand loan, or

b) Term loan

a) Demand loan

Demand loan is repayable on demand. In other words it is repayable at short notice. The entire amount of demand loan is disbursed at one time and the borrower has to pay interest on it. The borrower can repay the loan either in lump sum (one time) or as agreed with the bank. Loans are normally granted by the bank against tangible securities including securities like N.S.C., Kisan Vikas Patra, Life Insurance policies and U.T.I. certificates.

b) Term loans

Medium and long term loans are called 'Term loans'. Term loans are granted for more than one year and repayment of such loans is spread over a longer period. The repayment is generally made in suitable installments of fixed amount. These loans are repayable over a period of 5 years and maximum up to 15 years.

Term loan is required for the purpose of setting up of new business activity, renovation, modernization, expansion/extension of existing units, purchase of plant and machinery, vehicles, land for setting up a factory, construction of factory building or purchase of other immovable assets. These loans are generally secured against the mortgage of land,

plant and machinery, building and other securities. The normal rate of interest charged for such loans is generally quite high.

iii) Bank Overdraft

Overdraft facility is more or less similar to cash credit facility. Overdraft facility is the result of an agreement with the bank by which a current account holder is allowed to withdraw a specified amount over and above the credit balance in his/her account. It is a short term facility. This facility is made available to current account holders who operate their account through cheques. The customer is permitted to withdraw the amount as and when he/she needs it and to repay it through deposits in his account as and when it is convenient to him/her. Overdraft facility is generally granted by bank on the basis of a written request by the customer. Some times, banks also insist on either a promissory note from the borrower or personal security to ensure safety of funds. Interest is charged on actual amount withdrawn by the customer. The interest rate on overdraft is higher than that of the rate on loan.

iv) Discounting of Bills

Apart from granting cash credit, loans and overdraft, banks also grant financial assistance to customers by discounting bills of exchange. Banks purchase the bills at face value minus interest at current rate of interest for the period of the bill. This is known as 'discounting of bills'. Bills of exchange are negotiable instruments and enable the debtors to discharge their obligations towards their creditors. Such bills of exchange arise out of commercial transactions both in internal trade and external trade. By discounting these bills before they are due for a nominal amount, the banks help the business community. Of course, the banks recover the full amount of these bills from the persons liable to make payment.

Agency and General Utility Services provided by Modern Commercial Banks:-

You have already learnt that the primary activities of commercial banks include acceptance of deposits from the public and lending money to businessmen and other members of society. Besides these two main activities, commercial banks also render a number of ancillary services.

These services supplement the main activities of the banks. They are essentially non-banking in nature and broadly fall under two categories:

i) Agency services, and

ii) General utility services.

i) Agency Services

Agency services are those services which are rendered by commercial banks as agents of their customers. They include:

a) Collection and payment of cheques and bills on behalf of the customers;

b) Collection of dividends, interest and rent, etc. on behalf of customers, if so instructed by them;

c) Purchase and sale of shares and securities on behalf of customers;

d) Payment of rent, interest, insurance premium, subscriptions etc. on behalf of customers, if so instructed;

e) Acting as a trustee or executor;

f) Acting as agents or correspondents on behalf of customers for other banks and financial institutions at home and abroad.

ii) General utility services

General utility services are those services which are rendered by Commercial banks not only to the customers but also to the general public. These are available to the public on payment of a fee or charge. They include:

a) Issuing letters of credit and travellers' cheques;
b) Underwriting of shares, debentures, etc.;
c) Safe-keeping of valuables in safe deposit locker;
d) Underwriting loans floated by government and public bodies.
e) Supplying trade information and statistical data useful to customers;
f) Acting as a referee regarding the financial status of customers;
g) Undertaking foreign exchange business.

Various sources of finances

A company needs finance to meet its various types of requirements. Some funds are required for a fairly long time for the purpose of acquiring fixed assets and some others are required for day to day working.

Sources of long term finance

The main sources of long term finance are as follows:

1. Shares:

These are issued to the general public. These may be of two types:
(i) Equity and (ii) Preference. The holders of shares are the owners of the business.

2. Debentures:

These are also issued to the general public. The holders of debentures are the creditors of the company.

3. Public Deposits:

General public also like to deposit their savings with a popular and well established company which can pay interest periodically and pay-back the deposit when due.

4. Retained earnings:

The company may not distribute the whole of its profits among its Shareholders. It may retain a part of the profits and utilize it as capital.

5. Term loans from banks:

Many industrial development banks, cooperative banks and commercial banks grant medium term loans for a period of three to five years.

6. Loan from financial institutions:

There are many specialized financial institutions established by the Central and State governments which give long term loans at reasonable rate of interest. Some of these institutions are: Industrial Finance Corporation of India (IFCI), Industrial Development Bank of India (IDBI), Industrial Credit and Investment Corporation of India (ICICI), Unit Trust of India (UTI), and State Finance Corporations etc. These sources of long term finance will be discussed in the next lesson..

The short-term sources are:

1. Trade credit,

Trade credit refers to credit granted to manufactures and traders by the suppliers of raw material, finished goods, components, etc. Usually business enterprises buy supplies on a 30 to 90 days credit. This means that the goods are delivered but payments are not made until the expiry of period of credit. This type of credit does not make the funds available in cash but it facilitates purchases without making immediate payment. This is quite a popular source of finance.

2. Bank Credit

Commercial banks grant short-term finance to business firms which are known as bank credit. When bank credit is granted, the borrower gets a right to draw the amount of credit at one time or in installments as and when needed. Bank credit may be granted by way of loans, cash credit, overdraft and discounted bills.

(i) Loans

When a certain amount is advanced by a bank repayable after a specified period, it is known as bank loan. Such advance is credited to a separate loan account and the borrower has to pay interest on the whole amount of loan irrespective of the amount of loan actually drawn. Usually loans are granted against security of assets.

(ii) Cash Credit

It is an arrangement whereby banks allow the borrower to withdraw money up to a specified limit. This limit is known as cash credit limit. Initially this limit is granted for one year. This limit can be extended after review for another year. However, if the borrower still desires to continue the limit, it must be renewed after three years. Rate of interest varies depending upon the amount of limit. Banks ask for collateral security for the grant of cash credit. In this arrangement, the borrower can draw, repay and again draw the amount within the sanctioned limit. Interest is charged only on the amount actually withdrawn and not on the amount of entire limit.

(iii) Overdraft

When a bank allows its depositors or account holders to withdraw money in excess of the balance in his account up to a specified limit, it is known as overdraft facility. This limit is granted purely on the basis of credit-worthiness of the borrower. Banks generally give the limit up to Rs.20,000. In this system, the borrower has to show a positive balance in his account on the last Friday of every month. Interest is charged only on the overdrawn money. Rate of interest in case of overdraft is less than the rate charged under cash credit.

(iv) Discounting of Bill

Banks also advance money by discounting bills of exchange, promissory notes and undies. When these documents are presented before the bank for discounting, banks credit the amount to customer's account after deducting discount. The amount of discount is equal to the amount of interest for the period of bill.

3. Customers' Advances

Sometimes businessmen insist on their customers to make some advance payment. It is generally asked when the value of order is quite large or things ordered are very costly. Customers' advance represents a part of the payment towards price on the product (s) which will be delivered at a later date. Customers generally agree to make advances when such goods are not easily available in the market or there is an urgent need of goods. A firm can meet its short-term requirements with the help of customers' advances.

4. Installment credit

Installment credit is now-a-days a popular source of finance for consumer goods like television, refrigerators as well as for industrial goods. You might be aware of this system. Only a small amount of money is paid at the time of delivery of such articles. The balance is paid in a number of installments. The supplier charges interest for extending credit. The amount of interest is included while deciding on the amount of installment. Another comparable system is the hire purchase system under which the purchaser becomes owner of the goods after the payment of last installment. Sometimes commercial banks also grant installment credit if they have suitable arrangements with the suppliers.

5. Loans from Co-operative Banks

Co-operative banks are a good source to procure short-term finance. Such banks have been established at local, district and state levels. District Cooperative Banks are the federation of primary credit societies. The State Cooperative Bank finances and controls the District Cooperative Banks in the state. They are also governed by Reserve Bank of India regulations. Some of these banks like the Vaish Co-operative Bank was initially established as a co-operative society and later converted into a bank. These banks grant loans for personal as well as business purposes. Membership is the primary condition for securing loan. The functions of these banks are largely comparable to the functions of commercial banks.

Merits of short-term finance

a) **Economical** : Finance for short-term purposes can be arranged at a short notice and does not involve any cost of raising. The amount of interest payable is also affordable. It is, thus, relatively more economical to raise short-term finance.

b) **Flexibility:** Loans to meet short-term financial need can be raised as and when required. These can be paid back if not required. This provides flexibility.

c) **No interference in management:** The lenders of short-term finance cannot interfere with the management of the borrowing concern. The management retains their freedom in decision making.

d) **May also serve long-term purposes** : Generally business firms keep on renewing short-term credit, e.g., cash credit is granted for one year but it can be extended upto 3 years with annual review. After three years it can be renewed. Thus, sources of short-term finance may sometimes provide funds for long-term purposes.

Demerits of short-term finance

Short-term finance suffers from a few demerits which are listed below:

a) **Fixed Burden:** Like all borrowings interest has to be paid on short-term loans irrespective of profit or loss earned by the organization. That is why business firms use short-term finance only for temporary purposes.

b) **Charge on assets:** Generally short-term finance is raised on the concern cannot raise further loans against the security of these assets nor can these be sold until the loan is cleared (repaid).

c) **Difficulty of raising finance:** When business firms suffer intermittent losses of huge amount or market demand is declining or industry is in recession, it loses its creditworthiness. In such circumstances they find it difficult to borrow from banks or other sources of short-term financed) **Uncertainty:** In cases of crisis business firms always face the uncertainty of securing funds from sources of short-term finance. If the amount of finance required is large, it is also more uncertain to get the finance.

e) **Legal formalities:** Sometimes certain legal formalities are to be complied with for raising finance from short-term sources. If shares are to be deposited as security, then transfer deed must be prepared. Such formalities take lot of time and create lot of complications.

Export import bank (EXIM bank)

Meaning of EXIM bank

Government or semi-government agency which commonly provides insurance cover to exporters against losses from non-payment by the importers, as a means to promote the country's foreign trade. Other services offered by EXIM banks may include (1) marine insurance, (2) post-shipment discounting of invoices, (3) pre-shipment advances against confirmed orders, and (4) help in finding new markets.

Objectives:

The objectives and functions of the Exim Bank include the following:

1. Grant of loans and advances in India solely or jointly with commercial banks to persons exporting or intending to export India goods which may include the export of turnkey projects and civil consultancy services.
2. Grant of lines credit to Governments, financial institutions and other suitable organizations in foreign countries to enable person outside India to import from India, goods including turnkey projects, civil construction contracts and other services including consultancy services.
3. Handling transaction where a mix of government credit and commercial credit for exports is involved.
4. Purchasing, discounting and negotiating export bills.
5. Selling or discounting export bills in international markets.
6. Discounting of export bills negotiated or purchased by a scheduled bank or financial institution notified by government, or granting loans and advances against such bills.
7. Providing refinance facilities to specified financial institutions against credits extended by them for specified exports or imports.
8. Granting loans and advances or issuing guarantees solely or jointly with a commercial bank for the import of goods and services from abroad.
9. Issuing confirmation/endorsing letters of credit on behalf of exporters in India, negotiating, collecting bills under letters of credit, opening letters of credit on behalf of importers of goods is services and negotiating documents received there under.
10. Buying and selling foreign exchange and performing such other functions of an authorized dealer as may necessary for the functions of an export- import bank.
11. Undertaking and financing research, surveys and techno-economic studies bearing on the promotion and development of international trade.
12. Providing technical, administrative and financial assistance to any exporter in India or any other person who intends to export goods from India for the promotion, management or expansion of any industry with a view to developing international trade.

Functions

Planning, promoting, developing and financing export oriented units.
Underwriting the issue of shares for the export oriented companies
Financing export or import of machinery or lease basis.
Granting loans and advances for joint ventures.

Accepting, discounting bills of exchange relating to export or import.
Subscribing the shares / securities of EXIM Bank of other countries.
Providing technical, administrative, financial assistance for the export / import units.
Creating data base about exporters.
Providing re-finance facilities to the commercial banks.
Providing agency services like
Advice on exchange control practices in other countries.
Advice and design financial packages for export oriented industries in India.
Exposing Indian exporting companies to Euro Financing
Guarding Indian companies on contracts abroad.

EXPORT FINANCING

Import LC

Applicant/importer --->Issuing Bank---> Advising Bank--->Beneficiary/exporter.

Payment

Applicant--->Issuing Bank--->Negotiating bank--->Beneficiary.

Modes

1. letter of credit
2. Payment in advance
3. Documentary collection

Payment in Advance.

Exporter risk is low
Importer risk is high

Exporter may dispatch goods not in accordance with specification
Exporter may not dispatch goods or dispatch late.
Loss of profit

Documentary collection

The collectin by banks of a sum of money ofn behalf of an exporters (the principal) due from an importer (the Drawee).

Letters of credit:

A conditional undertaking given by a bank (issuing bank) at the request of the customer (applicant) to pay a seller (beneficiary) against stipulated documents, provided all terms of conditions are compiled.

Parties to a letter of Credit.

Applicant – Buyer importer
Beneficiary – seller / exporter
Issuing Bank – Applicant Bank
Advising Bank – Issuing banks agent in Beneficiary's country
Reimbursing Bank – Bank authorized by issuing bank to reimburse in bank making payment.

International sources of finance

Following are the international sources of finance:

1. Foreign Direct Investment

Foreign direct investment is one of the most important sources of foreign investment in developing countries like India. It is seen as a means to supplement domestic investment

for achieving a higher level of growth and development. FDI is permitted under the forms of investments.

1. Through financial collaborations / capital / equity participation;
2. Through Joint ventures and technical collaborations;
3. Through capital markets (Euro Issues);
4. Through private placements or preferential allotment.

2. GDR/ADR

Depository Receipts (DRs): A DR means any instrument in the form of depository receipt or certificate created by the overseas depository bank outside India and issued to non-resident investors against the issue of ordinary shares. In depository receipt, negotiable instrument evidencing a fixed number of equity shares of the issuing company generally denominated in U.S. $. DRs are commonly used by the company which sells their securities in international market and expanding their share holdings abroad. These securities are listed and traded in international stock exchanges. These can be either American depository receipt (ADR) or global depositary receipt (GDR). ADRs are issued in case the funds are raised through retail market in United States. In case of GDR issue, the invitation to participate in the issue cannot be extended to retail US investors.

3. FII

Institutional investors are organizations which pool large sums of money and invest those sums in securities, real property and other investment assets. They can also include operating companies which decide to invest its profits to some degree in these types of assets.

Types of typical investors include banks, insurance companies, retirement or pension funds, hedge funds, investment advisors and mutual funds. Their role in the economy is to act as highly specialized investors on behalf of others. For instance, an ordinary person will have a pension from his employer. The employer gives that person's pension contributions to a fund. The fund will buy shares in a company, or some other financial product. Funds are useful because they will hold a broad portfolio of investments in many companies. This spreads risk, so if one company fails, it will be only a small part of the whole fund's investment.

4. International Monetary fund

The **International Monetary Fund** (**IMF**) is an intergovernmental organization that oversees the global financial system by taking part in the macroeconomic policies of its established members, in particular those with an impact on exchange rate and the balance of payments. The objectives are to stabilize international exchange rates and facilitate development through the influence of neoliberal economic policies in other countries as a condition of loans, debt relief, and aid. It also offers loans with varying levels of conditionality, mainly to poorer countries. Its headquarters is in Washington, D.C. The IMF’s relatively high influence in world affairs and development has drawn heavy criticism from some sources.

Functions:

- Helping in international trade, that is, business between countries
- Looking after exchange rates
- Looking after balance of payments
- Helping member countries in economic development

DEFINITION OF SICKNESS

"An industrial company whose accumulated loss is more than fifty percent or more of its peak net worth during the immediately preceeding four financial years"

Symptoms of sick units

1. Financial symptoms

1. irregularity in bank accounts unable to provide security
2. Non payment of interest on borrowings
3. Non payment of installments dues on loans.
4. inability to pay the creditors on tine
5. adverse reaction in the stock exchange to the shares of the company

2. Non-financial symptoms

1. Incapacity to produce according to schedule
2. in ability to market the goods produced
3. Fast turnover of labor.
4. Generally poor reputation in the market

Causes

Internal causes

1. Low productivity of labour.
2. High cost of labour.
3. Obsolete plant and machinery
4. Obsolete technology
5. A weak marketing department
6. Inefficient and dishonest management.
7. Poor financial panning.

External causes

1. Non availability of raw material
2. High cost of raw material.
3. Non availabity of infrastructure facilities
4. Marketing difficulties because of government interference.
5. Non availability of finance due to governmental measures.

General and personnel administration: The problem areas are summarized as under:

- Dispute/difference of opinion among the promoters/directors.
- Poor industrial relations leading to labour unrest.
- Lack of motivation and co-ordination.
- Lack of manpower planning.
- Lack of assigning equal importance to all areas of business. It is generally observed that the
- main promoter takes more interest in the area of his specialization and ignores other aspects of
- The business. For example, technocrat entrepreneurs, by their nature are more inclined to improving the technical aspects of the product. The result may be that

the product will not be a commercial success though it may have technical excellence.

- Projects that solely depend upon the skills of a key promoter may find it difficult to sail
- Through in the event of death or ill-health of the key person.

BOARD OF INDUSTRIAL AND FINANCIAL RECONSTRUCTION (BIFR)

Board of industrial and Financial Reconstruction (BIFR) was established by the Central Government, under section 3 of the Sick Industrial Companies (Special provisions) Act, 1985 and it became fully operational in May, 1987. BIFR deals with issues like revival and rehabilitation on sick companies, winding up of sick companies, institutional finance to sick companies, amalgamation of companies etc. BIFR is a quasi judicial body.

The role of BIFR as envisaged in the SICA (Sick Industrial Companies Act) is:

(a) Securing the timely detection of sick and potentially sick companies

(b) Speedy determination by a group of experts of the various measures to be taken in respect of the sick company

(c) Expeditious enforcement of such measures

BIFR has a chairman and may have a maximum of 14 members, drawn from various fields including banking, labour, accountancy, economics etc. It functions like a court and has constituted four benches.

<u>Course of Action by BIFR</u>

1. Allowing the company time on its own to make its net worth positive with in a reasonable period.
2. Having a scheme through the operating agency in respect of the company.
3. Deciding of the winding up of the company.

The scheme may be of the following

1. Financial assistance.
2. Merger.
3. Sale or lease of a part of the company.
4. Suspension of existing contracts

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<u>IRCI (Industrial Reconstruction Corporation of India)</u>

The central Government in the year 1971 has established IRCI with the specific objective of dealing with the problem of industrial sickness.

IRBI

1. The IRCI ceased to exist when the industrial Reconstruction Bank of India was established in 1985.
2. The assets and liabilities were taken over by IRBI.
3. The IRBI identifies the sick units in the initial stage and corrects the imbalances of the long term and shout term funds, replacement of balancing equipment and modernization of obsolete plant and machinery.
4. IRBI also provides finance for expansion, diversification, Modernization etc.

Reporting to the BIFR

The Board of Directors of a sick industrial company is required, by law, to report the sickness to the BIFR within 60 days of finalization of audited accounts, for the financial year at the end of which the company has become sick. BIFR has prescribed a format for this report. While reporting by a company of its sickness to the BIFR is mandatory as per the provisions of law, any other interested person/party can also report the fact of sickness of a company to the BIFR. Such interested parties may be the financial institution/bank that has lent loan to the company, the RBI, the Central/State Governments. The BIFR has prescribed a different format for the report to be submitted by such interested parties. When a company has been financed by a consortium of banks, it is the Lead Bank that should report to the BIFR about the sickness under advice to other participating banks in the consortium.

Viability study for rehabilitation proposal: Once bitten, twice shy! - Before attempting to rehabilitate a sick unit, a detailed and thorough viability study is to be undertaken to ensure that the revival programme will really bear fruits. It is not advisable to venture upon any revival programme if there are gray areas that need further study.

The viability study shall enquire into the technical, commercial, managerial and financial aspects.

Technical Appraisal

(a) Study the manufacturing process used by the unit. Ascertain if any new process has since been developed. Explore the necessity of switching over to the latest manufacturing process and study the cost, benefit aspects of such switchover.

(b) Study the production capacity of different production sections and checkup if the production capacities of different sections are perfectly balanced. If there is any production section, which has a lower capacity than that required for perfect balancing, the overall capacity of the plant can be significantly increased without huge investments, by adding the required balancing machinery.

(c) Explore the possibilities of adding additional/special features to the products that will add competitive edge to the product. Also examine the need for changing the product-mix that is in tune with the market requirement.

(d) Find out if any plant/equipment need major repair/overhauling to improve its operating efficiency.

(e) If the locational disadvantages outweigh all other factors, the scope for shifting the location to an advantageous place may be examined and the consequent cost-benefit analysis studied. This may be possible if the firm is functioning in a leased premise and owns only the plant and machinery. If the unit is located in own building, the proposal for shifting the plant and machinery to a leased building in an advantages location may also be studied. The building owned by the firm can be leased out to some other firms. The

long-term cost benefit analysis will give lead to the acceptability or otherwise of such a proposal.
(f) Study the modifications required, if any in the plant layout so that the material handling output.
(g) Examine if any of the manufacturing operations that are done in house can be entrusted to outside agencies, which may result in cost reduction.

Commercial Appraisal

(a) Commercial failure of a project will be mainly due to problems relating to the product itself *viz.*, defects/imperfections in product design which may lead to consumer resistance. Such situations indicate that the products offered by competitors have better features that attract consumers. Hence, the scope for product improvement and the cost involved are to be studied.
(b) In spite of consumer acceptance of the product, if the project has gone sick, it is likely that the profit margins might be low. Minor modifications in designing and packing the product with upward revision in price may be accepted by the market which may bring better returns to the company. This aspect may be studied by carrying out test marketing for the improved product.
(c) Every product follows a life cycle which passes through four stages *viz.*,
-Introduction.
-Rapid expansion.
-Maturity.
- Decline.
Profit margins shrink and signs of sickness appear when the product is in its 'decline' stage. Product innovation can only sustain the product at this stage. The decline once started can not be contained for long in spite of product innovations. Product diversification may prove to be a feasible solution. Hence for rehabilitating a unit whose product has already reached its 'decline' stage, the feasibility of witching over to diversify products making use of the existing production facilities is to be studied. The cost-benefit analyses of additional investments needed for product diversification and additional benefits that may accrue are to be analyzed.

Management Appraisal: A good project in the hands of an ineffective management turns the project bad. Similarly a good management is capable making a not-so-good project, a success.

Hence the first thing under management appraisal is to study whether the sickness is due to reasons beyond the control of the present management or due to ineffective management.

If the sickness is due to reasons beyond the control of the management, for any revival package to come out successful, it should be first ascertained if the management is still committed to the project and is serious about reviving the unit. The management's commitment and seriousness may be indicated by,

- Its readiness to inject additional funds to revive the unit.
- Its readiness to strengthen the existing management by agreeing to induct professionals as directors at various functional areas like technical/finance/marketing/research and development etc.

The managerial appraisal shall suggest the required changes in the existing organisational set up of the unit and also shall study the possible reduction in the man power that can be

achieved without affecting the organisiational efficiency, the likely compensation payable for retrenchment etc.

Financial appraisal: Since appraisal of all other areas have a financial commitment in one form or the other, financial appraisal assumes greater importance. All aspects of financial reconstruction need to be considered and analysed.

When a project that has long term debt component in its capital structure becomes sick, it becomes necessary to ease the burden of debt to enable the sick unit to recover from its sickness. This necessitates restructuring of the debts. In general, banks and financial institutions offer the following concessions in their package of rehabilitation assistance.

(a) Reduction in interest rate of existing loans.

(b) Conversion of short-term loans in to long-term loans.

(This gives the unit under revival the much-needed leeway to repay short term borrowings.)

(c) Conversion of part of long term loans into equity.

(d) Funding of the overdue interest (un-paid interest) and making it repayable in easy installments.

The funded interest component may carry concessional rate of interest or even at times bears no interest.

(e) Offering a revised schedule of repayment for the principal components of term loan.

(f) Sanction of additional loan to meet the additional capital expenditure.

(g) Enhancement of working capital limits and regularizing the irregular portion of working capital finance already availed.

If any asset is found not useful, the wise choice would be to dispose off the asset and use the amount realized to support the rehabilitation programme.

CORPORATE FINANCE

II Unit

Short term working capital

Estimating working capital requirements – Approach adopted by Commercial banks, Commercial paper- Public deposits and inter corporate investments.

WORKING CAPITAL MANAGEMENT

INTRODUCTION

The term working capital is commonly used for the capital required for day-to-day working in a business concern, such as for purchasing raw material, for meeting day-to-day expenditure on salaries, wages, rents rates, advertising *etc.* But there are much disagreement among various financial authorities (Financiers, accountants, businessmen and economists) as to the exact meaning of the term working capital.

Working capital refers to the capital required for day-to-day operations of a business enterprise. There are two concepts of Working Capital – Gross Working capital and Net Working capital.

1. Gross Working Capital

Gross Working capital refers to the firm's investment in current assets (Cash, Short Term Securities, Debtors, Bills Receivable and Inventory). Current assets are those assets, which can be converted into cash within a period of one year.

2. Net Working Capital

Net Working capital refers to the difference between current assets and current liabilities. It may be positive or negative.

TYPES OF WORKING CAPITAL

Working capital can be divided into two categories on the basis of time. They are – Permanent Working Capital and Temporary or Variable Working capital.

Permanent Working Capital refers to that minimum amount of investment in current assets, which is required at all times to carry on minimum level of business activities. It represents the current assets required on a continuing basis over the entire year, and hence should be financed out of long term funds.

Temporary Working capital represents the additional current assets required at different times during the operating year.

Need for Working Capital

Working capital is needed till a firm gets cash on sale of finished products. It depends on two factors:

i. Manufacturing cycle *i.e.* time required for converting the raw material into finished product; and

ii. Credit policy *i.e.* credit period given to Customers and credit period allowed by creditors.

Thus, the sum total of these times is called an *"Operating cycle"* and it consists of the following six steps:

i. Conversion of cash into raw materials.

ii. Conversion of raw materials into work-in-process.

iii. Conversion of work-in-process into finished products.

iv. Time for sale of finished goods—cash sales and credit sales.

v. Time for realization from debtors and Bills receivables into cash.

vi. Credit period allowed by creditors for credit purchase of raw materials, inventory and creditors for wages and overheads.

Importance or Advantages of Adequate Working Capital

Working capital is the life blood and nerve centre of a business. Just as circulation of blood is essential in the human body for maintaining life, working capital is very essential to maintain the smooth running of a business. No business can run successfully

without an adequate amount of working capital. The main advantages of maintaining adequate amount of working capital are as follows:

1. Solvency of the business: Adequate working capital helps in maintaining solvency of the business by providing uninterrupted flow of production.

2. Goodwill: Sufficient working capital enables a business concern to make prompt payments and hence helps in creating and maintaining goodwill.

3. Easy loans: A concern having adequate working capital, high solvency and good credit standing can arrange loans from banks and other on easy and favourable terms.

4. Cash Discounts: Adequate working capital also enables a concern to avail cash discounts on the purchases and hence it reduces costs.

5. Regular supply of raw materials: Sufficient working capital ensures regular supply of raw materials and continuous production.

6. Regular payment of salaries, wages and other day-to-day commitments:
A company which has ample working capital can make regular payment of salaries, wages and other day-to-day commitments which raises the morale of its employees, increases their efficiency, reduces wastages and costs and enhances production and profits.

7. Exploitation of favourable market conditions: Only concerns with adequate working capital can exploit favourable market conditions such as purchasing its requirements in bulk when the prices are lower and by holding its inventories for higher prices.

8. Ability to face Crisis: Adequate working capital enables a concern to face business crisis in emergencies such as depression because during such periods, generally, there is much pressure on working capital.

9. Quick and Regular return on Investments: Every Investor wants a quick and regular return on his investments. Sufficiency of working capital enables a concern to pay quick and regular dividends to its investors as there may not be much pressure to plough back profits. This gains the confidence of its investors and creates a favourable market to raise additional funds i.e., the future.

10. High morale: Adequacy of working capital creates an environment of security, confidence, and high morale and creates overall efficiency in a business.

Excess or Inadequate Working Capital

Every business concern should have adequate working capital to run its business operations. It should have either redundant or excess working neither capital nor inadequate or shortage of working capital. Both excess as well as short working capital positions are bad for any business. However, out of the two, it is the inadequacy of working capital which is more dangerous from the point of view of the firm.

Disadvantages of Redundant or Excessive Working Capital

1. Excessive Working Capital means ideal funds which earn no profits for the business and hence the business cannot earn a proper rate of return on its investments.
2. When there is a redundant working capital, it may lead to unnecessary purchasing and accumulation of inventories causing more chances of theft, waste and losses.
3. Excessive working capital implies excessive debtors and defective credit policy which may cause higher incidence of bad debts.
4. It may result into overall inefficiency in the organization.
5. When there is excessive working capital, relations with banks and other financial institutions may not be maintained.

6. Due to low rate of return on investments, the value of shares may also fall.
7. The redundant working capital gives rise to speculative transactions.

FACTORS EFFECTING WORKING CAPITAL NEEDS OF FIRMS

1. Nature of business:
In the case of public utility concern like railways, electricity etc most of the transactions are on cash basis. Further they do not require large inventories. Hence working capital requirements are low. On the hand, manufacturing and trading concerns require more working capital since they have to invest heavily in inventories and debtors. Example cotton or sugar mil

2. Size of business
Generally large business concerns are required to maintain huge inventories are required. Hence bigger the size, the large will be the working capital requirements.

3. Time consumed in manufacture
To run a long production process more inventories is required. Hence the longer the period of manufacture, the higher will the requirements of working capital and vice-versa.

4. Seasonal fluctuations
A number of industries manufacture and sell goods only during certain seasons. For example the sugar industry produces practically all sugar between December and April. Their working capital requirements will be higher during this session. It is reduced as the sales are made and cash is realized.

5. Fluctuations in supply
If the supply of raw materials is irregular companies, are forced to maintain huge stocks to avoid stoppage of production. In such case, working capital requirement will be high.

6. Speed of turnover
A concern say hotel which effects sales quickly needs comparatively low working capital. This is because of the quick conversion of stock into cash. But if the sales are slow, more working capital will be required**.**

7. Terms of sales
Liberal credit sales will result in locking up of funds in sundry debtors. Hence a company, which allows liberal credit, will need more working capital than companies, which observe strict credit norms.

8. Terms of purchase
Working capital requirements are also affected by the credit facilities enjoyed by the company. A company enjoying liberal credit facilities from its suppliers will need lower amount working capital. (For example book shops). But a company that has to purchase only for cash will need more working capital.

9. Labour intensive Vs. Capital intensive industries
In labour intensive industries, large working capital is required because of heavy wage bill and more time taken for production. But the capital intensive industries require lesser amount of working capital because of have investment in fixed assets and shorter time taken for production.

10. Growth and expansion of business

A growing concern needs more working capital to finance its increasing activities and expansion. But working capital requirements are low in the case static concerns.

11. Price level changes

Changes in price level also affect the working capital requirements. Generally the rising prices will require the firm to maintain large amount of working capital. This is because more funds will be required to maintain the same amount of working capital to maintain the same level of activity.

Working capital advance by commercial banks

Working capital advance by commercial banks represents the most important source for financing current assets.

Forms of Bank Finance: Working capital advance is provided by commercial banks in three primary ways: (i) cash credits / overdrafts, (ii) loans, and (iii) purchase / discount of bills. In addition to these forms of direct finance, commercials banks help their customers in obtaining credit from other sources through the letter of credit arrangement.

i. Cash Credit / Overdrafts: Under a cash credit or overdraft arrangement, a pre-determined limit for borrowing is specified by the bank. The borrower can draw as often as required provided the out standings do not exceed the cash credit / overdraft limit.

ii. Loans: These are advances of fixed amounts which are credited to the current account of the borrower or released to him in cash. The borrower is charged with interest on the entire loan amount, irrespective of how much he draws.

iii. Purchase / Discount of Bills: A bill arises out of a trade transaction. The seller of goods draws the bill on the purchaser. The bill may be either clean or documentary (a documentary bill is supported by a document of title to goods like a railway receipt or a bill of lading) and may be payable on demand or after a usual period which does not exceed 90 days. On acceptance of the bill by the purchaser, the seller offers it to the bank for discount / purchase. When the bank discounts / purchases the bill it releases the funds to the seller. The bank presents the bill to the purchaser (the acceptor of the bill) on the due date and gets its payment.

iv. Letter of Credit: A letter of credit is an arrangement whereby a bank helps its customer to obtain credit from its (customer's) suppliers. When a bank opens a letter of credit in favour of its customer for some specific purchases, the bank undertakes the responsibility to honour the obligation of its customer, should the customer fail to do so.

Commercial Paper

Commercial paper can be defined as a short term, unsecured promissory notes which are issued at discount to face value by well known companies that are financially strong and enjoy a high credit rating. Here are some of the features of commercial paper –

1. They are negotiable by endorsement and delivery and hence they are flexible as well as liquid instruments. Commercial paper can be issued with varying maturities as required by the issuing company.

2. They are unsecured instruments as they are not backed by any assets of the company which is issuing the commercial paper.

3. They can be sold either directly by the issuing company to the investors or else issuer can sell it to the dealer who in turn will sell it into the market.

4. It helps the highly rated company in the sense they can get cheaper funds from commercial paper rather than borrowing from the banks.

However use of commercial paper is limited to only blue chip companies and from the point of view of investors though commercial paper provides higher returns for him they are unsecured and hence investor should invest in commercial paper according to his risk -return profile.

Eligibility for issuance of CP

Presently, companies, which satisfy the following requirements, shall be eligible to issue commercial paper:

- The tangible net worth of the company is not less than Rupees four crore
- Working capital (fund-based) limit of the company is not less than four crore
- The minimum credit rating of the company shall be P-2 from CRISIL or equivalent from other Rating agencies

The borrowed account of the company is classified as a Standard Asset.

Besides companies, Primary Dealers (PDs) and Satellite Dealers are also permitted to issue CP.

Public Deposits

Public Deposits

Many firms, large and small, have solicited unsecured deposits from the public in recent years, mainly to finance their working capital requirements.

Inter-corporate Deposits

A deposit made by one company with another, normally for a period up to six months, is referred to as an inter-corporate deposit. Such deposits are usually of three types.

a. Call Deposits: In theory, a call deposit is withdrawal by the lender on giving a day's notice. In practice, however, the lender has to wait for at least three days. The interest rate on such deposits may be around 10 percent per annum.

b. Three-months Deposits: More popular in practice, these deposits are taken by borrowers to tide over a short-term cash inadequacy that may be caused by one or more of the following factors: disruption in production, excessive imports of raw material, tax payment, and delay in collection, dividend payment, and unplanned capital expenditure. The interest rate on such deposits is around 12 percent per annum.

c. Six-months Deposits: Normally, lending companies do not extend deposits beyond this time frame. Such deposits usually made with first-class borrowers, carry and interest rate of around 15 percent per annum.

The various **advantages** of public deposits enjoyed by the companies are:

1. There is no involvement of restrictive agreement
2. The process involved in gaining public deposit is simple and easy
3. The cost incurred after tax is reasonable
4. Since there is no need to pledge security for public deposits, the assets of firm that can be mortgaged can be preserved

The **disadvantages** of public deposits from the company's point of view are:

1. The maturity period is short enough
2. Limited fund can be obtained from the public deposits

Who accepts public Deposits?

1. Public and private limited non banking non financial companies of varying sizes.
2. Public and private limited non banking financial companies
3. Government companies since 1980.
4. Branches of foreign companies.
5. Partnership terms.
6. Proprietary concerns.

Inter corporate investments

Inter corporate investment occurs when one corporation purchases the shares of another. There are four types of long term inter corporate investments: portfolio, significant influence, controlling and joint controlling.

Portfolio investments

Portfolio investments are long-term investments whereby the investor is unable to exercise significant influence or control over the invitee’s strategic, operating, financing and investing policies. This is presumed to be the case when the investor owns less than 20% share ownership. However, this presumption may be overturned by evidence to the contrary. Portfolio investments are accounted for using the cost method.

Significant influence investments

Significant influence investments are long-term investments whereby the investor is able to exercise significant influence over the invitee’s strategic, operating, financing and investing policies, but does not unilaterally control the investee. Significant influence is presumed to be the case when the investor owns between 20% 49% of the shares of the investee. Again, this presumption may be overturned by evidence to the contrary. For example, the presence of a controlling investor with a large equity interest might preclude any other investors from exercising significant influence. Evidence that an investor exercises significant influence includes representation on the board of directors, dictating the terms of related party transactions, interchange of management personnel, etc. Significant influence investments are accounted for using the equity method.

Difference between cost and equity method

The cost and equity method differ in terms of how they record the change in the value of the investment over time. Because investors with significant influence are able to

determine the investee's policies, the income earned by the investee is treated as if it was earned by the investor itself. As a result, in the equity method, the investor accrues the income earned by the investee. Inter company profits are eliminated because the investor and investee are considered to be part of the same economic entity. Also, significant influence investors control the dividend policy of the investee, so dividends are treated as a liquidation of the investment rather than income.

In terms of a portfolio investment, the investor cannot impact the management policies of the investee and so, does not accrue income. Also, the investor does determine the dividend policy, so dividends are recognized as income. Inter company profits are recognized because the investor and investee are considered separate economic entities. The change in the value of the investee is recognized when the investor sells the investment.