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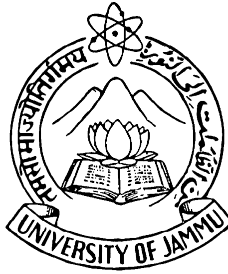

SELF LEARNING MATERIAL
FOR
M.COM IIIrd SEMESTER
FINANCIAL POLICIES & PRACTICES
For the Year 2020 onwards

Course No. M. Com FE-315 **UNIT : I TO IV**

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FINANCIAL POLICIES & PRACTICES

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FINANCIAL POLICIES & PRACTICES

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DIRECTORATE OF DISTANCE EDUCATION
UNIVERSITY OF JAMMU
M.COM. THIRD SEMESTER (NC BOS)
FINANCE GROUP
FINANCIAL POLICIES ND PRACTICES
(Elective Course)

Course No. M.COM-FE-315 **Max Marks: 100 Marks**
Credit : 4 **External : 80 Marks**
Time : 3:00 Hours **Internal : 20 Marks**

(Syllabus for the examinations to be held in Dec 2020,2021 & 2022)

OBJECTIVE : To enable the students to acquire the sound knowledge of concpets nature, structure, policies and practices followed in business Finance.

Page No.

UNIT-I : FINANCING PLANNING & CAPITALISATION : **1-74**

Concept of investment, financing and dividend policy decisions; Concept and objectives of financial planning; Essentials of financial planning; Steps in financial planning; Estimating financial requirements; Limitations of financial planning; Over-capitalisation-causes, effects and remedies; Under-capitalisation-causes, effects and remedies; Over -Capitalisaton versus under-capitalisation.

UNIT-II : LONG TERM SOURCES OF FINANCE : **75-172**

Concept of equity shares; Characteristics of equity shares; Advantage and disadvantages of equity shares; Concept of preference shares; Characteristics of preference shares; Types of preference shares; Advantages and disadvantages of preference shares; Concept of debentures; Characteristics of debentures; Classification of debentures; Procedure of issuing debentures; Concept of venture capital; Concept of leasing; Types of leasing; Buy or leasing decisions.

UNIT-III : SHORT TERM FINANCE & WORKING CAPITAL **173-279**

Concept and characteristics of short term financing; Advantages and disadvantages of short term financing; Sources of short term financing; Concept of trade credit; Bank financing; Account receivables; Concept and functions of Factoring; Concept of working capital management; Working capital cycle;

Approaches of working capital financing; Different components of working capital management; Inventory managment; Cash Management; Receivable managment; Credit policies; Credit terms; Collection policies.

UNIT-IV : MANAGEMENT OF SURPLUS AND DIVIDEND POLICIES

Concept of retained earnings; Advantages and disadvantages of retained earnings; Concept of divided; Fixed dividend policy, Pay out ratio; Models of dividend-Walter model; Gordon model and MM hypothesis of irrelevance of dividend; Factors influencing dividend policy; Dividend policy in practice.

BOOKS RECOMMENDED

1. Bhattacharya, Hrishikas, Working Capital Management, Strategies and Techniques, Prentice Hall, New Delhi.
2. Chandra, Prasanna, Financial Decision Making. Prentice Hall, New Delhi.
3. Hampton, John, Financial Decision Making, Prentice Hall, New Delhi.
4. Pandey, I.M., Financal Management Vikas Publishign House New Delhi.
5. Van Horne, J.C. and J.M. Wachowicz Jr. Fundamentals of Financial Management, Prentice-Hall, New Delhi.
6. Van Horne, James C. Financial Management and Policy, Prentice Hall New Delhi.

NOTE FOR PAPER SETTING :

The Paper consists of two sections, Each section will cover the whole of the syllabus without repeating the question in the entire paper.

Section A: It will consist of eight short answer questions, selecting two from each unit. A candidate has to attempt any six and answer to each questions shall be within 200 words. Each question carries four marks and total weightage to this section shall be 24 marks.

Section B: It will consist of six essay type questions with answer to each question within 800 words. One question will be atleast from each unit and the candidate has to attempt four. Each question will carry 14 marks and total weightage shall be 56 marks.

MODEL QUESTION PAPER

FINANCIAL POLICIES AND PRACTICES

M. Marks: 80

SECTION A

Attempt any six questions. Each question carries four marks. Answer to each question should be within 200 words

1. Define the term “Financial planning”. State its limitations.
2. Differentiate between under-capitalization and over-capitalization.
3. What are the types of leasing?
4. What is the criterion to compare buy or leasing decisions?
5. Explain the concept and characteristics of short term financing.
6. What is factoring? Explain the functions of factoring.
7. Discuss the advantages of retained earnings.
8. What is dividend? What are the features of dividend?

SECTION B

Attempt any four questions. Each question carries 14 marks. Answer to each question should be within 800 marks.

1. Discuss in detail the causes, effects and remedies of overcapitalization.

2. What are the steps involved in issue of debentures by the companies?

3. What do you mean by preference shares? Also discuss the characteristics and types of preference shares.

4. Explain in detail the concept and components of working capital management.

5. Write a detailed note on inventory management and receivable management.

6. Explain in detail two models for relevance of dividend concept which is supported by two eminent persons like Walter and Gordon.

UNIT -1

FINANCIAL PLANNING AND CAPITALIZATION

LESSON No. 1

Concept of Investment, Financing and Dividend Policy Decisions

Structure:

1.1 Introduction

1.2 Objectives

1.3 Concept of Investment Meaning of Investment Decisions

1.4 Types of Investment Decisions

1.5 Factors affecting Investment Decisions

1.6 Meaning of Financing Decisions

1.7 Factors affecting Financing Decisions

1.8 Meaning of Dividend Decisions

1.9 Factors affecting Dividend Decisions

1.10 Summary

1.11 Glossary

1.12 Self Assessment Questions

1.13 Lesson End Exercise

1.14 Suggested Readings

1.1 INTRODUCTION

In our present day economy, finance is defined as the provision of money at the time when it is required. Every enterprise, whether big, medium or small needs finance to carry on its operations and to achieve its targets. In fact, finance is so indispensable today that it is rightly said to be the life blood of an enterprise. Finance may be defined as the art and science of managing money. It includes financial service and financial instruments. Finance also is referred as the provision of money at the time when it is needed. Finance function is the procurement of funds and their effective utilization in business concerns. The concept of finance includes capital, funds, money, and amount. But each word is having unique meaning. Studying and understanding the concept of finance become an important part of the business concern. Finance may be defined as the provision of money at the time when it is required. Finance refers to the management of flow of money through an organization. Running an organization must involve taking thousands of decisions a day as you can imagine. The decisions that have to be taken with respect to the capital structure are known as Financing Decision.

If carefully analyzed what constitutes a business, we will come to the conclusion that there are two things that matter, money and decision. Without money, a company won't survive and without decisions, money can't survive. An administration has to take countless decisions in the lifetime of the company. Thus, the most important ones are related to money. The decisions related to money are called 'Financing Decisions.'

There are three decisions that financial managers have to take:

- Investment Decision
- Financing Decision and
- Dividend Decision

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 relates 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 decisions are the decisions that are taken by the finance manager with regards to the net profit distribution. Net profits are generally divided into two :

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

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

1.2 OBJECTIVES

After going through this lesson, you should be able to:

- Describe the concept of investment decisions and the factors affecting investment decisions
- Understand the financing decisions of companies
- Appreciate the factors affecting financing decisions
- Examine the meaning and factors affecting dividend decisions

1.3 CONCEPT OF INVESTMENT AND MEANING OF INVESTMENT DECISIONS

Concept of Investment : An investment is an asset or item accrued with the goal of generating income or recognition. In an economic outlook, an investment is the purchase of goods that are not consumed today but are used in the future to generate wealth. In finance, an investment is a financial asset bought with the idea that the asset will provide income further or will later be sold at a higher cost price for a profit. An investment is created with the intention of allowing money to grow. The wealth created can be used for a variety of objectives such as meeting shortages in income, saving up for retirement, or fulfilling certain specific obligations such as repayment of loans, payment of tuition fees, or purchase of other asset.

Meaning of Investment Decision : In the terminology of financial management, the investment decision means capital budgeting. Investment decision and capital budgeting are not considered different acts in business world. In investment decision, the word 'Capital' is exclusively understood to refer to real assets which may assume any shape i.e. building, plant and machinery, raw material and so on, whereas investment refers to any such real assets.

In other words, investment decisions are concerned with the question whether adding to capital assets today will increase the revenues of tomorrow to cover costs. Thus investment decisions are commitment of money resources at different time in expectation of economic returns in future dates. Choice is required to be made amongst available alternative revenues for investments. As such investment decisions are concerned with the choice of acquiring real assets over the time period in a productive process.

The need for investment decisions arrives for attaining the long term objective of the firm like, survival or growth, preserving share of a particular market and retain leadership in a particular aspect of economic activity.

The firm may like to make investment decision to avail the economic opportuni-ties which may arise due to the following reasons:

(i) Expansion of the productive process to meet the existing excessive demand in local market to exploit the international markets and to avail the benefits of economies of scale.

(ii) Replacement of an existing asset, plant, machinery or building may become necessary for reaping advantages of technological innovations, minimising cost of products and increasing the effi-ciency of labour.

(iii) Buy or hire on rent or lease a particular asset, is another important consideration which establishes the need for making investment decisions.

1.4 TYPES OF INVESTMENT DECISIONS

There are several categories of investment decisions.

The common categories are as follows:

(i) Inventory Investment:

Holding of stocks of materials is unavoidable for smooth running of a business. The expenditure on stocks comes in the category of investments.

(ii) Strategic Investment Expenditure:

In this case, the firm makes investment decisions in order to strengthen its market power. The return on such investment will not be immediate.

(iii) Modernisation Investment Expenditure:

In this case, the firm decides to adopt a new and better technology in place of the old one for the sake of cost reduction and other reasons. It is also known as capital deepening process.

(iv) Expansion Investment on a New Business:

In this case, the firm decides to start a new business or diversify into new lines of production for which a new set of machines are to be purchased.

(v) Replacement Investment:

In this category, the firm takes decisions about the replacement of worn out and obsolete assets by new ones.

(vi) Expansion Investment:

In this case, the firm decides to expand the productive capacity for existing products and thus grows further in a uni-direction. This type of investment is also called capital widening.

1.5 FACTORS AFFECTING INVESTMENT DECISIONS

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 affects 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. The following factors generally affect the investment decisions :

- **Cash flow of the venture:** When an organization starts a venture it invests a huge capital at the start. Even so, the organization expects at least some form of income to meet everyday day-to-day expenses. Therefore, there must be some regular cash flow within the venture to help it sustain.
- **Profits:** The basic criteria for starting any venture is to generate income but moreover profits. The most critical criteria in choosing the venture are the rate of return it will bring for the organization in the nature of profit for, e.g., if venture A is getting 10% return and venture Â is getting 15% return then one must prefer project B.
- **Investment Criteria:** Different capital budgeting procedures are accessible to a business that can be utilized to assess different investment propositions. Above all, these are based on calculations with regard to the amount of investment, interest rates, cash flows and rate of returns associated with propositions. These procedures are applied to the investment proposals to choose the best proposal.

1.6 MEANING OF FINANCING DECISIONS

Financial decision is important to make wise decisions about when, where and how should a business acquire fund. Because a firm tends to profit most when the market estimation of an organization's share expands and this is not only a sign of development for the firm but also it boosts investor's wealth. Consequently, this relates to the composition of various securities in the capital structure of the company. 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

Finance is the lifeblood of business concern, because it is interlinked with all activities performed by the business concern. In a human body, if blood circulation is not proper, body function will stop. Similarly, if the finance not being properly arranged, the business system will stop. Arrangement of the required finance to each department of business concern is highly a complex one and it needs careful decision. Financial requirement of the business differs from firm to firm and the nature of the requirements on the basis of terms or period of financial requirement; it may be long term and short-term financial requirements Long-term Financial Requirements or Fixed Capital Requirement and Short-term Financial Requirements or Working Capital Requirement.

Long-term financial requirement means the finance needed to acquire land and building for business concern, purchase of plant and machinery and other fixed expenditure. Long term financial requirement is also called as fixed capital requirements. Fixed capital is the capital, which is used to purchase the fixed assets of the firms such as land and building, furniture and fittings, plant and machinery, etc. Hence, it is also called a capital expenditure. Apart from the capital expenditure of the firms, the firms should need certain expenditure like procurement of raw materials, payment of wages, day-to-day expenditures, etc. This kind of expenditure is met with

the help of short-term financial requirements which will meet the operational expenditure of the firms. Short-term financial requirements are popularly known as working capital.

1.7 FACTORS AFFECTING FINANCING DECISIONS

The factors that affects the financing decisions are discussed as under :

1. **Cost-** 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.

2. **Risk-** 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 it is also repaid after a fixed period of time or on expiry of its tenure.

3. **Flotation cost-** 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.

4. **Cash flow position of the business**- In case the cash flow position of a company is good enough then it can easily use borrowed funds.

5. **Control considerations-** 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.

6. **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.

1.8 MEANING OF DIVIDEND DECISIONS

Dividend refers to a reward, cash or otherwise, that a company gives to its shareholders. Dividends can be issued in various forms, such as cash payment, stocks or

any other form. A company's dividend is decided by its board of directors and it requires the shareholders' approval. However, it is not obligatory for a company to pay dividend. Dividend is usually a part of the profit that the company shares with its shareholders. In other words, 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). The current year's profits as well as the retained earnings of previous years are available for distribution; a corporation usually is prohibited from paying a dividend out of its capital. Distribution to shareholders may be in cash (usually a deposit into a bank account) or, if the corporation has a dividend reinvestment plan, the amount can be paid by the issue of further shares or by share repurchase. In some cases, the distribution may be of assets.

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. Dividend policy is about the decision of the management regarding distribution of profits as dividends. This policy is probably the most important single area of decision making for finance manager. Action taken by the management

in this area affects growth rate of the firm, its credit standing, share prices and ultimately the overall value of the firm. Erroneous dividend policy may plunge the firm in financial predicament and capital structure of the firm may turn out unbalanced. Progress of the firm may be disabled owing to insufficiency of resources which may result in fall in earnings per share.

Stock market is very likely to react to this development and share prices may tend to sag leading to decline in total value of the firm. Extreme care and prudence on the part of the policy framers is, therefore, necessary. If strict dividend policy is formulated to retain larger share of earnings, sufficiently larger resources would be available to the firm for its growth and modernization purposes. This will give rise to business earnings. In view of improved earning position and robust financial health of the enterprise, the value of shares will increase and a capital gain will result. Thus, shareholders earn capital gain in lieu of dividend income; the former in the long run while the latter in the short run. The reverse holds true if liberal dividend policy is followed to pay out high dividends to share-holders. As a result of this, the stockholders' dividend earnings will increase but possibility of earning capital gains is reduced. Investors desirous of immediate income will greatly value shares with high dividend. The stock market may, therefore, respond to this development and the value of shares may soar. Therefore, in retention of earnings lies capital gain while distribution of income increases dividend earnings. Owing to varying notions and attitudes of shareholders due to differences with respect to age, sex, tax bracket, security, income habits, preferences and responsibilities, some are primarily concerned with the short run returns, others think in terms of long range returns; still others seek a portfolio which balances their expectations over time.

1.9 FACTORS AFFECTING DIVIDEND DECISIONS

The factors affecting divided decisions are as under :

- **Earnings:** Returns to investors are paid out of the present and past income. Consequently, earning is a noteworthy determinant of the dividend.

- **Dependability in Earnings:** An organization having higher and stable earnings can announce higher dividend than an organization with lower income.
- **Balancing Dividends:** For the most part, organizations attempt to balance out dividends per share. A consistent dividend is given every year. A change is made, if the organization's income potential has gone up and not only the income of the present year.
- **Development Opportunity**: Organizations have great development openings if they hold more cash out of their income to fund their required investment. The dividend announced in growing organizations is smaller than that in the non-development companies.

Other Factors

- **Cash flow:** Dividends are an outflow of funds. To give the dividends, the organization must have enough to provide them, which comes from regular cash flow.
- **Shareholders' Choices:** While announcing dividends, the administration must remember the choices of the investors. Some shareholders want at least a specific sum to be paid as dividends. The organizations ought to consider the preferences of such investors.
- **Taxes:** Compare tax rate on dividend with the capital gain tax rate that is applicable to increase in market price of shares. If the tax rate on dividends is lower, shareholders will prefer more dividends and vice versa.
- **Stock market**: For the most part, an expansion in dividends positively affects the stock market, though, a lessening or no increment may negatively affect the stock market. Consequently, while deciding dividends, this ought to be remembered.

- **Access to Capital Market:** Huge organizations with a good reputation, for the most part, have simple access to the capital market and, consequently, may depend less on retained earnings to finance their development. These organizations tend to pay higher dividends than the smaller organizations.
- **Contractual and Legal Constraints**: While giving credits to an organization, once in a while, the lending party may force certain terms and conditions on the payback of dividends in future. The organizations are required to guarantee that the profit payout does not abuse the terms of the loan understanding in any manner.

1.10 SUMMARY

Investment decisions are also known as Capital Budgeting Decisions. A company's assets and resources are rare and must be put to their utmost utilization. A firm should pick where to invest in order to gain the highest conceivable returns. This decision relates to the careful selection of assets in which funds will be invested by the firms. The firm puts its funds in procuring fixed assets and current assets. When choice with respect to a fixed asset is taken it is known as capital budgeting decision. After deciding the type of asset and the amount which should be expended on the asset, the job of the finance manager is to decide how to finance the asset. Raising of funds is mainly the result of financing decision. The most important question before the finance manager is to select a particular source from amongst the financial resources which may be available to raise the fund as required. Funds may be raised either from equity or from debt. The main objective is to achieve the optimum mix of external equity and internal equity so that the market value of the shares is maximised. The use of external equity may lead to increase in return on equity but in exchange it also increases the risk. The finance manager has to trade off between risk and return. The point where the shareholders value is maximised with minimum risk is that very point where the market value of the shares will be maximum and will lead the company to attain the optimum capital structure which is an ideal proposition. Another key point that the

finance manager is to determine what should be the dividend policy of an entity. The surplus profit of a business can either be distributed as dividend or can be ploughed back into business. The dividend policy should be determined considering the impact on shareholders' value. In addition, a number of other factors also determine the dividend policy. The above four decision areas of finance department are both interdependent and interrelated. Therefore, the company should strive for an optimal combination of the four interrelated financial decisions in order to achieve its objectives.

1.11 GLOSSARY

- **Investment Decisions:** 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.
- **Financial risk:** The risk of default on payment of periodical interest and repayment of capital on 'borrowed funds' is called financial risk.
- **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.
- **Dividend**: Dividend refers to the business concerns net profits distributed among the shareholders. It may also be termed as the part of the profit of a business concern, which is distributed among its shareholders.
- **Dividend Decision:** 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.

1.12 SELF ASSESSMENT QUESTIONS

1. What are Investment Decisions? What are the factors affecting it ?

2. Discuss the factors affecting financing decisions.

1.13 LESSON END EXERCISE

1. What are the types of Investment decisions ?

2. Explain in detail the factors that affect the dividend decisions in the companies.

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1.14 SUGGESTED READINGS

- Pandey, I. M., Financial Management, Vikas Publishing House, New Delhi.
- Gupta and Sharma, Management Accounting-Kalyani Publishers
- Guthmann and Dougall, Corporate Financial Policy, Pentice Hall.
- Babu, G. Ramesh (2005), "Indian Financial System", 1st Edition, Himalayan Publishing House, Mumbai.
- Desai, Vasant (2005), "The Indian Financial System and Development", 1st Edition, Himalayan Publishing House, Mumbai.
- Hampton, John, Financial Decision Making, Pentice Hall, New Delhi.

UNIT -1

FINANCIAL PLANNING AND CAPITALIZATION

LESSON No. 2

Concept and Objectives of Financial Planning, Essentials of Financial Planning

Structure:

2.1 Introduction

2.2 Objectives

2.3 Concept of Financial Planning

2.4 Characteristics of Financial Planning

2.5 Objectives of Financial Planning

2.6 Essentials of Financial Planning

2.7 Considerations in Formulating Financial Plans

2.8 Summary

2.9 Glossary

2.10 Self Assessment Questions

2.11 Lesson End Exercise

2.12 Suggested Readings

2.1 INTRODUCTION

Financial Planning is a vital part of Financial Management. In fact, planning is the first function of management. Before embarking on any venture, the company must have a plan. A financial plan is a statement estimating the amount of capital and determining its composition. The quantum of fund needed will depend upon the assets requirements of the business. The time at which funds will be needed should be carefully decided so that finances are raised at a time when these are needed.

The next aspect of a financial plan is to determine the pattern of financing. There are a number of ways for raising funds. The selection of various securities should be done carefully. The funds may be raised by issuing of capital and debentures, rising of loans, etc. Which source of finance should be raised and up to what amount these should be raised is very important.

2.2 OBJECTIVES

After going through this lesson, you should be able to:

- Explain concept of financial planning.
- Understand the characteristics of financial planning.
- Examine the considerations for formulating good financial plan.
- Understand the essentials of a good financial plan.

2.3 CONCEPT OF FINANCIAL PLANNING

Financial Planning is the process of estimating the capital required and determining it's competition. It is the process of framing financial policies in relation to procurement, investment and administration of funds of an enterprise.

Once a pattern of financing is selected then it becomes very difficult to modify it a financial plan also spells out the policies to be pursed for the floatation of various corporate securities, particularly regarding the time of their floatation. Financial Planning

is process of framing objectives, policies, procedures, programmes and budgets regarding the financial activities of a concern. This ensures effective and adequate financial and investment policies. Financial Planning helps in ensuring a reasonable balance between outflow and inflow of funds so that stability is maintained. Financial planning ensures that the suppliers of funds are easily investing in companies which exercise financial planning. It helps in making growth and expansion programmes which helps in long-run survival of the company. It reduces uncertainties with regards to changing market trends which can be faced easily through enough funds. Financial planning helps in reducing the uncertainties which can be a hindrance to growth of the company. This helps in ensuring stability and profitability in concern.

2.4 CHARACTERISTICS OF FINANCIAL PLANNING

The characteristics of financial planning are discussed as under :

a. Financial planning should attempt to minimize risk.

b. The primary aim of financial planning is to obtain better forecasts of future cash flows and earnings.

c. Financial planning is necessary because financing and investment decisions interact and should not be made independently.

d. Firms' planning horizons rarely exceed 3 years.

e. Individual capital investment projects are not considered in a financial plan unless they are very large.

f. Financial planning requires accurate and consistent forecasting.

g. Financial planning models should include as much detail as possible.

2.5 OBJECTIVES OF FINANCIAL PLANNING

Financial Planning has got many objectives to look forward to:

a. **Determining capital requirements-** This will depend upon factors like cost of current and fixed assets, promotional expenses and long-range planning. Capital requirements have to be looked with both aspects: short- term and long- term requirements.

b. **Determining capital structure-** The capital structure is the composition of capital, i.e., the relative kind and proportion of capital required in the business. This includes decisions of debt- equity ratio- both short-term and long- term.

c. **Framing financial policies** with regards to cash control, lending, borrowings, etc.

d. A finance manager **ensures that the scarce financial resources are maximally utilized in the best possible manner** at least in order to get maximum returns on investment.

e. **Ensuring availability of funds**: Financial planning majorly excels in the area of generating funds as well as making them available whenever they are required. This also includes estimation of the funds required for different purposes, which are, long-term assets and working capital requirements.

f. **Estimating the time and source of funds**: Time is a game-changing factor in any business venture. Delivering the funds at the right time at the right place is very much crucial. It is as vital as the generation of the amount itself. While time is an important factor, the sources of these funds are necessary as well.

g. **Generating capital structure**: The capital structure is the composition of the capital of a company, that is, the kind and proportion

of capital required in the business. This includes planning of debt-equity ratio both short-term and long-term.

h. **Avoiding unnecessary funds:** It is an important objective of the company to make sure that the firm does not raise unnecessary resources. Shortage of funds and the firm cannot meet its payment obligations. Whereas with a surplus of funds, the firm does not earn returns but adds to cost.

2.6 ESSENTIALS OF FINANCIAL PLANNING

The essentials of financial planning are:

1. Simplicity:

A financial plan should be so simple that it may be easily understood even by a layman. A complicated financial structure creates complications and confusion.

2. Based on Clear-cut Objectives:

Financial planning should be done by keeping in view the overall objectives of the company. It should aim to procure funds at the lowest cost so that profitability of the business is improved.

3. Less Dependence on Outside Sources:

A long-term financial planning should aim to reduce dependence on outside sources. This can be possible by retaining a part of profits for ploughing back. The generation of own funds is the way of financial operations. In the beginning, outside funds may be a necessity but financial planning should be such that dependence on such funds may be reduced in due course of time.

4. Flexibility:

The financial plan should not be rigid. It should allow a scope for adjustments as and when new situations emerge. There may be a scope for raising additional

funds if fresh opportunities occur. Similarly, idle funds, if any, may be invested in short-term and low-risk bearing securities. Flexibility in a plan will be helpful in coping with the demands of the future.

5. Solvency and Liquidity:

Financial planning should ensure solvency and liquidity of the enterprise. Solvency requires that short-term and long-term payments should be made on dates when these are due. This will ensure credit worthiness and goodwill to the concern.

Solvency will be possible when liquidity of assets is maintained. There should be sufficient funds whenever payments are to be made. Proper forecasting of future payments will be helpful in planning liquidity.

6. Cost:

The cost of raising capital is an important consideration in selecting a financial plan. The selection of various sources should be such that the cost burden should be minimum. As and when possible interest bearing securities should be returned so that this burden is reduced.

7. Profitability:

A financial plan should adjust various securities in such a way that profitability of the enterprise is not adversely affected. The interest bearing securities and other liabilities should be so adjusted that business is able to improve its profitability.

2.7 CONSIDERATIONS IN FORMULATING FINANCIAL PLANS

A financial plan should be carefully determined. It has long-term impact on the working of the enterprise. The following variables should be kept in mind while selecting a financial plan:

1. **Nature of the Industry:**

The needs for funds are different for various industries. The asset structure, element of seasonality, stability of earnings is not common factors for all industries. These variables will influence determining the size and structure of financial requirements.

2. **Standing of the Concern:**

The standing of a concern will influence a decision about financial plan. The goodwill of the concern, credit rating in the market, past performance, attitude of the management is some of the factors which will be considered in formulating a financial plan.

3. **Future Plans:**

The future plan of a concern should be considered while formulating a financial plan. The plans for expansion and diversification in near future will require a flexible financial plan. The sources of funds should be such which will facilitate required funds without any difficulty.

4. **Availability of Sources:**

There are a number of sources from which funds can be raised. The pros and cons of all available sources should be properly discussed for taking a final decision on the sources. The sources should be able to provide sufficient and regular funds to meet needs at various periods. A financial plan should be selected by keeping in view the reliability of various sources.

5. **General Economic Conditions:**

The prevailing economic conditions at the national level and international level will influence a decision about financial plan. These conditions should be considered before taking any decision about sources of funds. A favourable economic environment will help in raising funds without any difficulty. On the

other hand, uncertain economic conditions may make it difficult for even a good concern to raise sufficient funds.

6. Government Control:

The government policies regarding issue of shares and debentures, payment of dividend and interest rate, entering into foreign collaborations, etc. will influence a financial plan. The legislative restrictions on using certain sources, limiting dividend and interest rates, etc.; will make it difficult to raise funds. So, government controls should be properly considered while selecting a financial plan.

2.8 SUMMARY

Financial planning involves taking certain important decisions so that funds are continuously available to the company and are used efficiently. These decisions highlight the scope of financial planning. The financial plan is generally prepared during the promotion stage. It is prepared by the Promoters (entrepreneurs) with the help of experienced (practicing) professionals. The promoters must be very careful while preparing the financial plan. This is because a bad financial plan will lead to over-capitalization or under-capitalization. It is very difficult to correct a bad financial plan. Hence immense care must be taken while preparing a financial plan.

2.9 GLOSSARY

- **Financial Planning:** Financial Planning is the process of estimating the capital required and determining its competition. It is the process of framing financial policies in relation to procurement, investment and administration of funds of an enterprise
- **Financial Plan:** A financial plan is a comprehensive evaluation of an individual's current pay and future financial state by using current known variables to predict future income, asset values and withdrawal plans.

- **Economic conditions:** Economic conditions refer to the state of macroeconomic variables and trends in a country at a point in time. Such conditions may include GDP growth potential, the unemployment rate, inflation, and fiscal and monetary policy orientations.

2.10 SELF ASSESSMENT QUESTIONS

1. What factors should be considered while formulating good financial plan?

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2. Outline the characteristics of financial planning.

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2.11 LESSON END EXERCISE

1. Discuss the concept of financial planning.

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2. Explain in detail the objectives of financial planning.

2.12 SUGGESTED READINGS

- Pandey, I. M., Financial Management, Vikas Publishing House, New Delhi.
- Gupta and Sharma, Management Accounting-Kalyani Publishers
- Guthmann and Dougall, Corporate Financial Policy, Pentice Hall.
- Babu, G. Ramesh (2005), "Indian Financial System", 1st Edition, Himalayan Publishing House, Mumbai.
- Desai, Vasant (2005), "The Indian Financial System and Development", 1st Edition, Himalayan Publishing House, Mumbai.
- Hampton, John, Financial Decision Making, Pentice Hall, New Delhi.

UNIT -1

FINANCIAL PLANNING AND CAPITALIZATION

LESSON No. 3

Steps in Financial Planning, Estimating Financial Requirements and Limitations of Financial planning

Structure:

3.1 Introduction

3.2 Objectives

3.3 Need for Financial Planning

3.4 Importance of Financial Planning

3.5 Steps in Financial planning

3.6 Estimating Financial Requirements

3.7 Limitations of Financial planning

3.8 Summary

3.9 Glossary

3.10 Self Assessment Questions

3.11 Lesson End Exercise

3.12 Suggested readings

3.1 INTRODUCTION

Financial planning, also called budgeting, is the process of setting performance goals and organizing systems to achieve these goals in the future. In other words, planning is the process of developing business strategies and visions for the future. Financial planning is the process of estimating the capital required and determining its competition. It is the process of framing financial policies in relation to procurement, investment, and administration of funds of an enterprise. Financial planning is done to achieve the following two objectives. Firstly, to ensure availability of funds whenever these are required and secondly, sufficient fund should be available in the company for different purposes such as for the purchase of long-term assets, to meet day-to-day expenses, etc. It ensures timely availability of finance. Along with availability financial planning also tries to specify the sources of finance. To see that firm does not raise resources unnecessarily, excess funding is as bad as inadequate or shortage of funds. If there is surplus money, financial planning must invest it in the best possible manner as keeping financial resources idle is a great loss for an organization. Financial planning has got many objectives to look forward to like, determining capital requirements. This will depend upon factors like the cost of current and fixed assets, promotional expenses and long-range planning. Capital requirements have to be looked with both aspects: short- term and long- term requirements. For determining capital structure, the capital structure is the composition of capital, i.e., the relative kind and proportion of capital required in the business. This includes decisions of debt-equity ratio- both short-term and long-term and framing financial policies with regards to cash control, lending, borrowings, etc. A finance manager ensures that the scarce financial resources are maximally utilized in the best possible manner at least cost in order to get maximum returns on investment. Financial Planning includes both short-term as well as the long-term planning. Long-term planning focuses on capital expenditure plan whereas short-term financial plans are called budgets. Budgets include a detailed plan of action for a period of one year or less.

3.2 OBJECTIVES

After going through this lesson, you should be able to:

- Define the financial planning and its objectives
- Understand about the steps involved in financial planning.
- Explain the importance of financial planning.
- Describe the assessment of fixed capital requirements.
- Identify the importance of assessing working capital and intangible assets requirements.

3.3 NEED FOR FINANCIAL PLANNING

According to Cohen and Robbins, financial planning should:

1. Determine the financial resources required to meet the company's operating programme;
2. Forecast the extent to which these requirements will be met by internal generation of funds and the extent to which they will be met from external sources;
3. Develop the best plans to obtain the required external funds;
4. Establish and maintain a system of financial control governing the allocation and use of funds;
5. Formulate programmes to provide the most effective profit-volume-cost relationships;
6. Analyse the financial results of operations;
7. Report facts to the top management and make recommendations on future operations of the firm.

The following is the need for financial planning :

- Determine the financial resources required to meet the company's operating programme.
- Forecast the extent to which these requirements will be met by internal generation of funds and the extent to which they will be met from external sources.
- Develop the best plans to obtain the required external funds.
- Establish and maintain a system of financial control governing the allocation and use of funds.
- Formulate programmes to provide the most effective profit-volume-cost relationships.
- Analyze the financial results of operations, and.
- Reporting of facts to the top management and making recommendations on future operations of the firm.

3.4 IMPORTANCE OF FINANCIAL PLANNING

The important benefits of financial planning to a business are discussed below:

- Financial planning provides policies and procedures for the sound administration of the finance function.
- Financial planning results in the preparation of plans for the future. Thus, new projects could be undertaken smoothly.
- Adequate funds have to be ensured.
- Financial Planning helps in ensuring a reasonable balance between outflow and inflow of funds so that stability is maintained.

- Financial planning ensures that the suppliers of funds are easily investing in companies which exercise financial planning.
- Financial planning helps in making growth and expansion programmes which helps in long-run survival of the company.
- Financial planning ensures required funds from various sources for the smooth conduct of business.
- Uncertainty about the availability of funds is reduced. It ensures the stability of business operations.
- Financial planning attempts to achieve a balance between the inflow and outflow of funds. Adequate liquidity is ensured throughout the year. This will increase the reputation of the company.
- Cost of financing is kept to the minimum possible and scarce financial resources are used judiciously.
- Financial planning serves as the basis of financial control. The management attempts to ensure utilization of funds in tune with the financial plans.
- Financial Planning reduces uncertainties with regards to changing market trends which can be faced easily through enough funds, and.
- Financial Planning helps in reducing the uncertainties which can be a hindrance to the growth of the company. This helps in ensuring stability and profitability in concern.

3.5 STEPS IN FINANCIAL PLANNING

Most people want to handle their finances so that they get full satisfaction from each available dollar. Typical financial goals include such things as a new car, a larger home, advanced career training, extended travel, and self-sufficiency during working and retirement years. To achieve these and other goals, people need to identify

and set priorities. Financial and personal satisfaction are the result of an organized process that is commonly referred to as personal money management or personal financial planning.

Personal financial planning is the process of managing the money to achieve personal economic satisfaction. This planning process allows to control the financial situation. Every person, family, or household has a unique financial position, and any financial activity therefore must also be carefully planned to meet specific needs and goals.

- A comprehensive financial plan can enhance the quality of the life and increase the satisfaction by reducing uncertainty about the future needs and resources. The specific advantages of personal financial planning include;

  a. Increased effectiveness in obtaining, using, and protecting your financial resources throughout your lifetime.

  b. Increased control of financial affairs by avoiding excessive debt, bankruptcy, and dependence on others for economic security.

  c. Improved personal relationships resulting from well-planned and effectively communicated financial decisions.

  d. A sense of freedom from financial worries obtained by looking to the future, anticipating expenses, and achieving your personal economic goals.

We all make hundreds of decisions each day. Most of these decisions are quite simple and have few consequences. Some are complex and have long-term effects on our personal and financial situations. The financial planning process is a logical, six-step procedure:

- determining the current financial situation
- developing financial goals

- identifying alternative courses of action
- evaluating alternatives
- creating and implementing a financial action plan, and
- evaluating and revising the plan.

Step 1: Determine Current Financial Situation

In this first step of the financial planning process, we will determine the current financial situation with regard to income, savings, living expenses, and debts. Preparing a list of current asset and debt balances and amounts spent for various items gives a foundation for financial planning activities.

Step 2: Develop Financial Goals

We should periodically analyze the financial values and goals. This involves identifying how you feel about money and why we feel that way. The purpose of this analysis is to differentiate the needs from the wants.

Specific financial goals are vital to financial planning. Others can suggest financial goals for us; however, we must decide which goals to pursue. our financial goals can range from spending all of our current income to developing an extensive savings and investment program for our future financial security.

Step 3: Identify Alternative Courses of Action

- Developing alternatives is crucial for making good decisions. Although many factors will influence the available alternatives, possible courses of action usually fall into these categories:
- Continue the same course of action.

- Expand the current situation.
- Change the current situation.
- Take a new course of action.
- Not all of these categories will apply to every decision situation; however, they do represent possible courses of action.
- Creativity in decision making is vital to effective choices. Considering all of the possible alternatives will help make more effective and satisfying decisions.

Step 4: Evaluate Alternatives

- We need to evaluate possible courses of action, taking into consideration our life situation, personal values and current economic conditions.
- Consequences of Choices. Every decision closes off alternatives. For example, a decision to invest in stock may mean we cannot take a vacation. A decision to go to school full time may mean we cannot work full time. Opportunity cost is what we give up by making a choice. This cost, commonly referred to as the trade-off of a decision, cannot always be measured in dollars.
- Decision making will be an ongoing part of our personal and financial situation. Thus, we will need to consider the lost opportunities that will result from our decisions.

Evaluating Risk

- Uncertainty is a part of every decision. Selecting a college and choosing a career field involve risk. What if we don't like working in this field or cannot obtain employment in it?

- Other decisions involve a very low degree of risk, such as putting money in a savings account or purchasing items that cost only a few dollars. The chances of losing something of great value are low in these situations.
- In many financial decisions, identifying and evaluating risk is difficult. The best way to consider risk is to gather information based on the experience and the experiences of others and to use financial planning information sources.

Financial Planning Information Sources

- Relevant information is required at each stage of the decision-making process. Changing personal, social, and economic conditions will require that we continually supplement and update the knowledge.

Step 5: Create and Implement a Financial Action Plan

- In this step of the financial planning process, we develop an action plan. This requires choosing ways to achieve our goals. As we achieve our immediate or short-term goals, the goals next in priority will come into focus.
- To implement our financial action plan, we may need assistance from others. For example, we may use the services of an insurance agent to purchase property insurance or the services of an investment broker to purchase stocks, bonds, or mutual funds.

Step 6: Reevaluate and Revise Your Plan

- Financial planning is a dynamic process that does not end when we take a particular action. We need to regularly assess our financial decisions. Changing personal, social, and economic factors may require more frequent assessments.

- When life events affect the financial needs, this financial planning process will provide a vehicle for adapting to those changes. Regularly reviewing this decision-making process will help to make priority adjustments that will bring the financial goals and activities in line with the current life situation.

3.6 ESTIMATING FINANCIAL REQUIREMENTS

Assessment of Fixed Capital Requirements:

Capital needed to acquire those assets which are used for production purposes for longer period of time and which are not acquired for selling purposes is termed as fixed capital or block capital. Obvious examples of fixed capital are capital for purchasing land and buildings, furniture's and fixtures and machinery and plant.

Such capital is required usually at the time of establishment of new enterprise. However, existing undertakings may also need such capital to finance expansion and development programmes and to affect replacement of equipment.

Initial planning of fixed capital requirements is made by the promoter. For this purpose first of all, he prepares a list of fixed assets to be needed by the firm in consultation with his colleagues and technical experts associated with that line of business. Thereafter, cost of these assets is estimated.

There is generally no problem in getting information regarding value of land. Cost of construction of building could be surmised with the help of building contractor. Value of plant and machinery could be determined by obtaining price list from their manufacturers. If the costs of different fixed assets are summed, the resulting figure would be the total of fixed capital requirement of a new undertaking.

Planning fixed asset requirements is the most difficult task which calls for greater acumen and skill on the part of the projector. This is essentially because of relatively high cost of the fixed assets as compared to current assets and any errors resulting from the acquisition will have long-term adverse effect on financial health of the enterprise

and so also its profitability. Furthermore, risk factor is greatly associated with investment in fixed assets.

The longer the life of assets, the greater the risk the management assumes when it commits itself for this asset. In recent years problem of estimating fixed asset requirements has assumed considerable significance particularly because modern industrial processes require increasing use of capital equipment.

Mass production method and automation demand ever increasing commitment in fixed assets. Further, rising wage rates are encouraging the constant search for mechanical substitutes for labour. In view of this, the finance manager must bear in mind various internal and external factors that affect initial investment in fixed capital requirement.

Factors Affecting the Estimate of Fixed Assets Requirements:

A. Internal Factors:

(i) Nature of Business:

Different industrial undertakings may have varying fixed capital requirements because of different nature of business and the technology of the industry in which a company operates. Concerns engaged in rendering personal services, merchandise, commerce and trade may need very little fixed investment.

As against this, manufacturing industries, and public utilities have to commit substantially large amount of funds to acquire fixed assets. Here too, fixed capital requirements in capital intensive industrial projects is much greater in relation to their labour intensive counterparts.

(ii) Size of Business:

Where a business enterprise is being set up to carry on large scale operations, naturally its fixed capital requirements are likely to be high since most of their production processes are based on automatic machines and equipment's. But

in smaller concerns use of automatic machines is not so economical and useful because these machines are not employed to the optimum level.

(iii) Scope of Business:

Sometimes enterprises are established to engage in only one phase of production or distribution activity. In a sharp contrast to this, there are many business firms which are formed to carry on production or distribution work on its own entirely. Obviously, in the former case fixed capital requirements would be less relative to the latter case.

(iv) Extent of Lease:

While planning fixed capital requirements an entrepreneur has to decide in advance as to how many assets would be acquired on lease hold basis and how many on free hold basis. If larger amount of fixed assets is to be acquired on lease basis, naturally less amount of funds will have to be committed in the enterprise.

(v) Arrangement of Subcontract:

In case an entrepreneur has thought out an arrangement of contracting out some process of production to others or he has decided to engage in assembling the parts being manufactured by others he will require only those assets that will help in carrying out the process of production in which the firm will be engaged. This would consequently minimise fixed capital requirements of the enterprise.

(vi) Acquisition of Old Equipment's:

In certain industrial areas where the rate of technological change in production method is slow or moderate, old equipment's of plant available at prices that are far below those of new equipment's or plant may be used satisfactorily. Their use can materially reduce the required investment in fixed assets.

(vii) Acquisition of Accommodation on Rent:

The extent to which needed plant or equipment is available on reasonable rental terms also determines the required investment in fixed assets. Many retailers and some manufacturers whose space needs are distinctive, are able to meet their major building needs through rental.

(vii) Availability of Fixed Assets on Concessional Rates:

With a view to fostering balanced industrial growth and regional development of industries the Government may provide land and other building materials at concessional rates. Plant and equipment may be made available on installment purchase system. Such facilities are very likely to reduce the requirements of fixed assets.

B. External Factors:

Since fixed asset investment is a long-term one where amount of risk is comparatively more, the promoter should also consider the following external factors:

(i) International Conditions:

This factor is assuming prominent role in the decision making process in globalized scenario particularly in large concerns carrying on business on international scale. For example, steel companies expecting war may decide to commit large funds to expand fixed assets before there is a shortage of material or before inflation becomes reality. An international crisis may force some companies to postpone their expansion plans.

(ii) Secular Trend in the Economy:

An in-depth study of long-run trends in the economy must be undertaken while assessing requirements for fixed assets. If the future of the economy is anticipated to be bright, it gives green signal to business entrepreneur to carry

out all sorts of expansions of the firms. In that case large amount of funds has to be committed right now in fixed assets so as to be ready to reap benefits when opportunity arises.

(iii) Population Trends:

If the firm has a national market, national population trend must be evaluated while forecasting for fixed asset needs. In India, the population is increasing at a high rate. Automobile manufacturers find this a factor that encourages them to expand. The age composition of the population may be important for certain businesses like furniture industry and the optical industry.

(iv) Consumer's Preferences:

Financial planning must be geared to acquiring fixed assets that will provide goods or services that consumers will accept.

(v) Competitive Factors:

Competitive factors are a prime element in the decision making process on planning future fixed assets needs. If company A shifts to automation, company B engaged in the same line of activity will follow the need of the innovator.

(vi) Shift in Technology:

Shift in technology should also be considered while estimating fixed asset requirements.

Assessment of Working Capital Requirements :

After estimating fixed capital requirements of the firm a promoter has to assess the amount of capital that would be needed to ensure smooth functioning of the enterprise. A manufacturing concern requires funds to pile up adequate amount of raw materials in stock to ensure uninterrupted production activity. Likewise, sufficient stock of finished goods has also to be maintained in the anticipation of future demand and for this purpose firm would need capital.

Some of the materials because of being in different stages of productions are in semi- finished form. Funds are tied in these materials until they come out of final stage of production and are disposed off in the market. In actual parlance, goods are sold in cash and or on credit (against accounts receivables).

Goods sold on credit do not return cash immediately. Firm will have, therefore, to arrange funds to finance accounts receivable for the period until they are collected. Alongside this, a minimum level of cash is required for the ordinary operations of the enterprise. This cash requirement applies to the need to pay ordinary expenses of operation, viz., wages and factory overheads before a product can be sold and receipts are collected. Ample cash is required to take advantage of cash discounts. Adequate cash is also essential from the point of view of maintaining good credit relations.

Furthermore, firm has to hold special cash reserves to avail the advantages emanating from business opportunities for merger, special purchases of supplies and so forth. Since uncertainty is always a characteristic of business, some excess of cash should be maintained as insurance against unexpected adversities.

Thus, a business entrepreneur will have to arrange capital for the following types of assets to ensure day-to-day operations of the firm:

(i) For building up inventories of requisite materials.

(ii) For financing receivables.

(iii) For covering day-to-day operating expenses of the firm and for providing insurance against contingencies.

The above assets needed to carry on the productive and distributive activities of a business, to pay liabilities as they become due and act as a protection for short-term creditors are termed as current assets. Capital invested in these assets is ordinarily referred to as the 'working capital'.

Assessing Intangible Asset Requirements :

Planning fund requirements for intangible assets except for such organisation expenses as legal fees and taxes is relatively more difficult work. However, guess estimate has to be made so that required funds may be provided for the purpose.

(1) Promotion Expenses:

These include cash compensation of the promoter for his personal services plus expenses incurred by him in investigating and assembling various elements of business and payment for any options acquired by the promoter. It is very difficult to determine remuneration for the promoter's personal efforts in promoting the enterprise. Suitable allowance should be made for his time, skill and judgement.

According to A. S. Dewing, "Custom seems to have decreed that about 10 percent of the common stock is a fair compensation to the promoter if he merely conceives the enterprise and renders only advisory services to the banker who forthwith assumes the constructive activities of promotion. Where the promoter combines the functions of inventor, promoter and bankers he may even take 51 percent of the entire capitalisation as his compensation".

(2) Organisation Expenses:

Expenses incurred in setting up the business such as lawyer's fees, filing fees or registration fees and incorporation taxes, etc., are termed as organisation expenses, Clerical help and office expenses during the organisation period should also be included while calculating organisation expenses. Once firm's capitalisation is determined, estimation of organisation expenses becomes an easy job.

(3) The Operating Losses:

It takes some time for a firm to reach break-even stage. Until that stage is reached every firm incurs losses in course of business activity. Such losses are

commonly known as operating losses. Business that requires a larger initial investment or those businesses that are introducing novel products in the market have to incur operating losses for a prolonged period to become self-supporting.

These early losses must be paid in cash. Ordinarily they do not appear on the balance sheet as intangible assets; both are shown as loss in profit and loss account.

(4) Cost of Financing:

Promoter may engage the services of investment bankers, underwriters, brokers, etc. to raise cash to meet varied requirements of the firm. The payment for their services as also expenses incurred in preparation of a registration statement and prospectus for capital issues are all included under the cost of financing.

These costs may be very substantial for smaller firms seeking public financing by floating equity shares. These costs should also be estimated while determining the requirements for intangible assets.

(5) Intangible Assets such as Patents or Goodwill:

If a firm acquires patents for stock or a promise of royalty payments, it must be also included while assessing inventory requirements of the firm. Question of purchasing goodwill arises in the case of existing ventures with high earning power.

3.7 LIMITATIONS OF FINANCIAL PLANNING

Some of the limitations of financial planning are discussed as follows:

1. Difficulty in Forecasting:

Financial plans are prepared by taking into account the expected situations in the future. Since, the future is always uncertain and things may not happen as these are expected, so the utility of financial planning is limited. The reliability of financial planning is uncertain and very much doubted.

2. **Difficulty in Change:**

Once a financial plan is prepared then it becomes difficult to change it. A changed situation may demand change in financial plan but managerial personnel may not like it. Even otherwise, assets might have been purchased and raw material and labour costs might have been incurred. It becomes very difficult to change financial plan under such situations.

3. **Problem of Co-ordination:**

Financial function is the most important of all the functions. Other functions influence a decision about financial plan. While estimating financial needs, production policy, personnel requirements, marketing possibilities are all taken into account.

Unless there is a proper-co-ordination among all the functions, the preparation of a financial plan becomes difficult. Often there is a lack of co-ordination among different functions. Even indecision among personnel disturbs the process of financial planning.

4. **Rapid Changes:**

The growing mechanisation of industry is bringing rapid changes in industrial process. The methods of production, marketing devices, consumer preferences create new demands every time. The incorporation of new changes requires a change in financial plan every time.

Once investments are made in fixed assets then these decisions cannot be reversed. It becomes very difficult to adjust a financial plan for incorporating fast changing situations. Unless a financial plan helps the adoption of new techniques, its utility becomes limited.

3.8 SUMMARY

Finance is the life-blood of the business. So financial planning is an integral part of the corporate planning of the business. Financial Planning is the process of

framing objectives, policies, procedures, programmes and budgets regarding the financial activities of concern. This ensures effective and adequate financial and investment policies. All business plans depend upon the soundness of financial planning. Finance is required in all type of organisations. For arriving at the figure of total financial requirements, estimates of current and fixed and intangible assets should separately be made and then they should be added. This method of estimating financial needs of a business is called the 'balance sheet method'.

Another method which may be used as supplementary to the above one is the 'cash budget method'. In this method a forecast of cash flow and cash outgo is made month-wise. The cash deficiencies are calculated up-to the month in which the receipts are expected to exceed the disbursements. The total of such cash deficiencies gives the amount of finance needed by the concern.

To this total is also added the normal cash balance to be kept on hand. In such an estimate, the promotion expenses and the cost of fixed assets appear in the initial months and the cost of inventory and other operating expenses are included in the disbursements of several months depending upon the schedule of production and sales.

Credit policy of the concern and the possibility of bad debts should also be kept in mind. The balance sheet method should be supplemented with this method in order to arrive at correct figure.

3.9 GLOSSARY

- **Financial requirement**: Actual or projected sum of money required to execute a plan, project, or program.
- **Financial Management:** Financial Management means planning, organizing, directing and controlling the financial activities such as procurement and utilization of funds of the enterprise. It means applying general management principles to financial resources of the enterprise.

3.10 SELF ASSESSMENT QUESTIONS

1. Define the term "Financial planning". State the need and its importance.

2. What are the different types of financial requirements ?

3.11 LESSON END EXERCISE

1. Explain in detail the steps involved in the process of Financial Planning ?

2. Explain in detail how to assess working capital and intangible assets requirement ?

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3.12 SUGGESTED READINGS

- Pandey, I. M., Financial Management, Vikas Publishing House, New Delhi.
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UNIT -1

FINANCIAL PLANNING AND CAPITALIZATION

LESSON No. 4

Over-Capitalisation-Causes, effects and Remedies

Structure:

4.1 Introduction

4.2 Objectives

4.3 Meaning of Capitalisation

4.4 Theories of Capitalisation

4.5 Meaning of Over-capitalisation

4.6 Causes of Over-capitalisation

4.7 Effects of Over-capitalisation

4.8 Remedies of Over-capitalisation

4.9 Summary

4.10 Glossary

4.11 Self Assessment Questions

4.12 Lesson End Exercise

4.13 Suggested Readings

4.1 INTRODUCTION

The objective of every business is to maximize the value of the business. In this respect the finance manager, as well as individual investors, want to know the value created by the business. The value of business relates to the Capitalisation of the business.

The need for Capitalisation arises in all the phases of a firm's business cycle. Virtually Capitalisation is one of the most important areas of financial man-agement. In this article we will discuss various aspects relating to Capitalisation.

Capitalisation is the recordation of a cost as an asset, rather than an expense. This approach is used when a cost is not expected to be entirely consumed in the current period, but rather over an extended period of time. For example, office supplies are expected to be consumed in the near future, so they are charged to expense at once. An automobile is recorded as a fixed asset and charged to expense over a much longer period through depreciation, since the vehicle will be consumed over a longer period of time than office supplies.

Capitalisation is also based on the concept of materiality. If a cost is too small, it is charged to expense at once, rather than bothering with a series of accounting calculations and journal entries to capitalize it and then gradually charge it to expense over time. The specific dollar amount below which items are automatically charged to expense is called the Capitalisation limit, or cap limit. The cap limit is used to keep record keeping down to a manageable level, while still capitalizing the bulk of all items that should be designated as fixed assets.

Capitalisation is used heavily in asset-intensive environments, such as manufacturing, where depreciation can be a large part of total expenses. Conversely, Capitalisation may be extremely rare in a services industry, especially when the cap limit is set high enough to avoid the recordation of personal computers and laptops as fixed assets. If a company constructs fixed assets, the interest cost of any borrowed funds used to pay for the construction can also be capitalized and recorded as part of

the underlying fixed assets. This step is usually only taken for substantial construction projects. Capitalisation can be used as a tool to commit financial statement reporting fraud. If costs are capitalized that should have been charged to expense, current income is inflated, at the expense of future periods over which additional depreciation will now be charged. This practice can be spotted by comparing cash flows to net income; cash flows should be substantially lower than net income. The "Capitalisation" term also refers to the market value of a business. It is calculated as the total number of shares outstanding, multiplied by the current market price of the stock. It can also be defined as the sum of a company's stock, retained earnings, and long-term debt.

4.2 OBJECTIVES

After going through this lesson, you should be able to:

- Describe the meaning of Capitalisation.
- Understand the different types of Capitalisation.
- Explain the theories of Capitalisation.
- Define the concept of Over-Capitalisation.
- Recognize the causes of Over-Capitalisation.
- Explain the effects of Over- Capitalisation.
- Be acquainted with the remedies for Over-Capitalisation.

4.3 MEANING OF CAPITALISATION

Capitalisation refers to the valuation of the total business. It is the sum total of owned capital and bor-rowed capital. Thus it is nothing but the valuation of long-term funds invested in the business. It refers to the way in which its long-term obligations are distributed between different classes of both owners and creditors. In a broader sense it means the total fund invested in the business and includes owner's funds, bor-rowed funds, long term loans, any other surplus earning, etc. Symbolically:

Capitalisation = Share Capital + Debenture + Long term borrowing + Reserve + Surplus earnings.

Different authors have defined capitalisation in different ways but the theme of those definitions remains almost same. Some of the important definitions are presented below:

According to **Guthmal and Dougall,** 'capitalisation is the sum of the par value of the outstanding stocks and the bonds'.

In the words of **Walker and Baughen,** 'capitalisation refers only to long-term debt and capital stock, and short-term creditors do not constitute suppliers of capital, is erroneous. In reality, total capital is furnished by short-term creditors and long-term creditors'.

Bonneville and Deway define capitalisation as 'the balance sheet values of stocks and bonds outstanding'.

Hence, capitalisation is the value of securities and may be defined as the par value of various obligations of a firm distributed over various classes of stocks, bonds, debenture and creditors.

4.4 THEORIES OF CAPITALISATION

It is already said that capitalisation refers to the determination of the value through which a firm is to be capitalized. In the context of capitalisation there are two popular theories: Cost Theory and Earning Theory.

i. Cost Theory

This theory is focused on the cost of acquiring assets. The total value of capitalisation under the Cost Theory is the sum total of costs of acquiring both fixed and current assets. Under this theory the costs incurred for issue of shares and other securities are also included in capitalisation.

Hence capitalisation is the sum of land and building, plant and machinery and other fixed assets, stock of raw materials, debtors and other current assets and preliminary expenses. This theory is best used by a new firm as it helps to find the total amount of capital needed for establishing the business.

The theory suffers from the following limitations

a) It highlights only the cost aspect but not the capacity of the assets;

b) It remains silent about time when the asset becomes obsolete; and

c) For a firm having fluctuating earnings, the theory loses its importance.

ii. Earning Theory:

Under this theory the earning capacity of the business is considered as the basis of capitalisation. According to this theory the capitalized value of earning of the firm is the amount of capitalisation. Industry's representative rate of return is taken as the rate of capitalisation

The value of capitalisation is calculated thus:

Capitalisation = Average Annual Future Earnings / Capitalisation Rate x 100

This theory also suffers from the following limitations:

a) Estimation of future earning for a new company is very difficult;

b) Rate taken for capitalisation may not be proper representative of the firm; and

c) Mistake committed at the time of estimating the earnings will directly influence the amount of capitalisation.

4.5 MEANING OF OVERCAPITALISATION

Overcapitalisation is a situation in which actual profits of a company are not sufficient enough to pay interest on debentures, on loans and pay dividends on shares

over a period of time. This situation arises when the company raises more capital than required. A part of capital always remains idle. With a result, the rate of return shows a declining trend.

In other words, overcapitalisation occurs when a company has issued more debt and equity than its assets are worth. The market value of the company is less than the total capitalized value of the company. An overcapitalized company might be paying more in interest and dividend payments than it has the ability to sustain long-term. The heavy debt burden and associated interest payments might be a strain on profits and reduce the amount of retained funds the company has to invest in research and development or other projects. To escape the situation, the company may need to reduce its debt load or buy back shares to reduce the company's dividend payments. Restructuring the company's capital is a solution to this problem.

It is the capitalisation under which the actual profits of the company are not sufficient to pay interest on debentures and borrowings and a fair rate of dividend to shareholders over a period of time. In other words, a company is said to be over-capitalised when it is not able to pay interest on debentures and loans and ensure a fair return to the shareholders.

We can illustrate over-capitalisation with the help of an example. Suppose a company earns a profit of Rs. 3 lakhs. With the expected earnings of 15%, the capitalisation of the company should be Rs. 20 lakhs. But if the actual capitalisation of the company is Rs. 30 lakhs, it will be over-capitalised to the extent of Rs. 10 lakhs. The actual rate of return in this case will go down to 10%. Since the rate of interest on debentures is fixed, the equity shareholders will get lower dividend in the long-run.

There are three indicators of over-capitalisation, namely:

(a) The amount of capital invested in the company's business is much more than the real value of its assets.

(b) Earnings do not represent a fair return on capital employed.

(c) A part of the capital is either idle or invested in assets which are not fully utilised.

4.6 CAUSES OF OVERCAPITALISATION

Over-capitalization is that aspect of a business enterprise, wherein long term funds (share capital, debentures and loans) exceed the amount of optimum capitalization. The company earns reasonably fair return on its investment in case of proper capitalization. In case of over-capitalization, the rate of return in lesser than the rate of return of competitive firms. Declining rate of return and dividend presents a case of over-capitalization. In case of over-capitalization, the supply of long term funds exceeds the required amount of funds, or the economic activities of the enterprise get slower. The causes can be-

1. **High promotion cost**- When a company goes for high promotional expenditure, i.e., making contracts, canvassing, underwriting commission, drafting of documents, etc. and the actual returns are not adequate in proportion to high expenses, the company is over-capitalized in such cases.

2. **Purchase of assets at higher prices**- When a company purchases assets at an inflated rate, the result is that the book value of assets is more than the actual returns. This situation gives rise to over-capitalisation of company.

3. **A company's flotation in boom period**- At times company has to secure its solvency and thereby float in boom periods. That is the time when rate of returns are less as compared to capital employed. This results in actual earnings lowering down and earnings per share declining.

4. **Inadequate provision for depreciation**- If the finance manager is unable to provide an adequate rate of depreciation, the result is that inadequate funds are available when the assets have to be replaced or when they become obsolete. New assets have to be purchased at high prices which prove to be expensive.

5. **Liberal dividend policy-** When the directors of a company liberally divide the dividends into the shareholders, the result is inadequate retained profits which are very essential for high earnings of the company. The result is deficiency in company. To fill up the deficiency, fresh capital is raised which proves to be a costlier affair and leaves the company to be over- capitalized.

6. **Over-estimation of earnings-** When the promoters of the company overestimate the earnings due to inadequate financial planning, the result is that company goes for borrowings which cannot be easily met and capital is not profitably invested. This results in consequent decrease in earnings per share.

4.7 EFFECTS OF OVERCAPITALISATION

Effects of Overcapitalisation

1. On Shareholders- The over capitalized companies have following disadvantages to shareholders:

   a. Since the profitability decreases, the rate of earning of shareholders also decreases.

   b. The market price of shares goes down because of low profitability.

   c. The profitability going down has an effect on the shareholders. Their earnings become uncertain.

   d. With the decline in goodwill of the company, share prices decline. As a result shares cannot be marketed in capital market.

2. On Company-

   a. Because of low profitability, reputation of company is lowered.

   b. The company's shares cannot be easily marketed.

c. With the decline of earnings of company, goodwill of the company declines and the result is fresh borrowings are difficult to be made because of loss of credibility.

d. In order to retain the company's image, the company indulges in malpractices like manipulation of accounts to show high earnings.

e. The company cuts down it's expenditure on maintainance, replacement of assets, adequate depreciation, etc.

3. **On Public-** An overcapitalized company has got many adverse effects on the public:

a. In order to cover up their earning capacity, the management indulges in tactics like increase in prices or decrease in quality.

b. Return on capital employed is low. This gives an impression to the public that their financial resources are not utilized properly.

c. Low earnings of the company affects the credibility of the company as the company is not able to pay it's creditors on time.

d. It also has an effect on working conditions and payment of wages and salaries also lessen.

4.8 REMEDIES FOR OVERCAPITALISATION

In order to correct the situation caused by over-capitalisation, the following measures should be adopted:

(i) The earning capacity of the company should be increased by raising the efficiency of human and non-human resources of the company.

(ii) Long-term borrowings carrying higher rate of interest may be redeemed out of existing resources.

(iii) The par value and/or number of equity shares may be reduced.

(iv) Management should follow a conservative policy in declaring dividend and should take all measures to cut down unnecessary expenses on administration

4.9 SUMMARY

Overcapitalisation occurs when a company has issued more debt and equity than its assets are worth. The market value of the company is less than the total capitalized value of the company. An overcapitalized company might be paying more in interest and dividend payments than it has the ability to sustain long-term. The heavy debt burden and associated interest payments might be a strain on profits and reduce the amount of retained funds the company has to invest in research and development or other projects. To escape the situation, the company may need to reduce its debt load or buy back shares to reduce the company's dividend payments. Restructuring the company's capital is a solution to this problem.

Capitalisation of a company neither should be low nor high. It should be suitably available at the time of need. Over capitalisation is a state in which the earning which are not sufficient to give a good return on the amount of share capital which has been issued. This is where when total owned and borrowed capital exceeds the fixed and current assets (it shows losses on the assets side). The company which comes under this state is like a person who can't carry his own weight properly. The company which comes under this kind of influence has many difficulties and not likely to be active until the state is been corrected. The causes of over capitalisation are idle funds, Company may have funds which might not have been used properly e.g. Money invested in such projects that are giving very low profits; Over-valued, Fixed assets may be having higher cost than that of its actual cost; Value degradation, Fixed assets may have been taken when the prices were high and when the prices have fallen the value of it may have fallen but then also the value for the company will be high only and Inadequate Depreciation provision, Fixed assets might not have adequate provision.

4.10 GLOSSARY

- **Capitalisation:** In finance, structure and amount of long-term equity and debt capitals of a firm expressed as percentage of the total (equity and debt) capital.
- **Over-capitalisation:** situation where a firm has more capital than it catered-for or needs. Thus, its assets are worth less than its issued share capital, and the earnings are insufficient to pay dividend and interest. This situation is remedied generally by buying back issued shares (stock) or by paying off debt.

4.11 SELF ASSESSMENT QUESTIONS

1. Explain the term "Capitalisation" along with its types?

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2. Discuss the various theories of "Capitalisation"?

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4.12 LESSON END EXERCISE

1. Illustrate the causes and effects of overcapitalisation ?

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2. What are the various remedies of overcapitalisation ?

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4.13 SUGGESTED READINGS

- Pandey, I. M., Financial Management, Vikas Publishing House, New Delhi.
- Gupta and Sharma, Management Accounting-Kalyani Publishers
- Guthmann and Dougall, Corporate Financial Policy, Pentice Hall.
- Babu, G. Ramesh (2005), "Indian Financial System", 1st Edition, Himalayan Publishing House, Mumbai.
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UNIT -1

FINANCIAL PLANNING AND CAPITALIZATION

LESSON No. 5

Under-Capitalisation-Causes, effects and Remedies

Under-Capitalisation versus Over-Capitalisation

Structure:

5.1 Introduction

5.2 Objectives

5.3 Meaning of Capitalisation

5.4 Meaning of Under-capitalisation

5.5 Causes of Under-capitalisation

5.6 Effects of Under-capitalisation

5.7 Remedies of Under-capitalisation

5.8 Under-Capitalisation versus Over-Capitalisation

5.9 Summary

5.10 Glossary

5.11 Self Assessment Questions

5.12 Lesson End Exercise

5.13 Suggested Readings

5.1 INTRODUCTION

An accountant may, however, use the concept of capitalisation in a different way. When dividends or retained earnings in the form of stock or bonus shares are issued to the existing shareholders, capital stock is increased and surplus decreased, the surplus is said to be capitalised and this process is known as capitalisation.

Again, in finance, capitalisation of income means the process of estimating the present investment value of a property by discounting the present worth, the anticipated stream of future income. In other words, when total earnings along with the current rate of interest are used for calculating the total capital, the process is called capitalisation of earnings.

Capitalisation has been used in the narrow sense to include the aggregate of all types of long-term securities and surpluses not meant for distribution. A separate term capital gearing or structure has been used to denote the forms and proportion of various securities to be issued.

We shall discuss first the basis of capitalisation and then the different aspects of capital structure. The separation of these two topics for the purposes of this explanation is not intended to give the impression that management arrives at total amount of capitalisation and then determines its capital structure.

Actually what happens is that management estimates the amount of capital that will be required and then tries to figure out how to raise that amount of capital. In making its deal with those who supply the capital, it arrives at the capitalisation and capital structure.

5.2 OBJECTIVES

After going through this lesson, you should be able to:

- Explain the meaning of Under-capitalisation.
- Identify the causes of Under-capitalisation\

- List out the effects of Under-capitalisation
- Understand the remedies of Under-capitalisation
- Describe the similarities and difference between the under-capitalisation and over-capitalisation.

5.3 MEANING OF CAPITALISATION

The term 'capitalisation' is derived from the word 'capital; hence it would be appropriate to understand the meaning of 'capital'. Capital in 'business usage' is mostly taken to mean total assets required to operate in a business and the money needed to acquire such assets.

The term capital in accounting literature means the net worth of the company. Net worth means assets minus liabilities. Economists use the term capital to mean all the accumulated wealth used to produce additional wealth. The debtors and similar accounting claims, the intangible assets like goodwill are excluded from the economist's version of capital.

Capital, in the legal parlance of the term, is the amount received in return for securities (shares allotted to the investors). The total amount of share values paid as shown in the company's books of accounts is legally known as its capital.

The term capitalisation is used in relation to companies and not in respect of sole proprietorships and partnership firms. Different views have been expressed on the concept and definition of capitalisation by various authors in the context of corporate sector.

Some authors have given it a broad meaning while others have used it in a narrow sense. According to first school of thought, capitalisation has been defined 'to include the amount of capital to be raised; the securities through which it is to be raised and the relative proportions of various classes of securities to be issued, and also the administration of capital.

The analysis of this definition clearly shows that capitalisation is synonymous with financial planning. Besides the amount of capital required in a business, it decides about the determination of the form and the relative proportions of the various classes of securities to be issued and administration of policies concerning capital.

Lillin Doris, Gilbert Harold and Charles Gerstenberg have given narrow interpretation of the term capitalisation. They feel that the term capitalisation refers to the amount at which a company's business can be valued.

Some of the important definitions are discussed below:

> "Capitalisation of a corporation comprises the ownership capital and the borrowed capital as represented by long-term, indebtness. It may also mean the total accounting value of capital stock, surplus in whatever form it may appear and funded long-term debt" **Lillin Doris.**
>
> "Capitalisation comprises (i) ownership capital which includes capital stock and surplus in whatever form it may appear; and (ii) borrowed capital which consists of bonds or similar evidences of long term debt"
>
> **According to Gerstenberg** "Capitalisation of a corporation is the sum of the par value of the stocks and bonds outstanding"
>
> **Guthman and Dougall** "Capitalisation is equivalent to the valuation placed upon the fixed capital by the corporation measured by stocks and bonds outstanding"

From these definitions it can be concluded that capitalisation is the sum-total of all long-term securities issued by a company and surplus not meant for distribution. In other sense, Bonneville and others defined capitalisation as the act or process of fixing the value of an enterprise for the purpose of determining the capital liabilities that the company may assume in exchange for the property.

5.4 MEANING OF UNDER-CAPITALISATION

A company is said to be under-capitalised when it is earning exceptionally higher profits as compared to other companies or the value of its assets is significantly higher than the capital raised. For instance, the capitalisation of a company is Rs. 20 lakhs and the average rate of return of the industry is 15%. But if the company is earning 30% on the capital investment, it is a case of under-capitalisation.

In the words of Gesternberg, **"**A company may be under-capitalised when the rate of profits it is making on the total capital is exceptionally high in relation to the return enjoyed by similarly situated companies in the same industry, or when it has too little capital with which to conduct its business".

In simple words, we can say that under-capitalisation is the reverse phenomenon of over-capitalisation, and occurs when a company's actual capitalisation is lower than its proper capitalisation as warranted by its earning capacity. The term under-capitalisation should never be considered synonymous with inadequate capital.

The real value of an under-capitalised company is more than its book value. The profits are higher than warranted by the book value of its assets. Such a company can pay a higher rate of dividend and the market value of its shares is much higher than its face value.

The assets acquired with the existing capitalisation facilitate the generation of higher profits. It so happens when:

(i) The assets have been acquired at lower rates, or

(ii) The company has generated secret reserves by paying lower dividends to the shareholders over a number of years.

The indicators of under-capitalisation are as follows:

There is an unforeseen increase in earnings of the company.

(b) Future earnings of the company were under-estimated at the time of promotion.

(c) Assets might have been acquired at very low prices.

5.5 CAUSES OF UNDER-CAPITALISATION

Following are the important causes of under-capitalisation in a company:

1. Under-Estimation of Capital Requirements:

If the future capital requirements are under-estimated by the promoters, the inadequacy of capital is experienced at a later stage. The company may arrange cheaper debt at lower rate of interest at that stage resulting in increased earnings per share. This leads the company to a situation of under-capitalisation.

2. Under-Estimation of Future Earnings:

While preparing the financial plan, if the future earnings of the company are under estimated and the actual earnings turn out to be higher than the estimated figure, the company may find itself in a condition of under-capitalisation.

3. Promotion during Depression:

Companies promoted during a period of depression often experience under-capitalisation when inflation sets in because of a sudden rise in their earnings.

4. Conservative Dividend Policy:

If the management of a particular company adopts an orthodox dividend policy, i.e. where it follows a cautious policy regarding the distribution of dividend and keeps a major part of its earnings for re-investment purpose, it results into higher earnings and conditions of under-capitalisation.

5. Very Efficient Management:

In companies, where the management is very efficient, the rate of return may be quite high as compared to other companies in the same industry, and such a high rate of return may eventually lead towards under-capitalisation.

6. Desire of Control and Trading on Equity:

In many companies, the promoter desires to retain control over the company and raises lesser amount of share capital. However, later on when the funds are required they resort to trading on equity. This raising of funds at a lower rate of interest than the earnings of the company eventually leads to under-capitalisation.

5.6 EFFECTS OF UNDER-CAPITALISATION

Like over-capitalisation, under-capitalisation also has many evil effects on the company and its owners as well as the society as a whole.

The main effects of under-capitalisation are as below:

1. Under-capitalisation induces management to change and manipulate the market value of shares and expanding the business.
2. As a consequence of under-capitalisation, earnings per share increase and so do the dividend per share, which is turn, increases the marketability of shares.
3. When the employees find that the company is earning high profits they press for higher wages and as a result, a tiff between the workers and employers takes place giving rise to labour unrest.
4. As a consequence of under-capitalisation, the companies earn huge profits and as a result, the burden of tax is great. The government introduces higher rate of taxation which is a financial burden on the companies.

5. Higher profits earned by the companies give a psychological feeling to the customers that they are being over-charged and hence they develop grouse towards that company.

6. Higher earnings may encourage competitors to enter into a cut-throat competition amongst themselves.

7. A situation of over-trading by the company may arise as a result of under-capitalisation, where the company does excessive business than what its finances can allow.

8. As a result of over-trading, creditors will not be paid timely and the company will effect its creditworthiness adversely.

9. Under-capitalisation eventually leads to over-capitalisation because of excessive profits, huge retained earnings and long-term debt financing.

Effects can also be explained and categorized in another way:

1. On Shareholders

a. Company's profitability increases. As a result, rate of earnings go up.

b. Market value of share rises.

c. Financial reputation also increases.

d. Shareholders can expect a high dividend.

2. On Company

a. With greater earnings, reputation becomes strong.

b. Higher rate of earnings attract competition in market.

c. Demand of workers may rise because of high profits.

d. The high profitability situation affects consumer interest as they think that the company is overcharging on products.

3. On Society

a. With high earnings, high profitability, high market price of shares, there can be unhealthy speculation in stock market.

b. ‘Restlessness in general public is developed as they link high profits with high prices of product.

c. Secret reserves are maintained by the company which can result in paying lower taxes to government.

d. The general public inculcates high expectations of these companies as these companies can import innovations, high technology and thereby best quality of product.

5.7 REMEDIES OF UNDER-CAPITALISATION

Under-capitalisation can be corrected by taking any of the following remedial measures:

1. Fresh Issue of Shares:

If under-capitalisation is due to inadequacy of capital, then it can be corrected by the issue of fresh shares, the company may also redeem its long-term debt by the issue of fresh share capital.

2. Issue of Bonus Shares:

The company may issue bonus shares by capitalising its accumulated earnings. This is the most commonly used and effective method of correcting under-capitalisation. It reduces earnings per share after the bonus issue.

3. Increasing the Par Value of Shares:

The company may revalue its assets and increase their values. In lieu, thereof, the par value of shares may also be increased. This will result into reduction

of earnings per rupee of share value but the amount of dividend per share will remain same.

4. **Splitting Stock.** Another effective method of correcting under-capitalisation is to split up the existing stock into larger number of shares reducing the value of each share. It neither affects the total earnings of the company nor the total amount of capital of the company but still dividend per share shall reduce.

5.8 OVER-CAPITALISATION VERSUS UNDER-CAPITALISATION

Over Capitalization:

A company is said to be overcapitalized when the aggregate of the par value of its shares and debentures exceeds the true value of its fixed assets.In other words, over capitalisation takes place when the stock is watered or diluted.

It is wrong to identify over capitalisation with excess of capital, for there is every possibility that an over capitalised concern may be confronted with problems of liquidity. The current indicator of over capitalisation is the earnings of the company.

If the earnings are lower than the expected returns, it is overcapitalised. Overcapitalisation does not mean surplus of funds. It is quite possible that a company may have more funds and yet to have low earnings. Often, funds may be inadequate, and the earnings may also be relatively low. In both the situations there is over capitalisation.

Over capitalisation may take place due to – exorbitant promotion expenses, inflation, shortage of capital, inadequate provision of depreciation, high corporation tax, liberalised dividend policy etc. Over capitalisation shows negative impact on the company, owners, consumers and society.

Under capitalization:

Under capitalisation is just the reverse of over capitalisation, a company is said to be under capitalised when its actual capitalisation is lower than its proper capitalisation as warranted by its earning capacity. This happens in case of well established companies, which have insufficient capital but, large secret reserves in the form of considerable appreciation in the values of fixed assets not brought into books.

In case of such companies, the dividend rate will be high and the market value of their shares will be higher than the value of shares of other similar companies. The state of under capitalisation of a company can easily be ascertained by comparing of a book value of equity shares of the company with their real value. In case real value is more than the book value, the company is said to be under capitalised.

Under capitalisation may take place due to – under estimation of initial earnings, under estimation of funds, conservative dividend policy, windfall gains etc. Under-capitalisation has some evil consequences like creation of power competition, labour unrest, consumer dissatisfaction, possibility of manipulating share value, etc.

The point of difference between over-capitalisation and under-capitalisation is given as under:

1. Over-capitalisation involves a great-strain on the financial resources of a company whereas under-capitalisation implies high rate of earnings on its shares.

2. The remedial procedure of over-capitalisation is more difficult and expensive as compared to the remedial procedure of under-capitalisation.

3. Under-capitalisation accelerates cut-throat competition amongst companies; results in discontentment among employees and grouse amongst customers;

whereas over-capitalisation adversely affects the shareholders and endangers the economic stability and Social prosperity.

4. Over-capitalisation is a common phenomena than under-capitalisation which is relatively a rare phenomena.

The phenomena is discussed with the help of following :

1) Over-Capitalisation:

Balance Sheet

Liabilities	₹	*Assets*	₹
Share Capital	10,00,000	Fixed Assets	12,00,000
Debentures	5,00,000	Current Assets	13,00,000
Current Liabilities	10,00,000		
	25,00,000		25,00,000

[Here the excess of fixed liabilities over fixed assets is (15,00.000 – 12,00,000) = Rs. 3,00,000. Thus, we say that the firm is over capitalised to the extent of Rs. 3,00,000]

(2) Under-Capitalisation:

Balance Sheet

Liabilities	₹	*Assets*	₹
Share Capital	10,00,000	Fixed Assets	16,00,000
Debentures	5,00,000	Current Assets	9,00,000
Current Liabilities	10,00,000		
	25,00,000		25,00,000

[Here the excess of fixed assets over fixed liabilities is Rs. (16,00,000 – 15,00,000) = Rs. 1,00,000. Hence, we say that the firm is under-capitalised to the extent Rs. 1,00,000]

(3) Fairly-capitalised:

Balance Sheet

Liabilities	₹	*Assets*	₹
Share Capital	10,00,000	Fixed Assets	15,00,000
Debentures	5,00,000	Current Assets	10,00,000
Current Liabilities	10,00,000		
	25,00,000		25,00,000

(4) An Under-capitalised concern really over-capitalised:

Balance Sheet			
Liabilities	₹	*Assets*	₹
Share Capital	10,00,000	Fixed Assets	16,00,000
Debentures	5,00,000	Current Assets	9,00,000
Reserve Fund	3,00,000		
Current Liabilities	7,00,000		
	25,00,000		25,00,000

[Here the fixed assets of the company of Rs. 16,00,000 exceed the fixed liabilities in the form of shares and debentures amounting to Rs. 15,00,000 (10,00,000+5,00,000). The concern seems to be under-capitalised. But in fact, there is a reserve fund amounting to Rs. 3,00,000.

In case reserve fund is taken into consideration, the fixed liabilities are Rs. 18,00,000 and there is an excess of fixed liabilities over fixed assets of Rs. 2,00,000 (18,00,000- 16,00,000). Hence, in reality, the concern is over-capitalised].

5.9 SUMMARY

The term capitalisation, or the valuation of the capital, includes the capital stock and debt. According to another view it is a word ordinarily used to refer to the sum of the outstanding stocks and funded obligations which may represent wholly fictitious values. The ordinary meaning of capitalisation in the computation appraisal or estimation of present value. This 'valuation' concept underlies the definitions of capitalisation and the emphasis is placed upon the amount of capital. But the term capitalisation has on thrown its previous concept.

Originally, it was used in the sense of 'valuation' and 'amount' but qualitative connotation now usually accompanies the quantitative expression. The term capitalisation is now taken as being synonymous with capital structure or financial plan. An undercapitalized company is one which incurs exceptionally high profits as compared to industry. An undercapitalized company situation arises when the estimated earnings are very low as compared to actual profits. This gives rise to additional funds, additional profits, high goodwill, high earnings and thus the return on capital shows an increasing trend. Under-capitalisation may be remedied by increasing the

par value and/or number of equity shares by revising upward the value of assets. This will lead to decrease in the rate of earnings per share. Management may capitalise the earnings by issuing bonus shares to the equity shareholders. This will also reduce the rate of earnings per share without reducing the total earnings of the company. Where under-capitalisation is due to insufficiency of capital, more shares and debentures may be issued to the public.

The most important area of financial planning is to determine the right proportion of debt and equity. The objective of a firm is to create value which can be performed through proper mobilization and use of funds. So the right amount of capitalization is the basic objective of a finance manager. Fair capitalization is that situation where the business has employed the correct amount of capital and its earnings are same as the average rate of earnings. The sources of funds and their amount should be carefully selected to attain the value maximization objective of a firm. Fair capitalization helps a firm achieve this objective. Under fair capitalization every rupee of the fund mobilized is used profitably. Neither is there any shortage of funds nor is any fund left unutilized. This can be done by balancing the debt and equity component in capitalization.

5.10 GLOSSARY

- **Under-capitalization:** Undercapitalization occurs when a company does not have sufficient capital to conduct normal business operations and pay creditors. This can occur when the company is not generating enough cash flow or is unable to access forms of financing such as debt or equity.

- **Shares:** In financial markets, a share is a unit used as mutual funds, limited partnerships, and real estate investment trusts. The owner of shares in the company is a shareholder of the corporation. A share is an indivisible unit of capital, expressing the ownership relationship between the company and the shareholder

- **Trading on equity:** Trading on equity occurs when a company incurs new debt (such as from bonds, loans, or preferred stock) to acquire assets on which it can earn a return greater than the interest cost of the debt.

5.11 SELF ASSESSMENT QUESTIONS

1. Trace the causes of undercapitalisation.

2. What are effects and remedies of under-capitalisation ?

5.12 LESSON END EXERCISE

1. What is the difference between under-capitalisation and over-capitalisation?

5.13 SUGGESTED READINGS

- Pandey, I. M., Financial Management, Vikas Publishing House, New Delhi.
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UNIT -II

LONG TERM SOURCES OF FINANCE

LESSON No. 6

Concept of Equity Shares, Characteristics of Equity Shares and Advantages & Disadvantages of Equity Shares

Structure :

6.1 Introduction

6.2 Objectives

6.3 Concept and Advantages of Equity Shares

6.3.1 Advantages to Company

6.3.2 Advantages to Investors

6.4 Disadvantages of Equity Shares

6.4.1 Disadvantages to Company

6.4.2 Disadvantages to Investors

6.5 Characteristics of Equity Shares

6.6 Kinds of Equity Shares

6.6.1 According to Stock Market

6.6.2 According to Peter Lynch's

6.7 SEBI Guidelines for Equity Shares

6.8 Summary

6.9 Glossary

6.10 Self Assessment Questions

6.11 Lesson End Questions

6.12 Suggested Readings

6.1 INTRODUCTION

In accounting and finance, equity is the residual claim or interest of the most junior class of investors in assets, after all liabilities are paid. If liability exceeds assets, negative equity exists. In an accounting context, Shareholders' equity (or stockholders' equity, shareholders' funds, shareholders' capital or similar terms) represents the remaining interest in assets of a company, spread among individual shareholders of common or preferred stock.

At the start of a business, owners put some funding into the business to finance operations. This creates a liability on the business in the shape of capital as the business is a separate entity from its owners. Businesses can be considered, for accounting purposes, sums of liabilities and assets; this is the accounting equation. After liabilities have been accounted for, the positive remainder is deemed the owner's interest in the business.

This definition is helpful in understanding the liquidation process in case of bankruptcy. At first, all the secured creditors are paid against proceeds from assets. Afterwards, a series of creditors, ranked in priority sequence, have the next claim/ right on the residual proceeds. Ownership equity is the last or residual claim against assets, paid only after all other creditors are paid. In such cases where even creditors could not get enough money to pay their bills, nothing is left over to reimburse owners' equity. Thus owners' equity is reduced to zero. Ownership equity is also known as risk capital or liable capital.

6.2 OBJECTIVES :-

After completion of this lesson, you should be able to

- understand the concept of equity shares
- explain the characteristics of equity shares
- understand the advantages and disadvantages of equity shares
- understand the guidelines for the issue of Equity Shares

6.3 CONCEPT OF EQUITY SHARES :

Equity shares or ordinary shares are those shares which are not preference shares. Dividend on these shares is paid after the fixed rate of dividend has been paid on preference shares. The rate of dividend on equity shares is not fixed and depends upon the profits available and the intention of the board. In case of winding up of the company, equity capital can be paid back only after every other claim including the claim of preference shareholders has been settled. The most outstanding feature of equity capital is that its holders control the affairs of the company and have an unlimited interest in the company's profits and assets. They enjoy voting right on all matters relating to the business of the company. They may earn dividend at a higher rate and have the risk of getting nothing. The importance of issuing ordinary shares is that no organisation for profit can exist without equity share capital. This is also known as risk capital.

6.3.1 Advantages to Company :

The advantages of issuing equity shares may be summarized as below:

I. **Long-term and Permanent Capital:** It is a good source of long-term finance. A company is not required to pay-back the equity capital during its life-time and so, it is a permanent source of capital.

II. **No Fixed Burden:** Unlike preference shares, equity shares has no fixed burden on the company's resources, because the dividend on these shares are subject to availability of profits and the intention of the board of directors. They may not get the dividend even when company has profits. Thus they provide a cushion of safety against unfavorable development

III. **Credit worthiness:** Issuance of equity share capital creates no change on the assets of the company. A company can raise further finance on the security of its fixed assets.

IV. **Risk Capital:** Equity capital is said to be the risk capital. A company can trade on equity in bad periods on the risk of equity capital.

V. **Dividend Policy:** A company may follow an elastic and rational dividend policy and may create huge reserves for its developmental programmes.

6.3.2 Advantages to Investors :

Investors or equity shareholders may enjoy the following advantages:

I. **More Income:** Equity shareholders are the residual claimant of the profits after meeting all the fixed commitments. The company may add to the profits by trading on equity. Thus equity capital may get dividend at high in boom period.

II. **Right to Participate in the Control and Management:** Equity shareholders have voting rights and elect competent persons as directors to control and manage the affairs of the company.

III. **Capital profits:** The market value of equity shares fluctuates directly with the profits of the company and their real value based on the net worth of the assets of the company. An appreciation in the net worth of the company's assets will increase the market value of equity shares. It brings capital appreciation in their investments.

IV. **An Attraction of Persons having Limited Income:** Equity shares are mostly of lower denomination and persons of limited recourses can purchase these shares.

V. **Other Advantages:** It appeals most to the speculators. Their prices in security market are more fluctuating.

6.4 DISADVANTAGES OF EQUITY SHARES

6.4.1 Disadvantages to Company :

Equity shares have the following disadvantages to the company:

I. **Dilution in control:** Each sale of equity shares dilutes the voting power of the existing equity shareholders and extends the voting or controlling power to the new shareholders. Equity shares are transferable and may bring about centralization of power in few hands. Certain groups of equity shareholders may manipulate control and management of company by controlling the majority holdings which may be detrimental to the interest of the company.

II. **Trading on equity not possible:** If equity shares alone are issued, the company cannot trade on equity.

III. **Over-capitalization:** Excessive issue of equity shares may result in over-capitalization. Dividend per share is low in that condition which adversely affects the psychology of the investors. It is difficult to cure.

IV. **No flexibility in capital structure:** Equity shares cannot be paid back during the lifetime of the company. This characteristic creates inflexibility in capital structure of the company.

V. **High cost:** It costs more to finance with equity shares than with other securities as the selling costs and underwriting commission are paid at a higher rate on the issue of these shares.

VI. **Speculation:** Equity shares of good companies are subject to hectic speculation in the stock market. Their prices fluctuate frequently which are not in the interest of the company.

6.4.2 Disadvantages to Investors :

Equity shares have the following disadvantages to the investors:

I. **Uncertain and Irregular Income:** The dividend on equity shares is subject to availability of profits and intention of the Board of Directors and hence the income is quite irregular and uncertain. They may get no dividend even three are sufficient profits.

II. **Capital loss During Depression Period:** During recession or depression periods, the profits of the company come down and consequently the rate of dividend also comes down. Due to low rate of dividend and certain other factors the market value of equity shares goes down resulting in a capital loss to the investors.

III. **Loss on Liquidation:** In case, the company goes into liquidation, equity shareholders are the worst suffers. They are paid in the last only if any surplus is available after every other claim including the claim of preference shareholders is settled. It is evident from the advantages and disadvantages of equity share capital discussed above that the issue of equity share capital is a must for a company, yet it should not solely depend on it. In order to make its capital structure flexible, it should raise funds from other sources also.

6. 5 CHARACTERISTICS OF EQUITY SHARES

Equity shares have a number of features which distinguish them from other shares and securities. These features generally relate to" the rights and position of equity shareholders. The following are the most significant features of equity shares:

1. **Maturity.** Equity shares provide permanent capital to the company and cannot be redeemed during the life time of the company. Under the Companies Act,

1956, a company cannot purchase its own shares. Equity shareholders can demand refund of their capital only at the time of liquidation of a company. Even at the time of liquidation, equity capital is paid back after meeting all other prior claims including that of preference shareholders.

2. **Claims/Right to Income**. Equity shareholders have a residual claim on the income of a company. They have a claim on income left after paying dividend to preference shareholders. The rate of dividend on these shares is not fixed, it depends upon the earnings available after paying dividends on preference shareholders. In many cases, they may not get anything if profits are sufficient; or may get even a higher rate of dividend. That is why, equity shares are also known as 'variable income security'. Even if the company is left with sufficient profits after meeting all obligations including that of preference shareholders, equity shareholders cannot legally force the company to pay dividends to them. The distribution of income as dividend to equity shareholders is left to the discretion of the Board of Directors of the Company under the Companies Act, 1956. But, even when the residual income is not distributed to equity shareholders by way of cash dividends, they stand to benefit in future by way of enhanced earning capacity of the company resulting in higher dividends in future as well as capital appreciation.

3. **Claim on Assets.** Equity shareholders have a residual claim on ownership of company's assets. In the event of liquidation of a company, the assets are utilised first to meet the claims of creditors and preference shareholders but everything left, thereafter, belongs to the equity shareholders. Thus, equity shares provide a cushion to absorb losses on liquidation and may, usually, remain unpaid.

4. **Right to Control or Voting Rights.** Equity shareholders are the real owners of the company. They have voting rights in the meeting of the company and have a control over the working of the company. The control in case of a company rests with the Board of Directors who are elected by the equity

shareholders. Directors are appointed in the Annual General Meeting by majority votes. Each equity share carries one vote and a shareholder has votes equal to the number of equity share held by him. Hence, equity shareholders exercise an indirect control over the working of the company. But, often, such indirect control is weak and ineffective because of the indifference of most of the shareholders in casting their votes

5. **Pre-emptive Right.** To safeguard the interest of equity shareholders and enable them maintain their proportion ownership, section 81 of the Companies Act, 1956 provides that whenever a public limited company proposes to increase its subscribed capital by the allotment of further shares, after the expiry of two years from the formation of the company or the expiry of one year from the first allotment of shares in the company, whichever is earlier, such shares must be offered to holders of existing equity shares in proportion, as nearly as circumstances admit, to the capital paid up on these shares. Shares so offered to existing shareholders are called Right Shares and their prior right to such is known as pre-emptive right. The pre-emptive right protects equity shareholders by ensuring that management cannot issue additional shares to persons of their choice in order to strengthen their control over the company. It also protects them from dilution of their financial interest in the company.

6. **Limited Liability.** Another distinct feature of equity shares is limited liability. Thus, although, equity shareholders are the real owners of the company, their liability is limited to the value of share they have purchased. If a shareholder has already fully paid the share price, he cannot be held liable further for any losses of the company even at the time of liquidation. This enables the equity shareholders to enjoy the ownership of a firm without risking unlimited liability as is the case in sole-proprietorship or partnership firms

6.6 CLASSIFICATION OF EQUITY SHARES

Equity shares have been classified on the basis of

- According to stock market.
- According to Peter Lynch’s.

6.6.1 According to Stock Market

Stock market has classified equity shares as follows:

- Blue chip shares
- Growth shares
- Income shares
- Cyclical shares
- Defensive shares
- Speculative shares

Blue chip shares: Blue chip shares means share of large, well established, and financially strong companies shares with an impressive record of earnings and dividends.

Growth shares: Growth shares means shares of companies that have a fairly entrenched position in a growing market and which enjoy an above average rate of growth as well as profitability.

Income shares: Income shares means shares of companies that have fairly stable operations, relatively limited growth opportunities, and high dividend payout ratios.

Cyclical shares: Cyclical shares means shares of companies that have a pronounced cyclicality in their operations.

Defensive shares: Means shares of companies that are relatively unaffected by the ups and downs in general business conditions.

Speculative shares: Speculative shares means shares that tend to fluctuate widely because there is a lot of speculative trading in them.

6.6.2 According to Peter Lynch's

According to Peter Lynch's Classification of Company Share

Peter Lynch's has classified company shares:

- Slow Growers
- Stalwarts
- Fast Growers
- Cyclical
- Turn Around
- Asset Plays
- Slow Growers

Slow growers: Slow growers large and aging companies that are expected to grow slightly faster than the gross national product.

Stalwarts: Stalwart giant companies that are faster than slow growers but are not agile climbers.

Fast Growers: Small, aggressive new enterprise that grow at 10 to 25per cent a year.

Cyclical: Cyclical companies whose sales and profit rises and falls in a regular, though not completely predictable fashion.

Turn Around: Turn around companies are steeped in accumulated losses but which show signs of recovery. Turn around companies have the potential to make up lost ground quickly.

Asset plays: Asset plays companies that have valuable assets which have been somewhat overlooked by the stock market.

6.7 SEBI GUIDELINES FOR EQUITY SHARES

The important aspects of SEBI Guidelines, with reference to issue of equity shares are as under:

Eligibility Norms for Public Issues

As per the guidelines, an unlisted company can make an initial public offering (IPO) of equity shares or any security convertible at a later date into equity only if it has net tangible assets of atleast Rs. 3 crores in each of the preceding 3 full years (of 12 months each), of which not more than 50% is held in monetary assets. If more than 50% of net tangible assets are held in monetary assets, the company should have made firm commitments to deploy such excess monetary assets in its business/ projects. The company has a track record of distributable profits in terms of Section 205 of the Companies Act, 1956 for atleast three out of immediately proceeding five years. Extraordinary items should, however not be considered for calculating distributable profits in terms of Section 205 of the Act. The guidelines also require that the company should have a net worth of atleast Rs. 1 crore in each of the preceding 3 full years (of 12 months each) and if the company has changed its name within the last one year, atleast 50% of the revenue for the preceding 1 full year is earned by the company from the activity suggested by the new name. Also, the aggregate of the proposed issue and all previous issues made in the same financial year in terms of size (i.e. offer through offer document and firm allotment and promoters contribution through the offer document) should not exceed five times its pre-issue net worth as per the audited balance sheet of the last financial year.

An unlisted company which does not satisfy the requirements specified above can make an offer to the public of equity or any security convertible at a later date into equity only through book building process. The company must allot 50% of the issue size to the Qualified Institutional Buyers (QIBs) otherwise full subscription money is to be refunded. Alternatively, the project should have atleast 15% participation by Financial Institutions/Scheduled Commercial Banks, of which atleast 10% comes from

the appraiser(s). In addition to this, atleast 10% of the issue size shall be allotted to QIBs otherwise full subscription monies should be refunded. QIBs here mean public financial institutions, as defined in Section 4A of the Companies Act, 1956, scheduled commercial banks, mutual funds, foreign institutional investors registered with SEBI, multilateral and development financial institutions or venture capital funds registered with SEBI, foreign venture capital investors registered with SEBI, State Industrial Development Corporations, insurance companies registered with IRDA, provident funds with minimum corpus of Rs. 25 crores, pension fund with a minimum corpus of Rs. 25 crores and 'Project' as aforesaid means the object for which the monies proposed to be raised to cover the objects of the issue.

Further, either the minimum post-issue face value capital of the company should be Rs. 10 crores or there should be a compulsory market-making for at least 2 years from the date of listing of the shares subject to the following:

- Market makers undertake to offer buy and sell quotes for a minimum depth of 300 shares;
- Market makers undertake to ensure that the bid-ask spread (difference between quotations for sale and purchase) for their quotes shall not at any time exceed 10%;
- The inventory of the market makers on each of such stock exchanges, as on the date of allotment of securities, shall be at least 5% of the proposed issue of the company.

Further, it is stipulated that an unlisted public company shall not make an allotment pursuant to a public issue or offer for sale of equity shares or any security convertible into equity shares unless in addition to satisfying the aforesaid conditions, the prospective allottees are not less than one thousand (1000) in number.

The guidelines require that a public issue of equity shares or any other security which may be converted into/exchanged with equity shares at a later date, in case of

a listed company, may be made provided that the aggregate of the proposed issue and all previous issues made in the same financial year, in terms of issue size, does not exceed five times its pre-issue net worth as per the audited balance sheet of the last financial year. The issue for this purpose includes offer through offer document, firm allotment and promoters' contribution through the offer document.

Also, if there is a change in the name of the issuer company within the last one year, the revenue accounted for by the activity suggested by the new name should not be less than 50% of its total revenue in the preceding one full year period. The last one year should be reckoned from the date of filing of the offer document.

If the net worth after the proposed issue of equity shares or any security convertible at a later date into equity becomes more than five times the net worth prior to the issue, it is also required to satisfy the criteria of book-building process and allot 50% of the issue size to QIBs failing which subscription money is required to be refunded.

Eligibility norms require credit rating from a credit rating agency registered with Board and its disclosure in the offer document. Where credit ratings are obtained from more than one credit rating agencies, all the credit rating/s, including the unaccepted credit ratings, should be disclosed. It also requires disclosure regarding all the credit ratings obtained during three years preceding the public or rights issue or issue of debt instrument in the offer document. It is also required that the company should not in the list of wilful defaulters of RBI and the company should not be in default of payment of interest or repayment of principal in respect of debentures issued to the public, if any, for a period of more than 6 months.

Further, an issuer company cannot make an allotment of non-convertible debt instrument pursuant to a public issue if the proposed allottees are less than fifty (50) in number. In such a case the company shall forthwith refund the entire subscription amount received. If there is a delay beyond 8 days after the company becomes liable to pay the amount, the company shall pay interest @15% p.a. to the investors.

Eligibility criteria also require the company to file a draft prospectus through eligible Merchant Banker with SEBI at least 30 days prior to the filing of prospectus with the Registrar of Companies as prescribed in the guidelines. If the Board specifies changes or issues observations on the draft Prospectus, the issuer company or the Lead Manager to the Issue is required to carry out such changes in the draft Prospectus or comply with the observations issued by the Board before filing the Prospectus with ROC. Further the period within which the Board may specify changes or issue observations, if any, on the draft Prospectus is 30 days from the date of receipt of the draft Prospectus by the Board. Where the Board has sought any clarification or additional information from the Lead Manager/s to the Issue, the period within which the Board may specify changes or issue observations, if any, on the draft Prospectus is 15 days from the date of receipt of satisfactory reply from the Lead Manager/s to the Issue. If the Board has made any reference to or sought any clarification or additional information from any regulator or such other agencies, the Board may specify changes or issue observations, if any, on the draft Prospectus after receipt of comments or reply from such regulator or other agencies. The Board may specify changes or issue observations, if any, on the draft Prospectus only after receipt of copy of in-principle approval from all the stock exchanges on which the issuer company intends to list the securities proposed to be offered through the Prospectus.

It also requires the company to make a statement to the effect that the company has made an application for listing of those securities in the Stock Exchanges and should not have been prohibited from accessing the capital market under any order or directions passed by SEBI. A listed company cannot make an issue of security through a rights issue, where the aggregate value of securities, including premium if any, exceeds Rs. 50 lacs, unless the letter of offer is filed with the Board, through an eligible Merchant Banker in the prescribed manner at least 30 days prior to the filing of letter of offer with Designated Stock Exchange.

The company is also required to enter into an agreement with a depository for dematerialisation of securities already issued or proposed to be issued to the public or existing shareholders and give an option to subscribers/shareholders/investors to

receive the security certificates or hold securities in the dematerialised form with a depository.

There should not be outstanding warrants or financial instruments or any other right which would entitle the existing promoters or shareholders any option to receive equity share capital after the initial public offering in case of unlisted company making a public issue of equity share or any security convertible at later date into equity shares. The guidelines also require that all the existing partly paid-up shares must be made fully paid or the subscription money be forfeited if the investor fails to pay call money within 12 months. A company cannot make a public or rights issue of securities unless firm arrangements of finance through verifiable means towards 75% of the stated means of finance, excluding the amount to be raised through proposed Public/ Rights issue, have been made.

The aforesaid norms of eligibility are not applicable in the case of –

i. A banking company including a local area bank set up under Section 5(c) of the Banking Regulation Act, 1949 and which has received license from the Reserve Bank of India, or

ii. A corresponding new bank set up under the Banking Companies (Acquisition and Transfer of Undertaking) Act, 1970; Banking Companies (Acquisition and Transfer of Undertaking) Act, 1980; State Bank of India Act, 1955; State Bank of India (Subsidiaries Banks) Act, 1959.

iii. An infrastructure company:

    a) whose project has been appraised by a Public Financial Institution (PFIs) or Infrastructure Development Finance Corporation (IDFC) or Infrastructure Leasing and Financing Service Ltd. (IL&FS), or a bank which was earlier a PFI, and

    b) not less than 5% of the project cost is financed by any of the institutions jointly or severally irrespective of the fact whether they appraise the

project or not, by way of loan or subscription to equity or a combination of both.

iv. Rights issues by a listed company.

6.8 SUMMARY

Equity Shares also known as ordinary shares, which means, other than preference shares. Equity shareholders are the real owners of the company. They have a control over the management of the company. Equity shareholders are eligible to get dividend if the company earns profit. Equity share capital cannot be redeemed during the lifetime of the company. The liability of the equity shareholders is the value of unpaid value of shares.

6.9 GLOSSARY

- **Company:** A company is an association or collection of individuals people or *"warm-bodies"* or else contrived "legal persons" (or a mixture of both).
- **Prospectus:** A formal legal document, which is required by and filed with the Securities and Exchange Commission, that provides details about an investment offering for sale to the public.
- **Bankruptcy:** A legal proceeding involving a person or business that is unable to repay outstanding debts.

6.10 SELF ASSESSMENT QUESTIONS

1. What are the different types of equity shares according to stock market ?

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2. According to Peter Lynch's what are the types equity shares.

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3. Critically examine the advantages of equity shares.

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4. What are the demerits of equity shares from the point of investors ?

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6.11 LESSON END QUESTIONS

1. What are equity shares ?

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2. What are the characteristics of equity shares ?

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3. What are the Guidelines given by SEBI for issue of equity shares ?

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4. Critically examine the advantages and disadvantages of equity shares.

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6.12 SUGGESTED READINGS

- P.V.Kulkarni: Business finance, Himalaya PublishingHouse
- S.C.Kuchal: Corporate Finance, Chaitanya PublishingHouse, Allahabad
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UNIT-II

LONG TERM SOURCES OF FINANCE

LESSON No. 7

Concept of Preference Shares, Characteristics of Preference Shares and Types of Preference Shares

Structure:

7.1 Introduction

7.2 Objectives

7.3 Concept of Preference Shares

7.4 Characteristics of Preference Shares

7.5 Types of Preference Shares

7.6 Summary

7.7 Glossary

7.8 Self Assessment Questions

7.9 Lesson End Exercise

7.10 Suggested Readings

7.1 INTRODUCTION

Share is defined as an interest in the company entitling the owner thereof to receive proportionate part of the profits, if any, and, at the' same time, proportionate part of the assets of the company in case of liquidation.

It can also be expressed as certain invisible units of a fixed amount, i.e., the units are known as 'shares'. It is the interest of a shareholder in the company measured, by a sum of money for the purpose of liability in the first place, and of interest in the second but also consisting of a series of mutual covenants entered into-by all the shareholders. It may be defined as "an interest having a money value and made up of diverse rights specified under the Articles of Association." In this context it is needless to mention that it has got certain rights and liabilities when the company is a going concern or the company is being wound-up.

According to Indian Companies Act, 1956, the shares of a company may be divided into the following categories like equity shares, preference shares, etc.

7.2 OBJECTIVES

After going through this lesson, you should be able to:

- Understand the concept of preference shares.
- Be familiar with the major types of preference shares.
- Define the arguments in favour of and against preference shares.
- Highlight the importance and characteristics of preference shares.

7.3 CONCEPT OF PREFERNCE SHARES

Preference shares are the shares which are preferred over equity shares in payment of dividend, the preference shareholders are the first to get dividends if the company decides to distribute or pay dividends.

These are shares having preferential rights to claim dividends during the lifetime of the company and to claim repayment of capital on wind up. In case of preference shares, the percentage of dividend is fixed i.e. the holders get the fixed dividend before any dividend is paid to other classes of shareholders.

Preference shares are one of the important source of hybrid financing because it has some features of equity shares and some features of debentures. The preference shareholders enjoy preferential rights with regard to receiving dividends and getting back capital in case the company winds-up.

Sec. 85(1) notes that a preference share is one which satisfies the following :

a. They have a preferential right to be paid as dividend during the lifetime of the company, and

b. They have a preferential right to the return of capital if the company goes into liquidation.

Moreover, the preference shareholders are entitled to receive a fixed rate of dividend before the dividend is received by the equity shareholders in the event of liquidation.

7.4 CHRACTERISTICS OF PREFERNCE SHARES

Preference shares have several characteristics. Some of them are common to all the types of preference shares while others are specific to some of them. The following are the most significant features of preference shares:

(i) Maturity:

Generally, preference shares resemble equity shares in respect of maturity. These are perpetual (irredeemable) and the company is not required to repay the amount during its life time. It is only at the time of liquidation that a company has to repay the preference shareholder after meeting the claim of creditors but before paying back the equity shareholders.

However, a company may issue redeemable preferences shares with a limited life after which these are supposed to be retired or paid back. The terms of the issue of preference shares may contain a call feature by which the company may call or buy back the shares at a specific price.

According to the Companies Act, 1956, a company can issue redeemable preference shares if authorised by its Articles of Association.

Section 80 of Act, provides that redeemable preference shares can be redeemed:

a. Only if these are fully paid

b. Redemption may be made either out of accumulated profits or out of the proceeds of a fresh issue of shares;

c. If shares are to be redeemed out of accumulated profits, the amount required must be transferred to Capital Redemption Reserve Account and,

d. If shares are to be redeemed at premium, it should be provided either out of the accumulated profits or Share Premium Account.

(ii) Claims on Income:

A fixed rate of dividend is payable on preference shares. Preference shareholders have prior claim on income (dividend) over equity shareholders. Whenever the company has distributable profits, the dividend is first paid on preference share capital. Only after payment of stipulated dividend on preferred stock, the company can pay any dividend to other (equity) shareholders. But, like equity shareholders, the holders of preference shares also cannot legally demand payment of dividends or distribution of earnings, as it is the prerogative of the management to decide whether to pay dividend or to reinvest its earnings.

However, the rate of dividend on preference shares, unlike equity shares, is fixed and they do not have share in the extra earnings of the company. But, a company may issue participating preference shares giving its holders a right to participate in the surplus profits of the company. In the same manner, a company may issue cumulative preference shares.

The cumulative feature gives right to its holders to claim arrears of dividend in the sense that in the event of non-declaration of dividends in any year, the same will not lapse and will be carried forward till the same is paid. A company may also issue cumulative convertible preference shares which are convertible into equity shares after the expiry of a certain period.

(iii) Claims on Assets:

Preference shares have a preference in the repayment of capital at the time of liquidation of a company. Their claims on assets are superior to those of equity shareholder. In the event of winding up of the company, their claim is to be settled first before making any payment to the equity shareholders.

But as they are not real owners of the company, the preference shareholder, usually, do not have any right in the surplus assets of the company. However, a company may issue participating preference shares which entitle its holders right to participate even in the surplus assets of the company at the time of liquidation in agreed ratio.

(iv) Control :

Ordinarily, preference shareholders do not have any voting rights; so they do not have any say in the management or control of the company. However, under section 87 of the Companies Act, 1956, preference shareholders can vote on a resolution which directly affects the rights to be attached to their preference shares.

They can also vote on every kind of resolutions placed before the meeting of the company if the dividend due to their shares or any part of has remained unpaid. In these situations, their right to vote shall be in the same proportion as the paid up preference share capital bears to the total paid up equity capital of the company.

(v) Hybrid Form of Security:

Preference share capital, in the real sense, represents a hybrid form of security as it includes some features of equity and other of debt financing.

It resembles equity in the sense that:

(i) Payment of dividend is not obligatory;

(ii) Preference dividend is payable only out of distributable profits and,

(iii) It is not deductible as an expense while determining tax liability of the company.

At the same time, it has certain characteristics of debt financing such as:

(i) It carries a fixed rate of dividend like interest;

(ii) It entitles to a right to its holder prior to equity shareholders and

(iii) It does not provide a right to vote

Therefore, we can sum up that preference shares have a wide range of features as corporate emphasize a set of features while issuing them such as:

- Preference shareholders have no right to vote in the annual general meeting of a company
- Dividend payable is generally higher than debenture interest
- Hybrid security of preference shares because it also bears some characteristics of debentures

- These are a long-term source of finance
- It consists of a part of share capital of a company.
- Since it is not considered as a debt, no collateral security/mortgage is required.
- As per. Sec. 87 of the Companies Act, it enjoys limited voting rights.
- It enjoys a fixed rate of dividend irrespective of the volume of profit gained.
- Preference dividend is a charge against appropriation of profit.
- It enjoys a priority income distribution of income and, at the same time, on assets distribution.
- It enjoys the cumulative rights to receive dividends.
- It is redeemable after the period of 20 years from the date of issue.
- It may or may not be converted into equity shares.
- It can be transacted (i.e. purchased/sold) through Stock Exchange.

7.5 TYPES OF PREFERENCE SHARES

The percentage of dividend is fixed in preference shares. The holders of preference shares get the fixed dividend before any dividend is paid to other classes of shareholders. At the time of winding up of the company, the preference shareholders can get back their capital before any other classes of shareholders can get back their money.

There are different types of preference shares according to the clause contained in the agreement at the time of their issue. The following are some important kinds of preference shares.

There are different classes of preference shares. They are as follows:

- Cumulative Preference Shares.
- Non-cumulative Preference Shares.
- Participating Preference Shares.
- Non-participating Preference Shares.
- Convertible Preference Shares.
- Non-convertible Preference Shares.
- Redeemable Preference Shares.
- Guaranteed Preference Shares.

1. Cumulative preference shares

Shares which have the right of dividend of a company even in those years in which it makes no profit are called cumulative preference share. The company must pay the unpaid dividends on preference shares before the payment of dividends to equity shareholders.

If in any year the company does not earn adequate profit, dividends on preference shares may not be paid for that year. In case of cumulative preference shares, such unpaid dividend is treated as arrears. The arrears will accumulate and they will be payable out of the profits of the subsequent years. Dividend on other classes of shares can be paid only after the payment of such arrears. If the Articles of Associationsilent, all preference shares are assumed to be cumulative preference shares.

2. Non-Cumulative preference shares

Non-cumulative preference shares are in contrast to cumulative preference shares. Non-cumulative dividends do not accumulate if they are not paid when due.

The dividend on these shares are payable only out of the profits of the current year. If in any year the company does not earn adequate profit, the holders get no dividend or partial dividend. In that case, the unpaid dividend will not be carried forward to subsequent years. The holder cannot claim arrears of dividend.

3. Participating Preference Shares

The holders of Participating preference share receive stipulated rate of dividend and also participate in the additional earnings of the company along with the equity shareholders.

During the lifetime of the company in addition to the fixed dividend, the shareholders of this kind of shares have a right to participate in the surplus of profits, which remains after payment to the equity shareholders. At the time of winding up in addition to their shares, the shareholders have a right to participate in the surplus of assets, which remains after payment to the equity shareholders. The surplus will be distributed between the participating preference shareholders and equity shareholders in an agreed ratio.

4. Non-Participating Preference Shares

In practice, most preference shares are non-participating in nature. It means that preference shareholders receive only stated dividend and no more. This is based on the fact that the preference shareholders surrender their claim to extra earnings in lieu of their right to receive the stated dividend.

The holders of non-participating preference shares have no right either to participate in the surplus of profits, which remains after payment to equity shareholders (during the lifetime) or to participate in the surplus of assets, which remains after payment to equity shareholders (at the time of winding up). If the Articles of Association is silent, all preference shares are treated as nonparticipating preference shares.

5. **Redeemable preference shares**

According to Sec. 80 of the Companies Act, the preference shares, which can be redeemed after a specified period or at the discretion of the company, are called redeemable preference shares.

Non-redeemable preference share is permanent in nature and its shareholding is continuous till the company goes into liquidation. In this sense, the preference share resembles the equity share. So, in order to attract the investor, a clause is included in the agreement for redeeming the preference share after the expiry of a specified period.

The redemption of preference share is advantageous for the company. It acts as a hedge against inflation. When the money rate declines, the company may redeem the shares and refinance it at a lower dividend rate.

6. **Non-redeemable preference shares**

Redeemable preference shares are also called, at the option of the company. If this call is exercised by the company, the investor must find alternative form of investment for investing the sum he gets on the retirement of the shares. Investment in equity share is more profitable than that of preference share.

Preference share holders do not participate, in the extra earnings of the company, except in the case of participating preference shares.

7. **Convertible preference shares**

Convertible preference shares are those which are converted into equity shares at a specified rate on the expiry of a stated period. The holders of this kind of shares have a right to convert their shares into equity shares within a specified period.

For example, a 100 Rupee preference share may become convertible into 10 equity shares of Rs.10 each.

8. Non-Convertible preference shares

Convertible preference share may also have cumulative or participating rights. This kind of preferred stock is ideal from the view point of the investor. Non-convertible preference shares are not converted into equity stock. Non-convertible preference shares may also be redeemable.

The holders of this kind of shares have no right to convert their preference shares into equity shares.

7.6 SUMMARY

Preference shares, which are issued by companies seeking to raise capital, combine the characteristics of debt and equity investments, and are consequently considered to be hybrid securities. Preference shareholders experience both advantages and disadvantages. On the upside, they collect dividend payments before common stock shareholders receive such income. But on the downside, they do not enjoy the voting rights that common shareholders typically do. Owners of preference shares receive fixed dividends, well before common shareholders see any money. In either case, dividends are only paid if the company turns a profit. But there is a wrinkle to this situation because a type of preference shares known as cumulative shares allow for the accumulation of unpaid dividends that must be paid out at a later date. So, once a struggling business finally rebounds and is back in the black, those unpaid dividends are remitted to preferred shareholders before any dividends can be paid to common shareholders. The main disadvantage of owning preference shares is that the investors in these vehicles don't enjoy the same voting rights as common shareholders. This means that the company is not beholden to preferred shareholders the way it is to traditional equity shareholders. Although the guaranteed return on investment makes up for this shortcoming, if interest rates rise, the fixed dividend that once seemed so lucrative can dwindle. This could cause buyer's remorse with preference shareholder investors, who may realize that they would have fared better with higher interest fixed-income securities.

7.7 GLOSSARY

- **Shares:** Shares can be described as the financial instrument issued by the company to raise funds from the general public. A share represents fractional ownership in a body corporate. Thus, a share is the smallest unit of the company's overall net worth.

- **Dividend:** Dividend refers to a reward, cash or otherwise, that a company gives to its shareholders. Dividends can be issued in various forms, such as cash payment, stocks or any other form. Dividend is usually a part of the profit that the company shares with its shareholders.

- **Exchange rate** Exchange rate (also known as a foreign-exchange rate, forex rate, FX rate or Agio) between two currencies is the rate at which one currency will be exchanged for another. It is also regarded as the value of one country's currency in terms of another currency.

- **Preferred stock**: It is a form of stock which may have any combination of features not possessed by common stock including properties of both an equity and a debt instrument, and is generally considered a hybrid instrument.

7.8 SELF ASSESSMENT QUESTIONS

1. What do you mean by preference shares? What are the characteristics of preference shares ?

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2. Explain the various types of preference shares.

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7.9 LESSON END EXERCISE

1. Enlist the points for and against preference shares.

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2. Write a note on types of preference shares

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7.10 SUGGESTED READINGS

- Pandey, I. M., Financial Management, Vikas Publishing House, New Delhi.
- Gupta and Sharma, Management Accounting-Kalyani Publishers
- Guthmann and Dougall, Corporate Financial Policy, Pentice Hall.
- Babu, G. Ramesh (2005), "Indian Financial System", 1st Edition, Himalayan Publishing House, Mumbai.
- Desai, Vasant (2005), "The Indian Financial System and Development", 1st Edition, Himalayan Publishing House, Mumbai.
- Hampton, John, Financial Decision Making, Pentice Hall, New Delhi.

UNIT -II

LONG TERM SOURCES OF FINANCE

LESSON No. 8

Advantages and Disadvantages of Preference Shares

Structure :

8.1 Introduction

8.2 Objectives

8.3 Preferred Shares : International Perspectives

8.3.1 Canada

8.3.2 Germany

8.3.3 United Kingdom

8.3.4 United States

8.4 Advantages of Preference Shares

8.4.1 Advantages of Preference Shares from the Company's Point of View

8.4.2 Advantages of Preference Shares from the Investor's Point of View

8.5 Disadvantages of Preference Shares

8.5.1 Disadvantages of Preference Shares from the Company's Point of View

8.5.2 Disadvantages of Preference Shares from the Investor's Point of View

8.6 Characteristics of Preference Shares

8.7 Difference between Equity and Preference Shares

8.8 Summary

8.9 Glossary

8.10 Self Assessment Questions

8.11 Lesson End Questions

8.12 Suggested Readings

8.1 INTRODUCTION

Preferred stock (also called **preferred shares**, **preference shares** or simply **preferreds**) is an equity security which may have any combination of features not possessed by common stock including properties of both an equity and a debt instruments, and is generally considered a hybrid instrument. Preferreds are senior (i.e. higher ranking) to common stock, but subordinate to bonds in terms of claim (or rights to their share of the assets of the company).

Preferred stock usually carries no voting rights, but may carry a dividend and may have priority over common stock in the payment of dividends and upon liquidation. Terms of the preferred stock are stated in a "Certificate of Designation".

Similar to bonds, preferred stocks are rated by the major credit-rating companies. The rating for preferreds is generally lower, since preferred dividends do not carry the same guarantees as interest payments from bonds and they are junior to all creditors.

8.2 OBJECTIVES :-

After completion of this lesson, you should be able to

- understand the concept of preference shares
- understand the nature of preference shares
- understand the types of preference shares
- understand the characteristics of preference shares

8.3 PREFERRED SHARES : INTERNATIONAL PERSPECTIVES

8.3.1 Canada

Preferred shares represent a significant portion of Canadian capital markets, with over C$5 billion in new preferred shares issued in 2005. Many Canadian issuers are financial organizations which may count capital raised in the preferred-share market as Tier 1 capital (provided that the shares issued are perpetual). Another class of issuer includes split share corporations. Investors in Canadian preferred shares are generally those who wish to hold fixed-income investments in a taxable portfolio. Preferential tax treatment of dividend income (as opposed to interest income) may, in many cases, result in a greater after-tax return than might be achieved with bonds.

Preferred shares are often used by private corporations to achieve Canadian tax objectives. For instance, the use of preferred shares can allow a business to accomplish an estate freeze. By transferring common shares in exchange for fixed-value preferred shares, business owners can allow future gains in the value of the business to accrue to others (such as a discretionary trust).

8.3.2 Germany

Preference shares in German stock exchanges are usually indicated with *V*, *VA* or *Vz* (short for *Vorzugsaktie*)—for example, "BMW Vz"—in contrast to *St* or *StA* (short for*Stammaktie*) for standard shares.

Preferred stock may comprise up to half of total equity. It is convertible into common stock, but its conversion requires approval by a majority vote at the stockholders' meeting. If the vote passes, German law requires consensus with preferred stockholders to convert their stock (which is usually encouraged by offering a one-time premium to preferred stockholders). The firm's intention to do so may arise from its financial policy (i.e. its ranking in a specific index). Industry stock indices usually do not consider preferred stock in determining the daily trading volume of a company's stock; for example, they do not qualify the company for a listing due to a low trading volume in common stocks.

8.3.3 United Kingdom

Perpetual non-cumulative preference shares may be included as Tier 1 capital. Perpetual cumulative preferred shares are Upper Tier 2 capital. Dated preferred shares (normally having an original maturity of at least five years) may be included in Lower Tier 2 capital.

8.3.4 United States

In the United States, the issuance of publicly listed preferred stock is generally limited to financial institutions, REITs and public utilities. Because in the U.S. dividends on preferred stock are not tax-deductible at the corporate level (in contrast to interest expense), the effective cost of capital raised by preferred stock is 35 percent greater than issuing the equivalent amount of debt at the same interest rate. This has led to the development of TRuPS: debt instruments with the same properties as preferred stock. With the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010, TRuPS will be phased out as a vehicle for raising Tier 1 capital by bank holding companies. Outstanding TRuPS issues will be phased out completely by 2015.

However, with a qualified dividend tax of 15 percent (compared to a top ordinary marginal tax rate of 35 percent), $1 of dividend income taxed at this rate provides the same after-tax income as approximately $1.30 in interest. The size of

the preferred stock market in the United States has been estimated as $100 billion (as of early 2008), compared to $9.5 trillion for equities and US$4.0 trillion for bonds.

Other countries

- **Czech Republic** – Preferred stock cannot be more than 50 percent of total equity.
- **France** – By a law enacted in June 2004, France allows the creation of preferred shares.
- **South Africa** – Dividends from preference shares are not taxable as income when held by individuals.
- **Brazil** – In Brazil, up to 50 percent of the capital stock of a company may be composed of preferred stock. The preferred stock will have at least one less right than the common stock (normally voting power), but will have preference in receiving dividends.

8.4 ADVANTAGES OF PREFERENCE SHARES

8.4.1 Advantages from the Point of view of Company

1. Absence of voting rights:

The preference shareholders do not possess the voting rights in the personal matters of the company. There is thus no interference in general by the preference shareholders, even though they gain more profits and advantages over the common shareholders.

2. Fixed return:

The dividends to be paid to the preference shareholders are fixed as compared to the equity shareholders. The company can thus maximize the profits that are available on the part of preference shareholders.

3. **Absence of charge on assets:**

Because preference shares have no payment of dividends, no charges are levied on the assets of the company unlike in the case of debentures.

4. **Capital structure flexibility:**

By means of issuing redeemable preference shares, flexibility in the company's capital structure can be maintained because redeemable preference shares can be redeemed under the terms of issue.

5. **Widening of the capital market:**

The scope of a company's capital market is widened as a result of the issuance of preference shares because of the reason that preference shares provide not only a fixed rate of return but also safety to the investors.

6. **Absence of financial burden:**

As a result of the issuance of preference shares, because dividends are paid only in the presence or profits; absence of profits means absence of dividends.

8.4.2 Advantages of Preference Shares from the Investor's Point of View

There are certain advantages of preference shares from the investor's point of view. The advantages are as follows:

I. **Fixed regular income:**

The culminative preference share investors even in case of absence of profits for the company get a regular hold of profits. The areas of dividends are generated in the years of profits of the company.

II. **Safety of interest voting rights:**

Voting rights are exerted by the investors in cases relating to the safety of interests. The interests of the preference shareholders are thus safeguarded.

III. Less capital losses:

The preference shareholders possess the preference rights of the repayment of their capital as a result of which there are less capital losses.

IV. Proper security:

Preference shareholders possess proper security in case of their shares in cases when the company fails to generate profits.

V. Presence of preferential rights:

When it comes to payment of dividend and repayment of capital, preference shareholders enjoy preferential rights.

8.5 DISADVANTAGES OF PREFERENCE SHARES

There are certain disadvantages of preference shares from the investor's point of view. The advantages are as follows:

8.5.1 Disadvantages of Preference Shares from the Investor's Point of View

I. Absence of voting rights:

Except in matters directly affecting their interests, the preference shareholders have no rights when it comes to voting on behalf of the company.

II. Absence of guarantee over assets:

As in the case of debentures, the company provides no guarantee on the assets of the preference shareholders too.

III. Fixed income:

There is a fixed income that is generated for the preference shareholders. In cases where the company generates exceptional profits, these are by no means

shared with the preference shareholders. It is thus obvious that the preferential shareholders have no claim over the surplus of the company

8.5.2 Disadvantages of Preference Shares fromthe point of view of the Company

The disadvantages of preference shares, from the point of view of the company are as follows:

1. High rate of dividends:

The Company has to pay higher rates of dividends to the preference shareholders as compared to the common shareholders. Thus the cost of capital of the company is also increased.

2. Dilution of claim over assets:

Because of the very reason that preference shareholders have preferential rights over the company assets in case of winding up of the company, dilution of equity shareholders claim over the assets take place.

3. Tax disadvantages:

In case of preference shareholders, the taxable income of the company is not reduced while in case of common shareholders, the taxable income of the company is reduced.

4. Effect on credit worthiness:

In case of preference shares, the credit worthiness of a company is definitely reduced because preference shareholders possess the right over the personal assets of the company.

5. Increase in financial burden:

Because most of the preference shares issued are cumulative, the financial burden on the part of the company increases vehemently. The company also

reduces the dividends of the equity shareholders because of the reason that it is essential on the part of the company to pay the dividends to the preference shareholders.

8.6 CHARACTERISTICS OF PREFERENCE SHARES

The features of preference shares are discussed as under :-

1. Dividends :

Preference shares have dividend provisions which are cumulative or non-cumulative. Most shares have the cumulative provisions, which mean that any dividend not paid by the company accumulates. Normally, the firm must pay these unpaid dividends prior to the payment of dividends on the common stock.

These unpaid dividends are known as dividends in arrears or arrearages. Non-cumulative dividends do not accumulate if they are not paid when due. An investor contemplating the purchase of preference shares with a non-cumulative dividend provision needs to be especially diligent in the investigation of the company because of the investor's potentially weak position vis-a-vis those preference shares with a cumulative dividend provision.

A study of the preference share financing in India has brought to light the fact that in 1971, one-fourth of the established companies' issues were in arrears whereas in case of new companies (upto 12 years of age) more than fifty per cent of the quoted preference shares had unpaid preference dividend arrears for varying lengths of time.

In case of cumulative preference shares, even if the arrears of the preference dividend are cleared in full, the investor would be loser as he is to get less in net worth.

2. Participating Preference Shares:

Most preference shares are non-participating, meaning that the preference shareholder receives only his stated dividend and no more. The theory is that the preference shareholder has surrendered claim to the residual earnings of his company in return for the right to receive his dividend before dividends are paid to common shareholders.

The participating preference shareholder receives stipulated dividend and shares additional earnings with the common shareholders. But this share is usually non-cumulative which confirms the view that preference share does have both protective and profit participating provisions.

3. Voting Rights:

Preference shares do not normally confer voting rights. The basis for not allowing the preference shareholder to vote is that the preference shareholder is in a relatively secure position and, therefore, should have no right to vote except in the special circumstances.

In India, for instance, the non- cumulative type qualifies for voting rights if preference dividends have been in arrears for the two financial years preceding the meeting or for any three years during a period of six years (ending with the financial year) preceding the meeting.

The cumulative preference shares can vote if their dividend is in arrears for 2 years. The voting right of each preference shareholder is to be in the proportion which the paid-up share capital on his shares bears to the total equity share capital of the company.

4. Par Value:

Most preference shares have a par value. When it does, the dividend rights and call price are usually stated in terms of the par value. However, those rights would be specified even if there were no par value. It seems, therefore,

as with equity shares, the preference share that has a par value has no real advantage over preference share that has no par value.

5. Redeemable Preference Shares:

Typically, preference shares have no maturity date. In this respect it is similar to equity shares. Redeemable or callable preference shares may be retired by the issuing company upon the payment of a definite price stated in the investment. Although the "call price" provides for the payment of a premium, the provision is more advantageous to the corporation than to the investor.

When money rates decline, the corporation is likely to call in its preference shares and refinance it at a lower dividend rate. When money rates rise, the value of the preference shares declines so as to produce higher yield, the call price acts as an upper peg or plateau through which the price will break only in a very strong market.

Non-callable preference shares and bonds are issued in periods of high interest rates. The issue is barred from redeeming them later in the event of generally falling yields or for a certain period so the investor has important protection against declining income.

6. Sinking Fund Retirement:

Preference share issue is often retired through sinking funds. In these cases, a certain percentage of earnings (above minimum amounts) are allocated for redemption each year. The shares required for sinking fund purposes can be called by lot or purchased in the open market.

The owners of preference shares called for sinking fund purposes must seek alternative investments. In this sense, preference sinking funds have unfavourable overtones for these investors.

But sinking funds have favourable overtones for the owners of shares that are not retired. Sinking fund requirements reduce preference shares outstanding

which will give the remaining shares a strong income position. Hence, dividend payments are more certain. The investment status of preference shares will improve gradually where sinking fund arrangements exist.

7. Preemptive Right:

Common law statute gives shareholders, equity or preference, the right to subscribe to additional issues to maintain their proportionate share of ownership. However, the existence of the preemptive right depends on the law and the provisions of the company's articles of incorporation. The right is a bit more likely to be waived for preference shares than for equity, particularly if preference shares are non-voting.

8.7 DIFFERENCE BETWEEN PREFERENCE AND EQUITY SHARE

Distinction Basis	Preference Share	Equity Share
Preference Right of Dividend Payout	Preference dividend is paid before the equity dividend amount.	Payment of equity dividend amount does not have the priority over the payment of the preference dividend.
Preference Right of Repayment of Capital Amount	Preference share has the priority of capital repayment over the equity share capital.	Equity share has the second priority of capital repayment over the preference share.
Rate of Dividend	The rate of dividend is fixed for the preference share.	The rate of equity share dividend may vary from time to time depending upon the terms and conditions made by member and directors.
Dividend Arrears	Arrears of the dividend may mount up for these shares.	Arrears of equity shares can not be mount up in any case.
Convertibility	They may be converted.	They can not convert
Market Value Fluctuation	Market value of preferred share normally does not fluctuate	Market value of equity share fluctuates according to market conditions.
Voting Rights	Preferred share holders have voting rights only at their class meetings but they do not have other voting rights.	Equity share holders commonly have voting rights.
Right of Premium on Redemption	Preferred share holders have right to gain premium on redemption.	Equity share holders do not have a right to receive premium on redemption.

8.8 SUMMARY

Overall, the major benefit to Preference Shares is the greater claim that they have on a Company's profits and assets compared to Ordinary Shareholders, however, this is still outweighed by the Company's creditors.

Investors will have to outweigh this benefit against the fact that their returns are fixed and that even if there is exponential growth in the Company, there returns will be fixed at what was agreed with the Company at the outset. This can lead to Preference Shareholders often holding a low yielding investment for a long period of time, especially if the rates are trending upwards and no one wants to buy the lower yielding Preference Shares.

8.9 GLOSSARY

- **Premium:** The specified amount of payment required periodically by an insurer to provide coverage under a given insurance plan for a defined period of time.
- **Arrears:** The term "in arrears" does not necessarily have a negative connotation in certain contexts such as fixed-income instruments, where it may indicate that interest payments are simply made at the end of a period.
- **Tax:** A deduction from gross income that arises due to various types of expenses incurred by a taxpayer.

8.10 SELF ASSESSMENT QUESTIONS

1. What are preference shares ?

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2. How preference shares treated in Canada & Germany ?

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3. How convertible shares different from non-convertible ?

4. What are the different types of preference shares ?

8.11 LESSON END QUESTIONS

1. Explain the merits and demerits of preference shares ?

2. Critically evaluate the utility of preferred stock as a means of obtaining long-term funds.

3. Differentiate between equity & preference shares.

8.12 SUGGESTED READINGS

- Financial Management - S.C. Kuchhal. -Chaitanya Publishing House
- Corporate Financial Policy - Guthmann and Dougall. -Prentice Hall
- Management Accounting- Gupta & Sharma- Kalyani Publishers

UNIT -II

LONG TERM SOURCES OF FINANCE

LESSON No. 9

Concept of debentures - Characteristics of debentures, Classification of debentures and Procedure of issuing debentures.

Structure :

9.1 Introduction

9.2 Objectives

9.3 Concept and Characteristics of Debentures and Bonds

9.4 Classification of Debentures

9.4.1 Security

9.4.2 Tenure

9.4.3 Registration

9.4.4 Coupon

9.4.5 Convertibility

9.5 Difference between Debentures and Shares

9.6 Importance of Debentures as a Source of Finance

9.6.1 Advantages of Debentures

9.6.1.1 Advantages To the Company

9.6.1.2 Advantages to the Investor

9.6.2 Disadvantages of Debentures

9.6.2.1 Disadvantages to the Company

9.6.2.2 Disadvantages to the Investor

9.7 Procedure of Issuing of Debentures

9.8 Summary

9.9 Glossary

9.10 Self Assessment Questions

9.11 Lesson End Questions

9.12 Suggested Readings

9.1 INTRODUCTION

Creditorship Securities also known as debt finance which means the finance is mobilized from the creditors. Debenture and Bonds are the two major parts of the Creditorship Securities.

A **debenture** is a document that either creates a debt or acknowledges it, and it is a debt without collateral. In corporate finance, the term is used for a medium- to long-term debt instrument used by large companies to borrow money. In some countries the term is used interchangeably with **bond**, **loan stock** or **note**. A debenture is thus like a certificate of loan or a loan bond evidencing the fact that the company is liable to pay a specified amount with interest and although the money raised by the debentures becomes a part of the company's capital structure, it does not become share capital. Senior debentures get paid before subordinate debentures, and there are varying rates of risk and payoff for these categories.

Debentures are generally freely transferable by the debenture holder. Debenture holders have no rights to vote in the company's general meetings of shareholders, but they may have separate meetings or votes e.g. on changes to the

rights attach to the debentures. The interest paid to them is a charge against profit in the company's financial statements.

A debenture is a debt security issued by a company (called the Issuer), which offers to pay interest in lieu of the money borrowed for a certain period.

- These are long term debt instruments issued by private sector companies.
- These are issued in denominations as low as Rs 1000 and have maturities ranging between one and ten years.
- Debentures enable investors to reap the dual benefits of adequate security and good returns.
- Unlike other fixed income instruments such as fixed deposits, bank deposits they can be transferred from one party to another by using transfer from.
- Debentures were issued in physical form. Now corporate/PSUs have started issuing debentures in Demat form.
- Debentures can be listed on a stock exchange, giving you an opportunity to sell them and exit earlier then the tenure of the debenture.

In simple words, a debenture is a debt instrument, just like a fixed deposit (FD), usually issued by a company. You invest a sum, and the company pays you a fixed rate of interest for the pre defined period. After the period gets over, you get back your principal amount.

A **bond** is an instrument of indebtedness of the bond issuer to the holders. It is a debt security, under which the issuer owes the holders a debt and, depending on the terms of the bond, is obliged to pay them interest (the coupon) and/or to repay the principal at a later date, termed the maturity date. Interest is usually payable at fixed intervals (semiannual, annual, sometimes monthly). Very often the bond is negotiable, i.e. the ownership of the instrument can be transferred in the secondary market. This means that once the transfer agents at the bank medallion stamp the bond, it is highly liquid on the second market.

Thus a bond is a form of loan or IOU (sounded "I owe you"): the holder of the bond is the lender (creditor), the issuer of the bond is the borrower (debtor), and the *coupon* is the interest. Bonds provide the borrower with external funds to finance long-term investments, or, in the case of government bonds, to finance current expenditure. Certificates of deposit (CDs) or short term commercial paper are considered to be money market instruments and not bonds: the main difference is in the length of the term of the instrument.

Bonds and stocks are both securities, but the major difference between the two is that (capital) stockholders have an equity stake in the company (i.e. they are investors), whereas bondholders have a creditor stake in the company (i.e. they are lenders). Being a creditor, bondholders have absolute priority and will be repaid before stockholders (who are owners) in the event of bankruptcy. Another difference is that bonds usually have a defined term, or maturity, after which the bond is redeemed, whereas stocks are typically outstanding indefinitely. An exception is an irredeemable bond, such as Consols, which is a perpetuity, i.e. a bond with no maturity.

9.2 OBJECTIVES :-

After completion of this lesson, you should be able to

- understand the concept of debentures
- understand the nature of debentures
- understand the types of debentures

9.3 CONCEPT AND CHARACTERISTICS OF DEBENTURES

Concept of Debentures : Debenture: The word 'debenture' has been derived from a Latin word 'debere' which means to borrow. Debenture is a written instrument acknowledging a debt under the common seal of the company. It contains a contract for repayment of principal after a specified period or at intervals or at the option of the company and for payment of interest at a fixed rate payable usually either half-yearly or yearly on fixed dates. According to section 2(30) of The Companies Act,

2013 'Debenture' includes Debenture Inventory, Bonds and any other securities of a company whether constituting a charge on the assets of the company or not. It is only acknowledgement of Debt. A share is a part of the owned capital whereas a debenture is a part of borrowed capital.

Return: The return on shares is known as dividend while the return on debentures is called interest. The rate of return on shares may vary from year to year depending upon the profits of the company but the rate of interest on debentures is prefixed.

The payment of dividend is an appropriation of profits, whereas the payment of interest is a charge on profits and is to be paid even if there is no profit.

Repayment: Normally, the amount of shares is not returned during the life of the company, whereas, generally, the debentures are issued for a special. Nominal, principal, par or face amount is the amount on which the issuer pays interest, and which, most commonly, has to be repaid at the end of the term. Some structured bonds can have a redemption amount which is different from the face amount and can be linked to performance of particular assets.

Maturity

The issuer has to repay the nominal amount on the maturity date. As long as all due payments have been made, the issuer has no further obligations to the bond holders after the maturity date. The length of time until the maturity date is often referred to as the term or tenor or maturity of a bond. The maturity can be any length of time, although debt securities with a term of less than one year are generally designated money market instruments rather than bonds. Most bonds have a term of up to 30 years. Some bonds have been issued with terms of 50 years or more, and historically there have been some issues with no maturity date (irredeemables). In the market for United States Treasury securities, there are three categories of bond maturities:

- **short term (bills):** maturities between one to five year; (instruments with maturities less than one year are called Money Market Instruments)

- **medium term (notes):** maturities between six to twelve years;
- **long term (bonds):** maturities greater than twelve years.

Coupon

The coupon is the interest rate that the issuer pays to the holder. Usually this rate is fixed throughout the life of the bond. It can also vary with a money market index, such as LIBOR, or it can be even more exotic. The name "coupon" arose because in the past, paper bond certificates were issued which had coupons attached to them, one for each interest payment. On the due dates the bondholder would hand in the coupon to a bank in exchange for the interest payment. Interest can be paid at different frequencies: generally semi-annual, i.e. every 6 months, or annual.

Yield

The yield is the rate of return received from investing in the bond. It usually refers either to

- the current yield, or running yield, which is simply the annual interest payment divided by the current market price of the bond (often the clean price), or to
- The yield to maturity or redemption yield, which is a more useful measure of the return of the bond, taking into account the current market price, and the amount and timing of all remaining coupon payments and of the repayment due on maturity. It is equivalent to the internal rate of return of a bond.

Credit quality

The quality of the issue refers to the probability that the bondholders will receive the amounts promised at the due dates. This will depend on a wide range of factors. High-yield bonds are bonds that are rated below investment grade by the credit rating agencies. As these bonds are more risky than investment grade bonds, investors expect to earn a higher yield. These bonds are also called *junk bonds*.

Market price

The market price of a tradable bond will be influenced amongst other things by the amounts, currency and timing of the interest payments and capital repayment due, the quality of the bond, and the available redemption yield of other comparable bonds which can be traded in the markets.

The price can be quoted as clean or dirty. ("Dirty" includes the present value of all future cash flows including accrued interest. "Dirty" is most often used in Europe. "Clean" does not include accrued interest. "Clean" is most often used in the U.S.)

The issue price at which investors buy the bonds when they are first issued will typically be approximately equal to the nominal amount. The net proceeds that the issuer receives are thus the issue price, less issuance fees. The market price of the bond will vary over its life: it may trade at a premium (above par, usually because market interest rates have fallen since issue), or at a discount (price below par, if market rates have risen or there is a high probability of default on the bond).

Others

- **Indentures and Covenants** — An indenture is a formal debt agreement that establishes the terms of a bond issue, while covenants are the clauses of such an agreement. Covenants specify the rights of bondholders and the duties of issuers, such as actions that the issuer is obligated to perform or is prohibited from performing. In the U.S., federal and state securities and commercial laws apply to the enforcement of these agreements, which are construed by courts as contracts between issuers and bondholders. The terms may be changed only with great difficulty while the bonds are outstanding, with amendments to the governing document generally requiring approval by a majority (or super-majority) vote of the bondholders.

- **Optionality:** Occasionally a bond may contain an embedded option; that is, it grants option-like features to the holder or the issuer:

- **Callability** — Some bonds give the issuer the right to repay the bond before the maturity date on the call dates; see call option. These bonds are referred to as callable bonds. Most callable bonds allow the issuer to repay the bond at par. With some bonds, the issuer has to pay a premium, the so-called call premium. This is mainly the case for high-yield bonds. These have very strict covenants, restricting the issuer in its operations. To be free from these covenants, the issuer can repay the bonds early, but only at a high cost.

- **Putability** — Some bonds give the holder the right to force the issuer to repay the bond before the maturity date on the put dates. These are referred to as retractable or putable bonds.

- **Call dates and put dates—**The dates on which callable and putable bonds can be redeemed early. There are four main categories.

  - A Bermudan callable has several call dates, usually coinciding with coupon dates.

  - A European callable has only one call date. This is a special case of a Bermudan callable.

  - An American callable can be called at any time until the maturity date.

  - A death put is an optional redemption feature on a debt instrument allowing the beneficiary of the estate of a deceased bondholder to put (sell) the bond (back to the issuer) at face value in the event of the bondholder's death or legal incapacitation. Also known as a "survivor's option".

- Sinking fund provision of the corporate bond indenture requires a certain portion of the issue to be retired periodically. The entire bond issue can be liquidated by the maturity date. If that is not the case, then the remainder is

called balloon maturity. Issuers may either pay to trustees, which in turn call randomly selected bonds in the issue, or, alternatively, purchase bonds in open market, then return them to trustees.

- Bonds are often identified by its international securities identification number, or ISIN, which is a 12 digit alpha numeric code that is distinct for debt securities.

Types of Bonds

The following descriptions are not mutually exclusive, and more than one of them may apply to a particular bond.

- **Fixed rate bonds** have a coupon that remains constant throughout the life of the bond. A variation is stepped-coupon bonds, whose coupon increases during the life of the bond.
- **Floating rate notes** (FRNs, floaters) have a variable coupon that is linked to a reference rate of interest, such as LIBOR or Euribor. For example the coupon may be defined as three month USD LIBOR + 0.20%. The coupon rate is recalculated periodically, typically every one or three months.
- **Zero-coupon bonds** (zeros) pay no regular interest. They are issued at a substantial discount to par value, so that the interest is effectively rolled up to maturity (and usually taxed as such). The bondholder receives the full principal amount on the redemption date. An example of zero coupon bonds is Series E savings bonds issued by the U.S. government. Zero-coupon bonds may be created from fixed rate bonds by a financial institution separating ("stripping off") the coupons from the principal. In other words, the separated coupons and the final principal payment of the bond may be traded separately. See IO (Interest Only) and PO (Principal Only).
- **High-yield bonds** (junk bonds) are bonds that are rated below investment grade by the credit rating agencies. As these bonds are more risky than investment grade bonds, investors expect to earn a higher yield.

- **Convertible bonds** let a bondholder exchange a bond to a number of shares of the issuer's common stock. These are known as hybrid securities, because they combine equity and debt features.
- **Exchangeable bonds** allows for exchange to shares of a corporation other than the issuer.
- **Inflation-indexed bonds** (linkers) (US) or Index-linked bond (UK), in which the principal amount and the interest payments are indexed to inflation. The interest rate is normally lower than for fixed rate bonds with a comparable maturity (this position briefly reversed itself for short-term UK bonds in December 2008). However, as the principal amount grows, the payments increase with inflation. The United Kingdom was the first sovereign issuer to issue inflation linked gilts in the 1980s. Treasury Inflation-Protected Securities (TIPS) and I-bonds are examples of inflation linked bonds issued by the U.S. government.
- **Other indexed bonds,** for example equity-linked notes and bonds indexed on a business indicator (income, added value) or on a country's GDP.
- **Asset-backed securities** are bonds whose interest and principal payments are backed by underlying cash flows from other assets. Examples of asset-backed securities are mortgage-backed securities (MBS's), collateralized mortgage obligations (CMOs) and collateralized debt obligations (CDOs).
- **Subordinated bonds** are those that have a lower priority than other bonds of the issuer in case of liquidation. In case of bankruptcy, there is a hierarchy of creditors. First the liquidator is paid, then government taxes, etc. The first bond holders in line to be paid are those holding what is called senior bonds. After they have been paid, the subordinated bond holders are paid. As a result, the risk is higher. Therefore, subordinated bonds usually have a lower credit rating than senior bonds. The main examples of subordinated bonds can be found in bonds issued by banks, and asset-backed securities. The

latter are often issued in tranches. The senior tranches get paid back first, the subordinated tranches later.

- **Covered bonds** are backed by cash flows from mortgages or public sector assets. Contrary to asset-backed securities the assets for such bonds remain on the issuer's balance sheet.

- **Perpetual bonds** are also often called perpetuities or 'Perps'. They have no maturity date. The most famous of these are the UK Consols, which are also known as Treasury Annuities or Undated Treasuries. Some of these were issued back in 1888 and still trade today, although the amounts are now insignificant. Some ultra-long-term bonds (sometimes a bond can last centuries: West Shore Railroad issued a bond which matures in 2361 (i.e. 24th century) are virtually perpetuities from a financial point of view, with the current value of principal near zero.

- **Bearer bond** is an official certificate issued without a named holder. In other words, the person who has the paper certificate can claim the value of the bond. Often they are registered by a number to prevent counterfeiting, but may be traded like cash. Bearer bonds are very risky because they can be lost or stolen. Especially after federal income tax began in the United States, bearer bonds were seen as an opportunity to conceal income or assets. U.S. corporations stopped issuing bearer bonds in the 1960s, the U.S. Treasury stopped in 1982, and state and local tax-exempt bearer bonds were prohibited in 1983.

- **Registered bond** is a bond whose ownership (and any subsequent purchaser) is recorded by the issuer, or by a transfer agent. It is the alternative to a Bearer bond. Interest payments, and the principal upon maturity, are sent to the registered owner.

- **A government bond,** also called Treasury bond, is issued by a national government and is not exposed to default risk. It is characterized as the safest

bond, with the lowest interest rate. A treasury bond is backed by the “full faith and credit” of the relevant government. For that reason, for the major OECD countries this type of bond is often referred to as risk-free.

- **Municipal bond** is a bond issued by a state, U.S. Territory, city, local government, or their agencies. Interest income received by holders of municipal bonds is often exempt from the federal income tax and from the income tax of the state in which they are issued, although municipal bonds issued for certain purposes may not be tax exempt.
- **Build America Bonds (BABs)** are a form of municipal bond authorized by the American Recovery and Reinvestment Act of 2009. Unlike traditional US municipal bonds, which are usually tax exempt, interest received on BABs is subject to federal taxation. However, as with municipal bonds, the bond is tax-exempt within the US state where it is issued. Generally, BABs offer significantly higher yields (over 7 percent) than standard municipal bonds.
- **Book-entry bond** is a bond that does not have a paper certificate. As physically processing paper bonds and interest coupons became more expensive, issuers (and banks that used to collect coupon interest for depositors) have tried to discourage their use. Some book-entry bond issues do not offer the option of a paper certificate, even to investors who prefer them.
- **Lottery bonds** are issued by European and other states. Interest is paid as on a traditional fixed rate bond, but the issuer will redeem randomly selected individual bonds within the issue according to a schedule. Some of these redemptions will be for a higher value than the face value of the bond.
- **War bond** is a bond issued by a country to fund a war.
- **Serial bond** is a bond that matures in installments over a period of time. In effect, a $100,000, 5-year serial bond would mature in a $20,000 annuity over a 5-year interval.

- **Revenue bond** is a special type of municipal bond distinguished by its guarantee of repayment solely from revenues generated by a specified revenue-generating entity associated with the purpose of the bonds. Revenue bonds are typically "non-recourse", meaning that in the event of default, the bond holder has no recourse to other governmental assets or revenues.

- **Climate bond** is a bond issued by a government or corporate entity in order to raise finance for climate change mitigation- or adaptation-related projects or programmes.

- **Dual currency bonds**

- **Retail bonds** are a type of corporate bond mostly designed for ordinary investors. They have become particularly attractive since the London Stock Exchange (LSE) launched an order book for retail bonds.

  Social impact bonds are an agreement for public sector entities to pay back private investors after meeting verified improved social outcome goals that result in public sector savings from innovative social program pilot projects.

Features / Attributes / Characteristics of Debentrues

1) **Trust Indenture:** It is an agreement which has to be entered into by the 'Issuing Company' and the 'Trust' which is involved to take care of the interest of the general investors. For issuing a debenture, it is something mandatory. Normally the trustee is a bank or a financial institution who is appointed by a trust deed.

2) **Coupon Rate:** It is the rate of interest which is promised by the company to pay to the debenture holder on a regular interval which may vary from case to case. The rate of interest may be fixed or floating. The rate of interest which the company opts depends on the credit rating of that company or that specific bond.

3) **Tax Benefit:** Most important element from the company point of view is that the interest paid is a tax deductible expense. Effectively, the company will get

the tax benefit because the taxable income will be reduced by the extent of interest paid. Due to this the effective cost of borrowing gets reduced. Please note the said benefit is there if the company is making profits and paying taxes.

4) **Date of Maturity:** For all the non convertible and redeemable debentures, the issuing company has to issue repayment to the debenture holders on the date of maturity. This date is also mentioned on the certificates and it infers the total time for which the money is invested by the lenders which is interval between the date of issue to the date of maturity.

5) **Redemption Choices:** In essence, debenture is a debt and it needs to be repaid by a company. There are three choices by which a company may opt to redeem the debentures. One is to make payment on the date of maturity which is the simplest of all and is called redemption out of capital. Second way is to create a debenture redemption reserve wherein the company transfers some fund every year from the divisible profits and this method is known as redemption out of profits. There is another innovative way of redeeming the debentures which is in the form of call and put option. Call option allows the company to buy back its debentures on some agreed terms on or before the maturity. In put option, the choice of redemption is given to the investor.

6) **Security:** Here, we should classify debentures into two – secured debentures and unsecured debentures. Secured debentures are secured by some or other immovable assets of the company whereas the unsecured assets are issued based on the general credit of the company. The general legal preference of debt is available to all types of debentures i.e. in the event of liquidation debenture will stand prior to preference shares and ordinary equity shares.

7) **Convertibility:** Certain types of debentures are issued with the option of conversion into equity. The ratio of conversion and the time period after which conversion will take place is mentioned in the agreement of debenture. Debentures may be fully or partly convertible in nature.

8) **Credit Rating:** Normally, an investor would not go and check the credibility and the risk involved with the debentures. Credit rating agencies are given this task and they rate the debentures and the overall company. Involving a rating agency is compulsory for the issuing company normally in every country.

9) **Charge on Assets and Profits in case of Default:** The debenture holders may have claims over the profits and assets of the company in case the company has defaulted in the payment of either the interest or the capital repayment.

9.4 CLASSIFICATION OF DEBENTURES

Debentures differ on the basis on terms and conditions on which they are issued :

9.4.1 Security :

Secured/Mortgage Debentures: Debentures secured against assets of the company .i.e. if the company is winding up, assets will be sold and debenture holders will be paid back. The charge/mortgage may be fixed or a floating charge. If it is fixed, charge is on a specific asset say plant, machinery etc. If it is floating charge, it means it is on general assets of the company.

- **Which assets are charged:** The ones available with the company presently and also assets in future
- **Mortgage deed:** Includes nature/value of the security, date of interest payment, and rate of interest, repayment terms, and rights of the debenture holders if the company defaults. In the event of default of company to pay interest or principal installment, they can recover their money via the assets mortgaged.

Unsecured/Naked Debentures: These are those debentures which are not secured against the assets of the company which means when the company is closing down its business, the assets will not be sold to pay off the debenture holders. These debentures do not create any charge on the assets of the company. There is no security for repayment of principal amount and payment of interest. The only security available to such debenture holders is the general solvency of the company. Therefore the

position of these debenture holders at the times of winding up of the company will be like that of unsecured debentures. That is they are considered with the ordinary creditors of the company

9.4.2 Tenure :

- **Redeemable Debentures:** These debentures are issued by the company for a specific period only. On the expiry of period, debenture capital is redeemed or paid back. Generally the company creates a special reserve account known as "Debenture Redemption Reserve Fund" for the redemption of such debentures. The company makes the payment of interest regularly. Under section 121 of the Indian Companies Act, 1956, redeemed debentures can be re-issued. Eg: 5% 2 years Rs. 1000 debenture means redeemable period is 2 years(5%:interest/coupon payment). After redemption, they can be reissued.

- **Irredeemable/Perpetual Debentures:** These can be paid back at any time during the life of the company .i.e. there is no specified period for redemption. Hence they are also called Perpetual Debentures. Nonetheless if the company has to wind up, then they have to repay the debenture holders.

9.4.3 Registration :

- **Registered Debentures:** These are those debentures which are registered in the register of the company. The names, addresses and particulars of holdings of debenture holders are entered in a register kept by the company. Such debentures are treated as non-negotiable instruments and interest on such debentures are payable only to registered holders of debentures. Registered debentures are also called as Debentures payable to Registered holders.

- **Bearer Debentures:** These are those debentures which are not registered in the register of the company. Bearer debentures are like a bearer check. They are payable to the bearer and are deemed to be negotiable instruments. They are transferable by mere delivery. No formality of executing a transfer deed is necessary. When bearer documents are transferred, stamp duty need not be

paid. A person transferring a bearer debenture need not give any notice to the company to this effect. The transferee who acquires such a debenture in due course bonafide and for available consideration gets good title not withstanding any defect in the title of the transfer-or. Interest coupons are attached to each debenture and are payable to bearer.

9.4.4 Coupon :

- **Zero Coupon Debentures:** Does not have a specified interest rate, thereby to compensate, they are issued at a substantial discount. Interest: Difference in face value and issue price.

- **Specific Coupon rate Debentures:** Debentures are normally issued with an interest rate which is nothing but the coupon rate. It can be fixed or floating. Floating is associated with the bank rates.

9.4.5 Convertibility :

- **Convertible Debentures (Fully/ Partly convertible):** These are those debentures which can be converted into equity shares. These debentures have an option to convert them into equity or preference shares at the stated rate of exchange after a certain period. If the holders exercise the right of conversion, they cease to be the lender to the company and become the members. Thus convertible debentures may be referred as debentures which are convertible into shares at the option of the holders after a specified period. The rate of exchange of debentures into shares is also decided at the time of issue of debentures. Interest is paid on such debentures till its conversion. Prior approval of the shareholders is necessary for the issue of convertible debentures. It also requires sanction of the Central Government.

- **Non Convertible Debentures (NCDs):** These are those debentures which cannot be converted either into equity shares or preference shares. They may be secured or unsecured. Non-convertible debentures are normally redeemed on maturity period which may be 10 or 20 years.

DISTINCTION BETWEEN SHARES AND DEBENTURES	
SHARES	**DEBENTURES**
1. A share is a part of owned capital.	1. A debenture is an acknowledgement of a debt.
2. Shareholders are paid dividend on the shares held by them.	2. Debenture holders are paid interest on debentures.
3. The rate of dividend depends upon the amount of divisible profits and policy of the Board of Directors.	3. A fixed rate of interest is paid on debentures irrespective of profit or loss.
4. Dividend on shares is a charge against Profit and Loss Appropriation account.	4. Interest on debentures is a charge against Profit and Loss account.
5. Shareholders have voting rights. They have control over the management of the company. They are the owners of the company.	5. Debenture holders are only creditors of the company. They have no say in the company.
6. Shares are not redeemable (with the exception of redeemable preference shares) during the life of the company.	6. Debentures can be redeemed after a certain period.
7. At the time of liquidation of the company, share capital is payable after meeting all outside liabilities.	7. Debentures are pay able in priority over share capital.

9.5 DIFFERENCE BETWEEN DEBENTURES AND SHARES

After studying the features of debentures and shares, we can make out the difference between the two forms of corporate securities. The main points of difference can be put up as follows :

9.6 IMPORTANCE OF DEBENTURES AS A SOURCE OF FINANCE

Debentures or bonds have a great significance in the financial plan of a company. The use of such creditorship securities along with ownership securities in financing of a company generally tends to reduce the cost of capital and consequently helps to improve the earnings of the shareholder. The importance of debentures or bonds as a source of corporate finance can be evaluated from the following advantages and limitations.

9.6.1 Advantages of Debentures

Debentures offer a number of advantages both to the company as well as investors. These are discussed as below:

9.6.1.1 Advantages to the Company

The company has the following main advantages of using debentures and bonds as a source of finance

i. Debentures provide long-term funds to a company.

ii. The rate of interest payable on debentures is, usually, lower than the rate of dividend paid on shares.

iii. The interest on debentures is a tax-deductible expense and hence the effective cost of debentures (debt-capital) is lower as compared to ownership securities where dividend is not a tax-deductible expense.

iv. Debt financing does not result into dilution of control because debenture holders do not have any voting rights.

v. A company can trade on equity by mixing debentures in its capital structure and thereby increase its earnings per share.

vi. Many companies prefer issue of debentures because of the fixed rate of interest attached to them irrespective of the changes in price levels.

vii. Debentures provide flexibility in the capital structure of a company as the same can be redeemed as and when the company has surplus funds and desires to do so.

viii. Even during depression, when stock market sentiment is very low, a company may be able to raise funds through issue of debentures or bonds because of certainty of income and low risk to investors.

9.6.1.2 Advantages to Investors

It is not only the company but also the investors who are benefited by investing in debentures or bonds. The following are the main advantages from the point of view of investors :

i. Debentures provide a fixed, regular and stable source of income to its investors.

ii. It is comparatively a safer investment because debenture holders have either a specific or a floating charge on all the assets of the company and enjoy the status of a superior creditor in the event of liquidation of the company.

iii. Many investors prefer debentures because of a definite maturity period.

iv. A debenture is usually more liquid investment and an investor can sell or mortgage his instrument to obtain loans from financial institutions.

v. The interest of debenture holders is protected by various provisions of the debenture trust deed and the guidelines issued by the Securities and Exchange Board of India SEBI in this regard.

9.6.2 Disadvantages of Debenture Finance

Inspite of many advantages, debenture financing suffers from certain limitations. The following are the major disadvantages of debentures:

9.6.2.1 Disadvantages to the Company

A company suffers from the following disadvantages of debt-financing:

i. The fixed interest charges and repayment of principal amount on maturity are legal obligations of the company. These have to be paid even when there are no profits. Hence, it is a permanent burden on the company. Default in these payments, adversely affects the credit-worthiness of the firm and even may lead to winding up of the company.

ii. Charge on the assets of the company and other protective measures provided to investors by the issue of debentures usually restrict a company from using this source of finance. A company cannot raise further loans against the security of assets already mortgaged to debenture holders.

iii. The use of debt financing usually increases the risk perception of investors in the firm. This enhanced financial risk increases the cost of equity capital.

iv. Cost of raising finance through debentures is also high because of high stamp duty.

v. A company whose expected future earnings are not stable or who deals in products with highly elastic demand or who does not have sufficient fixed assets to offer as security to debenture holders cannot use this source of rasing funds to its benefit.

9.6.2.2 Disadvantages to the Investor

Many investors do not find debentures or bonds as an attractive investment because of the following :

i. Debentures do not carry any voting rights and hence its holders do not have any controlling power over the management of the company.

ii. Debenture holders are merely creditors and not the owners of the company. They do not have any claim on the surplus assets and profit of the company beyond the fixed interest and their principal amount.

iii. Interest on debentures is fully taxable while shareholders may avoid tax by way of stock dividend (bonus shares) in place of cash dividend.

iv. The prices of debentures in the market fluctuate with the changes in the interest rates.

v. Uncertainly about redemption also restricts certain investors from investing in such securities.

9.7 PROCEDURE OF ISSUING DEBENTURES

Debentures are said to be issued at premium when these are issued at a value which is more than their nominal value. For example, a debenture of Rs 100 is issued at Rs 110. This excess amount of Rs 10 is the amount of premium. The premium on the issue of debentures is credited to the Securities Premium A/c as per section 78 of the Companies Act, 1956.

Procedure of Issue of Debentures at Discount

When debentures are issued at less than their nominal value they are said to be issued at discount. For example, debenture of Rs 100 each is issued at Rs 90 per debenture. Companies Act, 1956 has not laid down any conditions for the issue of debentures at a discount as have been laid down in case of issue of shares at discount. However, there should be provision for issue of such debentures in the Articles of Association of the Company.

Procedure of Issue of Debentures for Consideration other than Cash

When a company purchases some assets and issues debentures as a payment for the purchase, to the vendors it is known as issue of debentures for consideration other than cash. Debentures can be issued to vendors at par, at premium and at discount.

Procedure of Issue of Debentures as Collateral Security

Collateral security means security given in addition to the principal security. It is a subsidiary or secondary security. Whenever a company takes loan from bank or any financial institution it may issue its debentures as secondary security which is in addition to the principal security. Such an issue of debentures is known as 'issue of debentures as collateral security'. The lender will have a right over such debentures only when company fails to pay the loan amount and the principal security is exhausted. In case the need to exercise this right does not arise debentures will be returned back to the company. No interest is paid on the debentures issued as collateral security because company pays interest on loan.

In the accounting books of the company issue of debentures as collateral security can be credited in two ways.

(i) No journal entry to be made in the books of accounts of the company:

Debentures are issued as collateral security. A note of this fact is given on the liability side of the balance sheet under the heading Secured Loans and Advances.

(ii) Entry to be made in the books of account the company

A journal entry is made on the issue of debentures as a collateral security. Debentures suspense A/c is debited because no cash is received for such issue.

Procedure of Issue of Debentures by a Private Limited Company

Following are the steps involved in the issue of debentures by a private company:

1. Position in Law :

(a) Under the Companies (Acceptance of Deposit) Rules, 1975 “any amount raised by issue of debentures (including convertible debentures) secured by the mortgage of any immovable property of the company and that the market value of the immovable property secured is higher than the amount of debentures issued” is not considered to be a DEPOSIT.

(b) Under Section 3(1)(d) of the Act, a private company is prohibited from accepting Deposit from persons other than its directors, members and their relatives.

(c) Hence, the private company must issue debentures only as a secured debenture.

2. Approvals :

The following approvals are required to be obtained by the Company:

Approval Level	Nature of approval
Board	For issue of Debentures under Section 292(1) (b).
Board	Creation / Declaration of Trust
Board	Appointment of Debenture Trustees (Section 117B)
Board	Approval of Draft Trust Deed
Board	Approval of the Form of Debenture Certificate.
Letter from Trustees	Consent from the Debenture Trustees to act as Trustees.

No approvals are required to be obtained under Section 293(1) (a) and (d) since, the Section does not apply to Private Limited Companies, unless it is a Subsidiary of a Public Company.

APPROVAL OF TRUST DEED:

The Chairman placed before the Board the draft Trust Deed to be entered with the Debenture Trustees of the Company for the issue of ___% __ debentures of Rs. ____/- each. The Board then after discussion

RESOLVED THAT the Debenture Trust Deed as per the draft placed before this meeting and initialed by the Chairman for the purpose of identification, be and is hereby approved and that Mr. __________ , Director and Mr. _________, Director be and are hereby authorised to execute the same on behalf of the Company.

3. Allotment

Since, the Company proposes to place the Debenture privately, it is suggested that a Letter of Offer is also made which would be circulated amongst the target buyers. The draft letter of offer is also required to be approved by the Board. The conditions relating to the payment for subscription, the Security, the rate of interest on the Debentures and the period by which the Debentures would be redeemed would have to be specified.

On receipt of the application from the person(s) subscribing for the Debentures, the Board needs to make the allotment.

SUGGESTED RESOLUTION FOR ALLOTMENT OF DEBENTURES:

The Chairman informed the Board that ____ has agreed to subscribe to the Debentures of the Company and has paid Rs. ___/- as specified in the Letter of Offer. He also informed that as per the Letter of Offer the Debentures are required to be alloted on or before __th _____, 200_. After deliberation the Board passed the following resolution:

RESOLVED THAT the Board do and hereby constitute and allot to _____,__ non-convertible debentures of Rs. __/- each.

RESOLVED FURTHER THAT the terms of issue of the aforesaid debentures allotted to _________ be and is hereby confirmed as follows:

TERMS	**___ NCD's**
Rate of Interest	
Moratorium Period of Interest	
Moratorium Period of Principal.	
Redemption (per debenture)	
Security	
Trustees	

RESOLVED FURTHER THAT the said Debentures bearing the following distinctive Nos. be and are hereby allotted to _____., on private placement basis as under:

Name of Allottee	No. of Debentures	Distinctive Numbers	Debenture Certificate No.

RESOLVED FURTHER THAT the Debenture Certificates in the format approved, bearing the above said numbers be issued under the Common Seal of the Company, to the Debentureholder duly signed by Mr. _______ , Chairman / Director and Mr. ______ , Director, and countersigned by Mr. _______, Authorised Signatory of the Company.

RESOLVED FURTHER THAT the above named persons are also severally authorised to execute and deliver on behalf of the Company all deeds, documents, declarations, undertakings and other writings and to do all such other acts and things as may be required with regard to the debenture issue.

RESOLVED FURTHER THAT a deposit of title deeds of the property of the company as described below be made to ________, having their registered office at ________________, and that Mr. __________, Managing Director of the Company be and is hereby authorised to call on the authorised office of the said trustees and convey his oral consent for creating the equitable mortgage.

4. Equitable Mortgage

The security is to be created by way of Equitable Mortgage by way of deposit of title deeds of the immovable property of the Company. The deposit is required to make with the Trustees. The procedure relating to this is as follows:

- The Board should authorise either of the Directors / Officer of the Company to Deposit the Title Deeds with the Trustees.
- The person so authorised to call on the Trustee and Deposit the same.

- ➢ The person so authorised should also convey the intention of the Company to create an Equitable Mortgage to the Trustee and instruct him to hold the Title Deeds till the time the debentures are redeemed in full.
- ➢ This consent is usually ORAL, and there would be no documentary proof for the same, for having deposited it.

Once the title deeds are deposited, the person so authorised should write to the Trustee so as to confirm the Deposit of Title Deeds by way of a letter. The format of the letter is given below :

To

____Trust Company Limited

Address

____

____

Dear Sir,

We are writing this letter to confirm that we have deposited on ________with you, the Debenture Trustees for Debentures issued / privately placed by our Company, on _____ in the presence of Mr./Mrs. _________, and Mr./Mrs. __________, the title deeds dated _______, relating to the property of our company situated at __________________ described below in detail (herein under referred to as the "SAID PROPORTY") with the intention of creating an equitable mortgage over the property by way of security for an amount of Rs. _______– __ Debentures of Rs. __ each.

DESCRIPTION OF THE PROPERTY

Thanking you.

5. Filling of Modification of Charge with the Registration of Companies :

After creation of the Equitable Mortgage the Company should file Form 8, if there is no Series of Debentures issued. Form 10 is to be filed only when a company issues a "Series of Debentures" containing any *pari passu* charge to the benefit of the debenture holders of that series.

6. Time Limit for Issue of Debenture Certificate

The time-limit for the issue of Debenture Certificate is 3 months from the date of allotment. If the Company is of the opinion that it might not be able to issue the Debenture Certificate within 3 months, then it is suggested that an application is made to the CLB requesting for extending the time-limit for issue of Debenture Certificate.

7. Creation of Debenture Redemption Reserve :

As per Section 117C of the Companies Act, 1956, a Debenture Redemption Reserve (DRR) needs to be created. From the profits of the Company each year, adequate amounts need to credited, which should be utilised for redemption, and not for any other purpose.

8. No Necessity to File Form 2 for Allotment of Debentures :

We would like to clarify that Form 2 - 'Return of Allotment' being a requirement under Section 75 of the Companies Act is limited to allotment of shares and it does not in its scope cover Allotment of Debentures.

9. Maintenance of Register of Debenture-Holders

Under Section 152 of the Act, the Company is required to maintain a Register of Debenture-holder.

10. **Payment of Stamp Duty onthe Debentures**

The stamp duty as prescribed under the Stamp Act required to be affixed to the Debenture Certificate on the face of the same or in the form of attaching a separate sheet of paper and affixing the stamps on the same. The fact that the stamps so affixed forms part of the Certificate with the Certificate Number should be mentioned on the sheet so attached.

9.8 SUMMARY

A Debenture is a document issued by the company. It is a certificate issued by the company under its seal acknowledging a debt. According to the Companies Act 1956, "debenture includes debenture stock, bonds and any other securities of a company whether constituting a charge of the assets of the company or not." Debentures are generally freely transferable by the debenture holder. Debenture holders have no rights to vote in the company's general meetings of shareholders, but they may have separate meetings or votes e.g. on changes to the rights attached to the debentures. The interest paid to them is a charge against profit in the company's financial statements. There are different types of debentures such as secured & unsecured, redeemable & irredeemable, convertible & non-convertible etc. The advantage of debentures to companies is that they carry lower interest rates than, say, overdrafts and are usually repayable a long time into the future. For an investor, they are usually saleable on a stock exchange and involve less risk than equities.

9.9 GLOSSARY

- **Interest Rate:** An interest rate on a liability, such as a loan or mortgage, that remains fixed either for the entire term of the loan or for part of this term.
- **Financial Statement:** A record of financial activity that is suitable for a variety of users to properly assess the financial health of a company.
- **Liquidation:** The total worth of a company's physical assets when it goes out of business or if it were to go out of business. Liquidation value is determined by assets such as the real estate, fixtures, equipment and inventory a company owns.

9.10 SELF ASSESSMENT QUESTIONS

1. List out the types of debentures.

2. Write a short note on:

i. Convertible Debentures

ii. Zero-Coupon Bonds

3. Write a short note on debentures.

4. Evaluate the overall nature of debentures.

9.11 LESSON END QUESTIONS

1. What are debentures ? What are the types of debentures can a joint stock company issue

   ____

   ____

2. Evaluate debentures as a source of funds?

   ____

   ____

3. "Debentures occupy a very important place in the financial plan". Discuss the statement and point out the limitations of debentures financing.

   ____

   ____

4. Between shares and debentures which is profitable for raising additional capital? Also Distinguish between shares & dentures ?

   ____

   ____

9.12 SUGGESTED READINGS

- M.Y. Khan & V.K. Jain -Financial Management Text & Problems- Tata McGraw Hill Publishing Company Ltd
- Aswath Damodaram: Corporate Finance: Theoryand Practice, Wiley International
- Van Home and C. James- Financial Management & Policy (9th Edition) - Prentice Hall of India. Ltd., New Delhi

UNIT -II

LONG TERM SOURCES OF FINANCE

LESSON No. 10

Concept of Venture Capital; Concept of Leasing, types of Leasing and Buying or Leasing Decisions

Structure :

10.1 Introduction

10.2 Objectives

10.3 Concept of Venture capital

10.3.1 Advantages of Venture capital

10.3.2 Disadvantages of Venture capital

10.4 Venture capital Process

10.4.1 Types of Venture Capital funding

10.5 Concept of Leasing

10.5.1 Advantages of Leasing

10.5.2 Disadvantages of Leasing

10.6 Types of Leasing

10.7 Buying or Leasing Decisions

10.8 Summary

10.9 Glossary

10.10 Self Assessment Questions

10.11 Lesson End Exercise

10.12 Suggested Readings

10.1 INTRODUCTION

Venture capital represent the most glamorous and appealing form of financing to many entrepreneurs. They are known for backing high-growth companies in the early stages, and many of the best-known entrepreneurial success stories owe their growth to financing from venture capitalists. VCs can provide large sums of money, advice and prestige by their mere presence. Just the fact that you've obtained venture capital backing means your business has, in venture capitalists' eyes, at least, considerable potential for rapid and profitable grow. The lease is a contract whereby one party, the lessor, grants the right to use a particular good for a period of time to the other party, the lessee (or tenant), which will pay for the transfer of the right to use a fixed amount regularly. In the leasing contract, the landlord transfers the right to use the property in exchange for payment of rents for a specified period after which the tenant can do three things: buying a good value (and low), return the property or extend the leasing period. The obligation of lessor is to deliver the goods in proper condition and receive payments. The obligation of lessee is to make payments and to make choice of whether to acquire ownership of asset at expiration of contract.

10.2 OBJECTIVES

After going through this lesson, you should be able to:

- Explain the concept of venture capital
- Be familiar with the types of venture capital.
- Describe the concept of leasing.
- Understand the types of leasing
- Evaluate between buy or leasing decisions

10.3 CONCEPT OF VENTURE CAPITAL

It is a private or institutional investment made into early-stage / start-up companies (new ventures). As defined, ventures involve risk (having uncertain outcome) in the expectation of a sizeable gain. Venture capital is money invested in businesses that are small; or exist only as an initiative, but have huge potential to grow. The people who invest this money are called venture capitalists (VCs). The venture capital investment is made when a venture capitalist buys shares of such a company and becomes a financial partner in the business. Venture capital investment is also referred to risk capital or patient risk capital, as it includes the risk of losing the money if the venture doesn't succeed and takes medium to long term period for the investments to fructify. Venture capital typically comes from institutional investors and high net worth individuals and is pooled together by dedicated investment firms. It is the money provided by an outside investor to finance a new, growing, or troubled business. The venture capitalist provides the funding knowing that there's a significant risk associated with the company's future profits and cash flow. Capital is invested in exchange for an equity stake in the business rather than given as a loan.

Venture Capital is the most suitable option for funding a costly capital source for companies and most for businesses having large up-front capital requirements which have no other cheap alternatives. Software and other intellectual property are generally the most common cases whose value is unproven. That is why; venture capital funding is most widespread in the fast-growing technology and biotechnology fields. Examples of venture capital funding

- **Kohlberg Kravis & Roberts (KKR),** one of the top-tier alternative investment asset managers in the world, has entered into a definitive agreement to invest USD150 million (Rs 962 crores) in Mumbai-based listed polyester maker JBF Industries Ltd. The firm will acquire 20% stake in JBF Industries and will also invest in zero-coupon compulsorily convertible preference shares with 14.5% voting rights in its Singapore-

based wholly owned subsidiary JBF Global Pte Ltd. The funding provided by KKR will help JBF complete the ongoing projects.

- **Pepperfry.com,** India's largest furniture e-marketplace, has raised USD100 million in a fresh round of funding led by Goldman Sachs and Zodius Technology Fund. Pepperfry will use the funds to expand its footprint in Tier III and Tier IV cities by adding to its growing fleet of delivery vehicles. It will also open new distribution centers and expand its carpenter and assembly service network. This is the largest quantum of investment raised by a sector focused e-commerce player in India. The features of venture capital are discussed as under:

- It involves high risk.
- There is a lack of liquidity in the venture capital.
- It involves long term horizon
- Venture capital has equity participation and capital gains
- Venture capital investments are made in innovative projects
- Suppliers of venture capital participate in the management of the company

10.3.1 Advantages of Venture Capital

- They bring wealth and expertise to the company
- Large sum of equity finance can be provided
- The business does not stand the obligation to repay the money
- In addition to capital, it provides valuable information, resources, technical assistance to make a business successful

10.3.2 Disadvantages of Venture Capital

- As the investors become part owners, the autonomy and control of the founder is lost
- It is a lengthy and complex process
- It is an uncertain form of financing
- Benefit from such financing can be realized in long run only

10.4 VENTURE CAPITAL PROCESS

The venture capital funding process typically involves four phases in the company's development:

- Idea generation
- Start-up
- Ramp up
- Exit

Step 1: Idea generation and submission of the Business Plan

The initial step in approaching a Venture Capital is to submit a business plan. The plan should include the below points:

- There should be an executive summary of the business proposal
- Description of the opportunity and the market potential and size
- Review on the existing and expected competitive scenario
- Detailed financial projections
- Details of the management of the company

There is detailed analysis done of the submitted plan, by the Venture Capital to decide whether to take up the project or no.

Step 2: Introductory Meeting

Once the preliminary study is done by the VC and they find the project as per their preferences, there is a one-to-one meeting that is called for discussing the project in detail. After the meeting the venture capital finally decides whether or not to move forward to the due diligence stage of the process.

Step 3: Due Diligence

The due diligence phase varies depending upon the nature of the business proposal. This process involves solving of queries related to customer references, product and business strategy evaluations, management interviews and other such exchanges of information during the time period.

Step 4: Term Sheets and Funding

If the due diligence phase is satisfactory, the Venture capital offers a term sheet, which is a non-binding document explaining the basic terms and conditions of the investment agreement. The term sheet is generally negotiable and must be agreed upon by all parties, after which on completion of legal documents and legal due diligence, funds are made available.

10.4.1 Types of Venture Capital funding

The various types of venture capital are classified as per their applications at various stages of a business. The three principal types of venture capital are early stage financing, expansion financing and acquisition/buyout financing.

The venture capital funding procedure gets complete in six stages of financing corresponding to the periods of a company's development

- **Seed money:** Low level financing for proving and fructifying a new idea

- **Start-up:** New firms needing funds for expenses related with marketing and product development
- **First-Round:** Manufacturing and early sales funding
- **Second-Round:** Operational capital given for early stage companies which are selling products, but not returning a profit
- **Third-Round:** Also known as Mezzanine financing, this is the money for expanding a newly beneficial company
- **Fourth-Round:** Also called bridge financing, 4th round is proposed for financing the "going public" process

A) Early Stage Financing:

Early stage financing has three sub divisions seed financing, start up financing and first stage financing.

- Seed financing is defined as a small amount that an entrepreneur receives for the purpose of being eligible for a start up loan.
- Start up financing is given to companies for the purpose of finishing the development of products and services.
- First Stage financing: Companies that have spent all their starting capital and need finance for beginning business activities at the full-scale are the major beneficiaries of the First Stage Financing.

B) Expansion Financing:

Expansion financing may be categorized into second-stage financing, bridge financing and third stage financing or mezzanine financing.

Second-stage financing is provided to companies for the purpose of beginning their expansion. It is also known as mezzanine financing. It is provided for the purpose of assisting a particular company to expand in a major way. Bridge

financing may be provided as a short term interest only finance option as well as a form of monetary assistance to companies that employ the Initial Public Offers (IPOs) as a major business strategy.

C) Acquisition or Buyout Financing:

Acquisition or buyout financing is categorised into acquisition finance and management or leveraged buyout financing. Acquisition financing assists a company to acquire certain parts or an entire company. Management or leveraged buyout financing helps a particular management group to obtain a particular product of another company.

10.5 CONCEPT OF LEASING

A famous quote by **Donald B. Grant**, "Why own a cow when the milk is so cheap? All you really need is milk and not the cow." The concept of lease is influenced by this quote. We can compare 'milk' with the 'rights to use an asset' and 'cow' with the 'asset' itself. Ultimately, a person who wants to manufacture a product using machinery can get to use that machinery under a leasing arrangement without owning it.

A lease can be defined as an arrangement between the lessor (owner of the asset) and the lessee (user of the asset) whereby the lessor purchases an asset for the lessee and allows him to use it in exchange for periodical payments called lease rentals or minimum lease payments (MLP). Leasing is beneficial to both the parties for availing tax benefits or doing tax planning. At the conclusion of the lease period, the asset goes back to the lessor (the owner) in an absence of any other provision in the contract regarding compulsory buying of the asset by the lessee (the user). There are four different things possible post-termination of the lease agreement.

- The lease is renewed by the lessee perpetually or for a definite period of time.
- The asset goes back to the lessor.

- The asset comes back to the lessor and he sells it off to a third party.
- Lessor sells to the lessee.

The maximum period of lease according to law is for 99 years. Previously land or real estete mines and quarries were taken on lease. But now a day's plant and equipment, modem civil aircraft and ships are taken.

(i) **Lessor :**

The party who is the owner of the equipment permitting the use of the same by the other party onpayment of a periodical amount.

(ii) Lessee :

The party who acquires the right to use equipment for which he pays periodically.

(iii) Lease rentals :

This refers to the consideration received by the lessor in respect of a transaction and includes:

- Interest on the lessor's investment;
- Charges borne by the lessor. Such as repairs, maintenance, insurance, etc;
- Depreciation;
- Service charges.

10.5.1 Advantages of Leasing

- **Balanced Cash Outflow**

  The biggest advantage of leasing is that cash outflow or payments related to leasing are spread out over several years, hence saving the burden of one-time significant cash payment. This helps a business to maintain a steady cash-flow profile.

- **Quality Assets**

  While leasing an asset, the ownership of the asset still lies with the lessor whereas the lessee just pays the rental expense. Given this agreement, it becomes plausible for a business to invest in good quality assets which might look unaffordable or expensive otherwise.

- **Better Usage Of Capital**

  Given that a company chooses to lease over investing in an asset by purchasing, it releases capital for the business to fund its other capital needs or to save money for a better capital investment decision.

- **Tax Benefit**

  Leasing expense or lease payments are considered as operating expenses, and hence, of interest, are tax deductible.

- **Off-Balance Sheet Debt**

  Although lease expenses get the same treatment as that of interest expense, the lease itself is treated differently from debt. Leasing is classified as an off-balance sheet debt and doesn't appear on the company's balance sheet

- **Better Planning**

  Lease expenses usually remain constant for over the asset's life or lease tenor or grow in line with inflation. This helps in planning expense or cash outflow when undertaking a budgeting exercise.

- Low Capital Expenditure

  Leasing is an ideal option for a newly set-up business given that it means lower initial cost and lower Capital Expenditure requirements.

- No Risk of Obsolescence

  For businesses operating in the sector, where there is a high risk of technology becoming obsolete, leasing yields great returns and saves the business from the risk of investing in a technology that might soon become out-dated. For example, it is ideal for the technology business.

- Termination Rights

  At the end of the leasing period, the lessee holds the right to buy the property and terminate the leasing contract, thus providing flexibility to business.

10.5.2 Disadvantages of Leasing

- **Lease Expenses**

  Lease payments are treated as expenses rather than as equity payments towards an asset.

- **Limited Financial Benefits**

  If paying lease payments towards a land, the business cannot benefit from any appreciation in the value of the land. The long-term lease agreement also remains a burden on the business as the agreement is

locked and the expenses for several years are fixed. In a case when the use of asset does not serve the requirement after some years, lease payments become a burden.

- **Reduced Return For Equity Holders**

  Given that lease expenses reduce the net income without any appreciation in value, it means limited returns or reduced returns for an equity shareholder. In such a case, the objective of wealth maximization for shareholders is not achieved.

- **Debt**

  Although lease doesn't appear on the balance sheet of a company, investors still consider long-term lease as debt and adjust their valuation of a business to include leases.

- **Limited Access to Other Loans**

  Given that investors treat long-term leases as debt, it might become difficult for a business to tap capital markets and raise further loans or other forms of debt from the market.

- **Processing and Documentation**

  Overall, to enter into a lease agreement is a complex process and requires thorough documentation and proper examination of an asset being leased.

- **No Ownership**

  At the end of the leasing period, the lessee doesn't end up becoming the owner of the asset though quite a good sum of payment is being done over the years towards the asset.

- **Maintenance of The Asset**

  The lessee remains responsible for the maintenance and proper operation of the asset being leased.

- **Limited Tax Benefit**

  For a new start-up, the tax expense is likely to be minimal. In these circumstances, there is no added tax advantage that can be derived from leasing expenses.

10.6 TYPES OF LEASING

1. Financial Lease:

This type of lease which is for a long period provides for the use of asset during the primary lease period which devotes almost the entire life of the asset. The lessor assumes the role of a financier and hence services of repairs, maintenance etc., are not provided by him. The legal title is retained by the lessor who has no option to terminate the lease agreement.

The principal and interest of the lessor is recouped by him during the desired playback period in the form of lease rentals. The finance lease is also called capital lease is a loan in disguise. The lessor thus is typically a financial institution and does not render specialized service in connection with the asset.

2. Operating Lease:

It is where the asset is not wholly amortized during the non-cancellable period, if any, of the lease and where the lessor does not rely for is profit on the rentals in the non- cancellable period. In this type of lease, the lessor who bears the cost of insurance, machinery, maintenance, repair costs, etc. is unable to realise the full cost of equipment and other incidental charges during the initial period of lease.

The lessee uses the asset for a specified time. The lessor bears the risk of obsolescence and incidental risks. Either party to the lease may termite the lease after giving due notice of the same since the asset may be leased out to other willing leases.

3. **Sale and Lease Back Leasing:**

To raise funds a company may-sell an asset which belongs to the lessor with whom the ownership vests from there on. Subsequently, the lessor leases the same asset to the company (the lessee) who uses it. The asset thus remains with the lessee with the change in title to the lessor thus enabling the company to procure the much needed finance.

4. **Sales Aid Lease:**

Under this arrangement the lessor agrees with the manufacturer to market his product through his leasing operations, in return for which the manufacturer agrees to pay him a commission.

5. **Specialized Service Lease**

In this type of agreement, the lessor provides specialised personal services in addition to providing its use.

6. **Small Ticket and Big Ticket Leases:**

The lease of assets in smaller value is generally called as small ticket leases and larger value assets are called big ticket leases.

7. **Cross Border Lease:**

Lease across the national frontiers is called cross broker leasing. The recent development in economic liberalisation, the cross border leasing is gaining greater importance in areas like aviation, shipping and other costly assets which base likely to become absolute due to technological changes

10.7 BUYING OR LEASING DECISIONS

Lease or buy decision involves applying capital budgeting principles to determine if leasing as asset is a better option than buying it. Leasing is a contractual arrangement in which a company (the lessee) obtains an asset from another company (the lessor) against periodic payments of lease rentals. It may typically also involve an option to transfer the ownership of the asset to the lessee at the end of the lease. Buying the asset involves purchase of the asset with company's own funds or arranging a loan to finance the purchase. In finding out whether leasing is better than buying, we need to find out the periodic cash flows under both the options and discount them using the after-tax cost of debt to see where does the present value of the cost of leasing stands as compared to the present value of the cost of buying. The alternative with lower present value of cash outflows is selected.

Buy vs Lease dilemma is faced by most of the entrepreneurs. The decision on whether to buy or lease is dependent on number of factors such as duration for which such an asset would be required, the returns that the business will generate on the asset, type of asset and related technological developments etc. This difference is especially important when businesses look at capital intensive assets such as property, machinery, land etc.

- **Capital**

  Purchasing (Buying): Purchasing requires more capital (cash reserve or lender support) as you look to purchase the asset by paying its full value.

  Leasing: Initial capital requirement under leasing contracts is limited and monthly payments also account to a smaller amount.

- **Ownership**

  Purchasing (Buying): When you buy equipment, you are the ultimate owner and are responsible for its maintenance etc.

Leasing: Under leasing, the lessee is not the owner of the asset. He just obtains the right to use the asset for a fixed term under pre-defined lease payments.

- **Term**

  Purchasing (Buying): Buying decision is not related to the term of the asset as the owner can use it till the end of its useful life. An asset that is bought can be replaced at any time.

  Leasing: Leasing agreements are run usually for a fixed term and at the end of the term, the lessee is required to either purchase the asset or to return it to lessor. Most of lease contracts cannot be terminated before the end of the term.

- **Risk & Rewards**

  Purchasing (Buying): Given that the ownership lies with the purchaser, the buyer is responsible for all risks and rewards associated with the asset. Hence, buying an asset should be avoided in an industry or segment where there are frequent technological innovations.

  Leasing: Under operating lease, all the rewards associated with the asset remain with the lessor whereas most of the risks and rewards stay with the lessee under finance lease.

- **Tax Benefits**

  Purchasing (Buying): Purchasing an asset will bring you limited tax benefit. If the asset is funded using existing cash reserves, there is likely no tax benefit at all. For a debt funded asset purchase, the owner will be able to claim tax benefit on interest on such debt. Principal amount is not deductible though.

  Leasing: Under a lease contract, all the lease payments are fully tax deductible. This will include any lease rental payment plus the interest on any outstanding lease amount. Thus from a taxation perspective, leasing is much more beneficial

There can be more factors which are important while considering a decision like buy vs lease. These factors could be different for different situations, circumstances etc. It is ideal to take all other factors into consideration before taking decisions. You can share the factors in comments below which you think are important and not considered here

10.8 SUMMARY

Start up companies with a potential to grow need a certain amount of investment. Wealthy investors like to invest their capital in such businesses with a long-term growth perspective. This capital is known as venture capital and the investors are called venture capitalists.

Such investments are risky as they are illiquid, but are capable of giving impressive returns if invested in the right venture. The returns to the venture capitalists depend upon the growth of the company. Venture capitalists have the power to influence major decisions of the companies they are investing in as it is their money at stake. Asset finance or leasing is a way of purchasing equipment, machinery or other assets without having to pay the full amount upfront.

There are various different structures that can be used and the attraction of each one will vary according to your requirements and, perhaps, according to tax changes made by the government.

In essence, a lease is an agreement between you (the lessee) and the finance company (the lessor). You will pay a periodic fee, usually monthly, for the use and possibly ownership of equipment.

The range of equipment that can be bought under a lease is expanding rapidly – from the most basic purchase, such as office computers or company cars, to more specialised equipment, such as a forklift truck or a safe.

This is partly due to the fact that the number of companies providing this service has expanded rapidly. Not only do most banks and a number of specialised finance houses offer this service, but there have also been a growing number of equipment manufacturers

entering the market. It is now possible to lease your office computer direct from Dell, Compaq and IBM among others.

In fact, the Finance and Leasing Association (FLA) estimates that some 15% of office equipment is financed through a lease. The FLA also expects the market to continue growing gradually but notes that the business is always dependent upon the latest tax and accounting changes.

To summarize, lease finance is appropriate for an individual or business which cannot raise money through other means of finance like debt or term loan because of the lack of funds. The business or lessee cannot even arrange the down payment money to raise debt. The lease works best for him. On the other hand, the lessor, who wants to invest his money efficiently, becomes the financier for the lessee and earns the interest.

To take an informed decision regarding the use of various types of lease finance, we may have a look at the comparison of lease finance with other forms of finance.

10.9 GLOSSARY

- **Bonds:** In finance, a bond is an instrument of indebtedness of the bond issuer to the holders. It is a debt security, under which the issuer owes the holders a debt and, depending on the terms of the bond, is obliged to pay them interest (the coupon) or to repay the principal at a later date, termed the maturity.
- **Stocks:** Stock is a type of security that signifies ownership in a corporation and represents a claim on part of the corporation's assets and earnings.
- **Financial asset:** A financial asset is any asset that can be quickly converted to purchasing power. Some assets are more easily converted to purchasing power than other.
- **Lease:** A lease is a contractual arrangement calling for the lessee to pay the lessor for use of an asset. Property, buildings and vehicles are common assets that are leased. Industrial or business equipment is also leased. Broadly lease agreement is a contract between two parties, the lessor and the lessee.

- **Venture capital:** Venture capital is a form of private equity financing that is provided by venture capital firms or funds to startups, early-stage, and emerging companies that have been deemed to have high growth potential or which have demonstrated high growth.

10.10 SELF ASSESSMENT QUESTIONS

1. Describe the meaning of venture capital and its various types.

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2. Explain the meaning of leasing along with its advantages and disadvantages.

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10.11 LESSON END EXERCISE

1. Discuss the advantages and disadvantages of venture capital.

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2. What is the criteria to compare buy or leasing decisions ?

10.12 SUGGESTED READINGS

- Pandey, I. M., Financial Management, Vikas Publishing House, New Delhi.
- Gupta and Sharma, Management Accounting-Kalyani Publishers
- Guthmann and Dougall, Corporate Financial Policy, Pentice Hall.
- Babu, G. Ramesh (2005), "Indian Financial System", 1st Edition, Himalayan Publishing House, Mumbai.
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- Hampton, John, Financial Decision Making, Pentice Hall, New Delhi.

UNIT - III

SHORT TERM FINANCE AND WORKING CAPITAL

LESSON No. 11

Concept and Characteristics of Short Term Financing; Advantages Disadvantages of Short Term Financing and Sources of Short Term Financing

Structure :

11.1 Concept and Characteristics of Short-Term Financing

11.1.1 Long-Term Financial Requirements

11.1.2 Short-Term Financial Requirements

11.2 Objectives

11.3 Short Term Financing

11.3.1 Purposes of Short-Term Finance

11.3.2 Characteristics of Short Term Financing

11.3.3 Advantages of Short Term Financing

11.3.4 Disadvantages of Short Term Financing

11.4 Why to use Short Term

11.5 Short Term & Long Term Finance

11.5.1 Short Term Finances over Long Term Finances

11.6 Recent RBI Guidelines Regarding Short Term Finance

11.7 Sources of Short Term Finance

11.8 Summary

11.9 Glossary

11.10 Self Assessment Questions

11.11 Lesson End Questions

11.12 Suggested Readings

11.1. INTRODUCTION

Finance is the lifeblood of business concern, because it is interlinked with all activities performed by the business concern. In a human body, if blood circulation is not proper, body function will stop. Similarly, if the finance not being properly arranged the business system will stop. Arrangement of the required finance to each department of business concern is highly a complex one and it needs careful decision. Quantum of finance may be depending upon the nature and situation of the business concern. But, the requirement of the finance may be broadly classified into two parts:

11.1.1 Long-term Financial Requirements or Fixed Capital Requirement

Financial requirement of the business differs from firm to firm and the nature of the requirements on the basis of terms or period of financial requirement, it maybe Long term and short-term financial requirements.

Long-term financial requirement means the finance needed to acquire land and building for business concern, purchase of plant and machinery and other fixed expenditure. Long term financial requirement is also called as fixed capital requirements. Fixed capital is the capital, which is used to purchase the fixed assets of the firms such as land and building, furniture and fittings, plant and machinery etc. Hence, it is also called a capital expenditure.

11.1.2 Short-term Financial Requirements or Working Capital Requirement

Apart from the capital expenditure of the firms, the firms should need certain expenditure like procurement of raw materials, payment of wages, day-to-day expenditures, etc. This kind of expenditure is to meet with the help of short-term

financial requirements which will meet the operational expenditure of the firms. Short-term financial requirements are popularly known as working capital.

11.2 OBJECTIVES

After completion of this lesson, you should be able to

- understand the concept of short term financing
- understand the nature of short term financing
- understand the sources of short term financing

11.3 CONCEPT OF SHORT TERM FINANCING

Short term financing has a repayment schedules of less than 1 year, while Long term financing matures in 10 years or longer. Short term financing is a loan or credit facility with a maturity of 1 year or less, while Long term financing, where liabilities plus interest) would not be due within 1 year.

11.3.1 Purposes of Short Term Finance

Short-term finance serves following purposes

1. It facilitates the smooth running of business operations by meeting day to day financial requirements.
2. It enables firms to hold stock of raw materials and finished product.
3. With the availability of short-term finance goods can be sold on credit. Sales are for a certain period and collection of money from debtors takes time. During this time gap, production continues and money will be needed to finance various operations of the business.
4. Short-term finance becomes more essential when it is necessary to increase the volume of production at a short notice,

5. Short-term funds are also required to allow flow of cash during the operating cycle. Operating cycle refers to the time gap between commencement of production and realisation of sales.

6. Lowering of cost (Low cost financing)

7. Raising funds according to necessity.

8. Facilitating prosecution of business with other's money

9. Secure additional fund

11.3.2 Characteristics of Short Term Financing :

The short term financing has the following features:

1. The duration of the short term funds is one year or less.

2. The main purpose of the short term financing is to fulfill the needs for working capital.

3. Short term financing is costly & risky because within a very short period of time the borrower has to repay the debts.

4. No collateral is usually required because the loans are repaid on the basis of daily cash inflows or sales revenue.

5. Short term financing is a revolving credit because if the borrower/buyer could repay the bill within due date, then he could enjoy another extension of credit by lender/supplier.

6. Short term financing from financial institutions can be easily renewed if the borrower can repay the debts within due date & fulfill all the terms & conditions.

7. The size & nature of short term borrowers are quite large since small, medium, large, i.e. every kinds of manufacturing & business organizations need short term financing to continue their day to day operations.

8. Since the purpose of short term financing is to invest in current assets, so the amount required is relatively small.

11.3.3 Advantages of Short Term Financing :

1. Easier to Obtain
2. Lower cost
3. Flexibility
4. No Sharing of control
5. Availability
6. Tax Savings
7. Convenience
8. Extension of credit

- **Easier to Obtain:** Short -term credit can be more easily obtained than long term credit. A firm which poor credit standing may be unable to obtain long term funds but it can procure, at least some trade credit from sellers who are anxious to increase their sales. The short-term creditors, by granting loans assume less risk than long term creditors because there is less chance of substantial change in the financial soundness of the creditor within a few week's or month's lime.

- **Lower cost:** Short term credit may be obtained with lower cost than the long term finance because of priority of creditors in general Because of the prior position given creditors in the matter of claim to income and to assets in dissolution they generally will accept a relatively low interest

- **Flexibility:** Due to seasonal nature of business many firms have a temporary demand for short-term funds to carry heavier inventories. Most enterprises are in constant need of short term funds. Short-term financing is flexible in the

sense that the firm is able to secure funds as they are needed and repay then as soon as the need vanishes. Funds may be needed to meet the daily, weekly or monthly requirements. Such funds can be advantageously supplied by short term credit. It long term credit is secured to finance the daily or weekly or seasonal variations, it would become inflexible because long term funds cannot be repaid as soon as the need for funds vanishes.

- **No Sharing of control**: Obtaining funds form short term creditors prevents the inclusion of more owners through the procurement of owner's funds. This results in maintaining the position of control by the existing owners. Because the creditors have no voice in the operations of the business.
- **Availability**: In many cases, particularly for small enterprises short term credit is the only source available. It may not be possible for a small firm to obtain long term funds because of poor credit standing. Long-term credit is not generally granted without adequate margin of protection which the small firms may not be able to provide with. The small business has then recourse to short term funds.
- **Tax Savings:** The cost of short term funds are deductible for income tax purposes while the dividend paid to the owners is not deductible. Thus a substantial tax-savings may result from the use of short-term funds.
- **Convenience**: Short Term credit can be more conveniently secured than the other types of funds. It is more convenient to pay labour weekly or employees monthly than every day
- **Extension of credit:** Many enterprises purchase equipments, supplies and good by ordering from a supplier with the intent of paying after delivery has been made. If subsequently the bills are met promptly, the firm acquires a good credit standing. Then , if any emergency arises for the purchase of any goods the firm

11.3.4 Disadvantages of Short-Term Financing :

1. Frequent Maturity
2. High Cost

- **Frequent Maturity:** Short-Term credit is disadvantageous in the sense that it matures frequently. The principal must be repaid when due, otherwise the creditors may close the business. The use of such credit is also a risk to the owners' investment from the inability to meet the creditor's claims when due. There may be danger of either meeting the principal payment at maturity of the loan or meeting the principal payment at maturity of the loan or meeting any periodic interest payment or both. The sorter the credits the greater the potential risk to the owners because of the problem of prompter repayment.

- **High Cost:** The rate of interest paid on short-term is usually higher than that on long-term credit is usually higher than that on long-term credit. The rate of interest usually depends on the risk involved, size of loan, collateral protection, etc. The lenders may demand a high interest if the credit involves large amount and the potential credit risk is also high or the debtor may not give suitable security. A high interest may also be demanded when the firm can not procure funds from other sources on suitable terms and conditions.

11.4 WHY TO USE SHORT TERM

When starting up a small business, entrepreneurs have the option to choose between debt and equity financing. Traditionally, owners have chosen debt financing which come in three different terms; short, intermediate and long. Today we'll be focusing on short term finance.

Short term finance is a vital part of a business's operation. These loans have a maturity date of one year or less i.e. Lenders must fully repay their loan within a one year period. However, because short term funding is relatively a small amount of

funds being borrowed in comparison to long term finance, full payments are usually made within ninety to one hundred and twenty days.

By applying for short term finance this allows owners to meet any prompt payments without engaging into a long term commitment. The loans are useful for helping small businesses who are affected by seasons, in particular retail business. For example if you have own a surf store, you will most likely find your cash outflow to be greater than your cash inflow during winter periods, causing you to fall behind on your bill payments. Or alternatively, if you operate a clothing store you may decide to stock up on inventory just before Christmas to maximise your sales, short term funding would be a perfect option for you to do this. Other reasons to apply for this loan is that you might have funds tied up in your accounts receivable. Instead of waiting for customers to make their payments, you can use short term financing to raise working capital. This enables you to safeguard any temporary deficiencies so you can meet your own account payables i.e. paying suppliers or your own expenses such as paying rent, income tax etc. Thus for these reasons this is where short term financing comes into play.

11.5 SHORT TERM & LONG TERM FINANCE

The primary difference between long-term and short-term financing is in the length of time the debt obligation remains outstanding. Short-term financing involves a loan term that is typically less than one year. Conversely, long-term financing is any debt obligation with a loan term that is greater than one year. The distinction is important for accounting and tax purposes.

Businesses keep a close eye on the money they make and the bills they owe. Anything that is not paid immediately is financed. Financing is a type of credit or loan that allows a business to take possession of an asset in the present but not pay for it until some time in the future. The financing obligation is carried in the company's accounting system as a liability, or an outstanding amount owed.

The evaluation of assets and liabilities allows a person to determine the financial health of a company at any particular time. If a company more assets than liabilities, it is in relatively good shape; however, if it has more liabilities than assets, it could be in trouble. There is a distinction to be made regarding types of liabilities, however, that relates to a company's operating cycle.

When a person is trying to figure out if a company makes enough money to keep up with its expenses, it is concerned with what the company makes and what it owes within an operating cycle. An operating cycle is typically a fiscal year. Anything that happens within the fiscal year is considered current, or short-term, while anything that happens outside of the one-year window is considered fixed or long-term.

From a financial management perspective, the categorization of debt as long-term and short-term financing relates to this analysis. Not only does the difference between long-term and short-term financing concern the underlying payment terms, it also dictates how liabilities are carried on the books and how taxes are paid. Short-term financing, also called current liabilities, are debts that can be paid off within the current operating cycle. These obligations directly affect cash flow and are included in any analysis of a company's liquidity. Current liabilities can also be expensed, or deducted, in the current year against revenue for income tax purposes.

Long-term financing, also known as long-term liabilities, are debt obligations that have multi-year payment terms. An example is a 15-year mortgage. The payments made on this type of financing are not included in an analysis of a company's cash flow or ability to pay monthly bills. Also, the payments are often treated differently for tax purposes. Tax codes typically require companies to spread out any deductions that the company is entitled to because of the long-term financing or the asset it enabled the company to acquire over the life of the loan, instead of placing the whole transaction in one year.

11.5.1 Short Term Finances Over Long Term Finances

From the general perception of loans is that the long term loans end up being the pinnacle of your financial stress for a long period of time. Which is different with short term finance, for example, short term finance are normally require of the repayments are between 6-18 months. Therefore the long term loans such as mortgages, with paying monthly installments of interests becoming a regular part of their daily activities, the fear of the additional stress causes most people to avoid loans at all costs, but what they don't realize is that loans can become beneficial when used appropriately and not exploited. For those afraid of long term commitments, there is short term finance.

So what is short term funding, as it simple as its name implies, and as above it is a loan in which repayments are generally repays in a shorter period of duration, which compares to long term founding this is the benefit. However, short term funding comes with the easier application and faster approval, as its disadvantage it also come with larger installments and higher interests. However, short term finance are aiming to help the people in need within an instantly way, such as medical bills, school fees or wedding costs and so on. Repayments are generally made through monthly or fortnightly installments through the duration of 12 months; however this will depends on the customer's ability of repayments. For example, if you get your salary every four weeks, so a monthly repayment would suit your situation, or you getting payments from parents every second month or so, most of the times we are fine with second monthly repayments as well. This is also another advantage of short term finance with simple Noble Financial Group, the repayments time and date are negotiable. And mostly short term finance are benefits for commercial purpose where an urgent need for sufficient cash flow, but it won't look good or the company does not want a long term loan to hinder the company in the long run, where most of people will have to face this instant need some point in life, where the advantage of short term finance will meet your needs.

However, it is also true that short term finance has higher interest rates than long term loans, and for the records, in the long run, the interest rates of long term funding would eventually accumulate to a greater value than that of short term finance. So ultimately, the repayments of long term funding paid through interests would be significantly higher than that of short term funding.

It is not only that short term funding can reach from application to settle in a shorter period, to look at the two of funding, short term funding is actually lower repayments than long term funding.

11.6 RECENT RBI GUIDELINES REGARDING SHORT TERM FINANCE

In the past, working capital financing was constrained with detailed regulations on how much credit the banks could give to their customers. The recent changes made by RBI in the guidelines for bank credit for working capital finance are discussed below:

1. The notion of Maximum Permissible Bank Finance (MPBF) has been abolished by RBI and a new system was proposed by the Indian Banking Association (IBA). This has given banks greater freedom and responsibility for assessing credit needs and credit worthiness. The salient features of new system are:

    - For borrowers with requirements of upto Rs. 25 lakhs, credit limits will be computed after detailed discussions with borrower, without going into detailed evaluation.

    - For borrowers with requirements above Rs. 25 lakhs, but upto Rs. 5 crores, credit limit can be offered upto 20% of the projected gross sales of the borrower.

    - For large borrowers not selling in the above categories, the cash budget system may be used to identify the working capital needs.

However, RBI permits banks to follow Tandon/Chore Committee guidelines and retain MPBF concept with necessary modifications.

2. Earlier RBI had prescribed consortium arrangements for financing working capital beyond Rs. 50 crores. Now it is not essential to have consortium arrangements. However, banks may themselves decide to form consortium so that the risks are spread. The disintegration of consortium system, the entry of term lending institutions into working capital finance and the emergence of money market borrowing options gives the best possible deal.

3. Banks were advised not to apply the second method of lending for assessment of MPBF to those exporter borrowers, who had credit export of not less than 25% of their total turnover during the previous accounting year, provided that their fund based working capital needs from the banking system were less than Rs. 1 crore. RBI has also suggested that the units engaged in export activities need not bring in any contribution from their long term sources for financing that portion of current assets as is represented by export receivables.

4. RBI had also issued lending norms for working capital, under which the banks would decide the levels of holding of inventory and receivables, which should be supported by bank finance, after taking into account the operating cycle of an industry as well as other relevant factors. Other aspects of lending discipline, viz; maintenance of minimum current ratio, submission and use of data furnished under quarterly information system etc. would continue though with certain modifications, which would make it easier for smaller borrowers to comply with these guidelines.

11.7 SOURCES OF SHORT-TERM FINANCE

Short term financing is that from of financing which embraces borrowing or lending of funds for a short period of time. It refers to the finance obtained on short term basis, usually one year or less in duration. Short term finance is secured for financing the current assets, for example, inventories. Short term finance is also known

as working capital which is the excess of current assets over current liabilities. Current liabilities become due within one year and indicate the amount of short-term credit being utilized by the business.

Practically all enterprises use the short-term credit as sources of finance. We find in the balance sheets of almost all the companies some kinds of current liabilities which are the indicator of the uses of short term finance in business. It has been found in the developed countries especially in USA that even the largest business establishment makes use of short term finance.

The size of business has an important bearing on the use of short term finance. There is variation in the use of short term finance between the large and small sized business establishments. In practically all types of business, there is lesser use of short term credit among larger concerns. The small concerns make more use of short term financing on account of lower average credit standing and impermanent nature of business.

Sources of Short Term Financing

1. Trade Creditors
2. Customers Advances
3. Commercial Banks
4. Finance Companies
5. Commercial Paper House
6. Personal Loan Companies
7. Governmental Institutions
8. Factors or Brokers
9. Inventory Financing

10. Accruals

11. Installment Credit

12. Deferred Expenses

13. Miscellaneous Sources

1. **Trade Creditors:** Trade creditors are probably the most important single source of short term credit. Trade creditors are those business establishments which sell good to others on credit. That is, they do not require payment on the spot; rather they are to be paid after some days from the date of sale.

2. **Customers Advances**: Customers often finance the seller through advance payment for the goods. The prices of the goods to be purchased are paid in advance, i.e. before the receipt of the goods. This practice is prevalent where the seller does not wish to sell goods without prepayment and the buyer also can not purchase goods from other sources. The seller might require advance it the quantity of goods ordered is so large that he cannot afford to tie up more fund in raw materials or in good-in-process. Special type machine manufactures often demand advance payment in order to protect them from the loss caused by cancellation of contract at a time when the machine has been built up or is in work in process.

3. **Commercial Banks**: A short term loan is a form of financing that is attached with a quick repayment schedule—short-term loans may have a maturation period as short as 90 days. The fulfilment of the loan is dependent on the amount of financing; however, all short-term loans possess maturity dates that are significantly shorter than regular loans. The repayment schedule associated with the financing is the distinctive characteristic of short-term loans. Unlike regular loans, which commonly have repayment schedules of 30 years, a short-term loan must be repaid in a much shorter time span (between 90 days and fifteen years) or immediately after the borrower achieves satisfies his initiative for securing the short-term loan. For example, when a business secures a loan

to keep afloat while awaiting customer pay for a service, a lender would expect repayment as soon as the company receives pay from their clients or customers. In contrast, a short-term business loan delivered to a company for inventory shortfalls would be repaid as soon as the inventory is sold off.

Benefits of Short Term Loans

Short-term loans are provided to businesses or individuals in need of quick financing—the funds are utilized to satisfy a payment, off-set a loss or to relieve a cash deficit problem. As a result, all initiatives tied to this loan schedule are used to alleviate shortcomings in the short-run; short-term loans are not used for long-term financing needs.

The primary benefit of these loans is that they are immediately delivered, enabling the borrower to operate with increased liquidity. Moreover, because of their brief repayment schedules, short-term loans do not require serious commitment—the borrower is not indebted to the lender for a significant period of time.

Negatives Associated with Short-Term Loans:

Fast business loans are appropriate for both existing and new businesses. In regards to new businesses, banks or lending institutions will grant short-term business loans over regular loans because they are less risk—short-term loans provide less money at higher interest rates. Before short-term loans are granted, a lender will review the company's cash-flow history and payment track record. Typically, short-term business loans are unsecured; they do not contain collateral and the bank relies solely on the borrower's credit history and credit score.

The primary negative aspect associated with short-term loans is that this method of financing is more susceptible to default. This increased vulnerability results because of the loan's conditions: short term loans have higher interest rates, shorter repayment dates and higher penalties if a default is realized.

4. **Finance Companies**: Finance companies usually lend money to business. They are specialized financial institutions and their primary function is to advance funds to the business. A large number of financial institutions have been established in India for providing long-term and short term financial assistance to industrial enterprises. There are many all-India institutions like Industrial Finance Corporation of India (IFCI); Industrial Credit and Investment Corporation of India (ICICI); Industrial Development Bank of India(IDBI), etc. At the State level, there are State Financial Corporations (SFCs) and State Industrial Development Corporations (SIDCs). These national and state level institutions are known as 'Development Banks'. Besides the development banks, there are several other institutions called as 'Investment Companies' or 'Investment Trusts' which subscribe to the shares and debentures offered to the public by companies. These include the Life Insurance Corporation of India (LIC); General Insurance Corporation of India (GIC); Unit Trust of India (UTI).

5. **Commercial Paper**: Commercial paper is a short-term unsecured promissory note issued by corporations and foreign governments. For many large, creditworthy issuers, commercial paper is a low-cost alternative to bank loans. Issuers are able to efficiently raise large amounts of funds quickly and without expensive Securities and Exchange Commission (SEC) registration by selling paper, either directly or through independent dealers, to a large and varied pool of institutional buyers. Investors in commercial paper earn competitive, market-determined yields in notes whose maturity and amounts can be tailored to their specific needs.

Features of Commercial Paper

- Cheaper source of funds than limits set b banks
- Highly liquid, can be transferred by endorsement livery
- Optimal combination of liquidity return

- Backed by liquidity and earnings of the issuer
- Involves less paper work

Types of Commercial Papers

Commercial papers are classified into:

- **Direct Papers:** A direct commercial paper is issued directly by the company to the investors without any intermediary. Companies issuing direct papers announce the current rate of commercial paper with different maturities for investors to choose the CP that suits their requirement.
- **Dealer Papers:** A dealer/merchant banker on behalf of a client issues these types of commercial papers. The dealer arranges for the private placement of the paper and also provides advisory services such as timing of the issue, determination of the discount rate and a suitable maturity period.

Companies and financial institutions tend to find alternative sources of funds whenever bank interest rates are higher than the interest rate prevailing in the market. Commercial paper is an easy, cheap and quick source of finance.

Issuing Procedure

A company planning to issue a commercial paper selects a merchant banker and an Issuing and Paying Agent (IPA) and gets the CP credit rated by an approved credit rating agency. The company then approaches its principal banker with the credit rating certificate for their approval. The banker forwards the application to the RBI for intimation after ascertaining that all the guidelines for the issue of commercial paper are followed.

Meanwhile, the merchant banker and the IPA locate clients and obtain their quotes for different maturity periods. The company then takes a final decision on maturity, discount rate and quantum of the issue after consultations with the merchant banker and the IPA. The company can opt for different maturity

periods depending upon the span of the CP. If the company plans to issue a CP for six months, it can raise money in tranche with different maturity periods of one, two or three months. In cases where a company decides for a two-month commercial paper, finance has to be raised within a period of two weeks from the date on which the proposal is taken on record by the bank. The company can issue the paper on a single day or in parts on different dates. However the entire issue has to be redeemed on the same day.

The proposed issue is to be completed within a period of 2 weeks and the banker has to be intimated to reduce the working capital limit to the extent of the amount raised. The company should inform the RBI about the actual amount raised through CP within three days of completion of the issue.

Commercial papers cannot be underwritten. The CP holder should present the instrument to the paying agent on maturity. The agent receives brokerage charges for services rendered by him depending upon the maturity period of the CP.

In India, commercial papers are open to individuals, financial institutions, corporate and Non-Resident Indians. Non-Resident Indians can only invest on a non-repatriable and non-transferable basis. CPs are issued in multiples of Rs.5 lakhs with a minimum investment of Rs.25 lakhs.

6. **Personal Loan Companies:** These companies make small loans to individual generally for consumption purposes. The small business undertakings can procure fund form such companies.

7. **Governmental Institutions:** There are some governmental and semi-governmental corporations which are authorized to advance short term funds to business concerns. There importance is of course not so much less than other sources.

8. **Factors or Brokers**: Factoring entails the sale of accounts receivable to another firm, called the factor, who then collects payment from the customer.

Through factoring, a business can shift the costs of collection and the risk of non payment to a third party. In a factoring arrangement, a company and the factor work out a credit limit and average collection period for each customer. As the company makes new sales to a customer, it provides an invoice to the factor. The customer pays the factor directly, and the factor then pays the company based on the agreed upon average collection period, less a slight discount that covers the factor's collection costs and credit risk. In addition to absorbing collection risk, a factor may advance payment for a large share of the invoice, typically 70% to 80%, providing the company with immediate cash flow from sales. In this case, the factor charges an interest rate on this advance and then deducts the advance amount from its final payment to the firm when an invoice is collected.

Factoring has several advantages for a firm over straight accounts receivable financing. First, it saves the cost of establishing and administering its own collection system. Second, a factor can often collect accounts receivable at a lower cost than a small business, due to economies of scale, and transfer some of these savings to the company. Third, factoring is a form of collection insurance that provides an enterprise with more predictable cash flow from sales. On the other hand, factoring costs may be higher than a direct loan, especially when the firm's customers have poor credit that lead the factor to charge a high fee. Furthermore, once the collection function shifts to a third party, the business loses control over this part of the customer relationship, which may affect overall customer relations, especially when the factor's collection practices differ from those of the company.

9. **Inventory Financing:** As with accounts receivable loans, inventory financing is a secured loan, in this case with inventory as collateral. However, inventory financing is more difficult to secure since inventory is riskier collateral than accounts receivable. Some inventory becomes obsolete and loses value quickly, and other types of inventory, like partially manufactured goods, have little or

no resale value. Firms with an inventory of standardized goods with predictable prices, such as automobiles or appliances, will be more successful at securing inventory financing than businesses with a large amount of work in process or highly seasonal or perishable goods. Loan amounts also vary with the quality of the inventory pledged as collateral, usually ranging from 50% to 80%. For most businesses, inventory loans yield loan proceeds at a lower share of pledged assets than accounts receivable financing. When inventory is a large share of a firm's current assets, however, inventory financing is a critical option to finance short term needs.

Lenders need to control the inventory pledged as collateral to ensure that it is not sold before their loan is repaid. Two primary methods are used to obtain this control: (1) warehouse storage; and (2) direct assignment by product serial or identification numbers. Less than one warehouse arrangement pledged inventory is stored in a public warehouse and controlled by an independent party (the warehouse operator). A warehouse receipt is issued when the inventory is stored, and the goods are released only upon the instructions of the receipt-holder. When the inventory is pledged, the lender has control of the receipt and can prevent release of the goods until the loan is repaid. Since public warehouse storage is inconvenient for firms that need on-site access to their inventory, an alternative arrangement, known as a field warehouse, can be established. Here, an independent public warehouse company assumes control over the pledged inventory at the firm's site. In effect, the firm leases space to the warehouse operator rather than transferring goods to an off-site location. As with a public warehouse, the lender controls the warehouse receipt and will not release the inventory until the loan is repaid. Direct assignment by serial number is a simpler method to control inventory used for manufactured goods that are tagged with a unique serial number. The lender receives an assignment or trust receipt for the pledged inventory that lists all serial numbers for the collateral. The company houses and controls its inventory and can arrange for product sales. However, a release of the assignment or return of

the trust receipt is required before the collateral is delivered and ownership transferred to the buyer. This release occurs with partial or full loan repayment.

While inventory financing involves higher transaction and administrative costs than other loan instruments, it is an important financing tool for companies with large inventory assets. When a company has limited accounts receivable and lacks the financial position to obtain a line of credit, inventory financing may be the only available type of short term debt.

Moreover, this form of financing can be cost effective when inventory quality is high and yields a good loan-to-value ratio and interest rate.

10. **Accruals:** Accrual (accumulation) of something is, in finance, the adding together of interest or different investments over a period of time. It holds specific meanings in accounting, where it can refer to accounts on a balance sheet that represent liabilities and non-cash-based assets used in accrual-based accounting. These types of accounts include, among others, accounts payable, accounts receivable, goodwill, deferred tax liability and future interest expense.

    For example, a company delivers a product to a customer who will pay for it 30 days later in the next fiscal year, which starts a week after the delivery. The company recognizes the proceeds as a revenue in its current income statement still for the fiscal year of the delivery, even though it will get paid in cash during the following accounting period. The proceeds are also an accrued income (asset) on the balance sheet for the delivery fiscal year, but not for the next fiscal year when cash is received.

    Similarly, a salesperson, who sold the product, earned a commission at the moment of sale (or delivery). The company will recognize the commission as an expense in its current income statement, even though the salesperson will actually get paid at the end of the following week in the next accounting period. The commission is also an accrued expense (liability) on the balance sheet for

the delivery period, but not for the next period the commission (cash) is paid out to the salesperson.

11. **Accrued revenue** (or **accrued assets**) is an asset, such as unpaid proceeds from a delivery of goods or services, when such income is earned and a related revenue item is recognized, while cash is to be received in a latter period, when the amount is deducted from accrued revenues.

    In the rental industry, there are specialized revenue accruals for rental income which crosses month end boundaries. These are normally utilized by rental companies who charge in arrears, based on an anniversary of a contract date. For example a rental contract which began on 15 January, being invoiced on a recurring monthly basis will not generate its first invoice until 14 February. Therefore at the end of the January financial period an accrual must be raised for sixteen days worth of the monthly charge. This may be a simple pro-rata basis (e.g. 16/31 of the monthly charge) or may be more complex if only week days are being charged or a standardized month is being used (e.g. 28 days, 30 days etc.).

12. **Installment Credit:** Also called Installment Plan, or Hire-purchase Plan, in business, credit that is granted on condition of its repayment at regular intervals, or installments, over a specified period of time until paid in full. Installment credit is the means by which most durable goods such as automobiles and large home appliances are bought by individuals. Installment credit involves the extension of credit from a seller (and lender) to a purchaser; the purchaser gets physical possession and use of the goods he has bought, but the seller retains legal title to them until every installment has been paid. The purchaser usually is advanced the goods after making an initial fractional payment called a down payment. If the purchaser defaults on his payments at some point, all previous payments are forfeited to the seller, who may also take possession of the goods.

The appeal of installment buying is that it allows prospective purchasers to enjoy the advantages of owning a relatively expensive good while paying for it gradually out of their future income, instead of having to save the necessary purchase price out of their income first. Installment credit can thus greatly expand the purchasing power of ordinary consumers. Installment credit for the purchase of durable consumer goods first appeared in the furniture industry of the United States in the 19th century. But such credit arrangements only acquired great economic importance around the time of World War I, when they were adopted in the United States on a wide scale in the purchase of automobiles. Installment credit now accounts for the majority of purchases of automobiles, expensive home appliances, and furniture, among other consumer goods.

13. **Deferred Expense:** Deferred charge(or deferral) is cost that is accounted-for in latter accounting period for its anticipated future benefit, or to comply with the requirement of matching costs with revenues. Deferred charges include costs of starting up, obtaining long-term debt, advertising campaigns, etc., and are carried as a non-current asset on the balance sheet pending amortization. Deferred charges often extend over five years or more and occur infrequently unlike prepaid expenses, e.g. insurance, interest, rent. Financial ratios are based on the total assets excluding deferred charges since they have no physical substance (cash realization) and cannot be used in reducing total liabilities.

A **Deferred expense** or **prepayment**, **prepaid expense**, plural often **prepaid**, is an asset representing cash paid out to a counterpart for goods or services to be received in a later accounting period. For example if a service contract is paid quarterly in advance, at the end of the first month of the period two months remain as a deferred expense. In the deferred expense the early payment is accompanied by a related recognized expense in the subsequent accounting period, and the same amount is deducted from the prepayment. The deferred expense shares characteristics with accrued

revenue (or accrued assets) with the difference that an asset to be covered later are proceeds from a delivery of goods or services, at which such income item is earned and the related revenue item is recognized, while cash for them is to be received in a later period, when its amount is deducted from accrued revenues.

For example, when the accounting periods are monthly, an 11/12 portion of an annually paid insurance cost is added to prepaid expenses, which are decreased by 1/12 of the cost in each subsequent period when the same fraction is recognized as an expense, rather than all in the month in which such cost is billed. The not-yet-recognized portion of such costs remains as prepayments (assets) to prevent such cost from turning into a fictitious loss in the monthly period it is billed, and into a fictitious profit in any other monthly period.

Similarly, cash paid out for (the cost of) goods and services not received by the end of the accounting period is added to the prepayments to prevent it from turning into a fictitious loss in the period cash was paid out, and into a fictitious profit in the period of their reception. Such cost is not recognized in the income statement (profit and loss or P&L) as the expense incurred in the period of payment, but in the period of their reception when such costs are recognized as expenses in P&L and deducted from prepayments (assets) on balance sheets.

Miscellaneous Sources: There are many more sources from which can secure funds for short period. They are—friend and relatives, public deposits, loan from officer and the company directors and foreign exchange banks.

11.8 SUMMARY

Short-term loans are usually extended on a revolving basis or for fixed terms of one year or less. Businesses need short-term funds for several reasons. For a small business, the cash flow from sales might not be sufficient for growth funding needs,

such as building new production capacity, adding new sales staff and opening new retail outlets. Companies can plug cash shortfalls or pay for emergency funding needs if they have access to operating lines of credit and other forms of short-term financing. It might be easier for businesses, especially small businesses, to secure short-term financing instead of long-term or equity financing. Short-term interest rates are lower than long-term rates, which gives management more flexibility in operating their business.

11.9 GLOSSARY

- **RBI:** The Reserve Bank of India (RBI) is India's central banking institution, which controls the monetary policy of the Indian rupee.
- **Debt:** An amount of money borrowed by one party from another.

11.10 SELF ASSESSMENT QUESTIONS

1. What is short term financing ?

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2. What is the purpose of using short term financing in any business ?

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3. What are the two main financial requirements of the company ?

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11.11 LESSON END QUESTIONS

1. What is the meaning of short term financing? What are the main advantages & disadvantages of short term financing ?

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2. How short term financing different from long term financing? Which one is better ?

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3. What are the recent RBI guidelines for short term finance ?

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11.12 SUGGESTED READINGS

- Financial Management - S.C. Kuchhal. -Chaitanya Publishing House
- Corporate Financial Policy - Guthmann and Dougall. -Prentice Hall
- Management Accounting- Gupta & Sharma- Kalyani Publishers
- Working Capital Management- V.K.Bhalla New Delhi, Anmol Publications Private Limited, 5th Edition.

UNIT - III

SHORT TERM FINANCE AND WORKING CAPITAL

LESSON No. 12

Concept of Trade Credit, Bank Financing and Account Receivable

Structure :

12.1 Introduction

12.2 Objectives

12.3 Concept of Trade Credit

12.3.1 Example of Trade Credit

12.4 Sources of Trade Credit

12.5 Trade Credit Insurance

12.5.1 History of Trade Credit Insurance

12.6 Advantages of Trade Credit

12.7 Disadvantages of Trade Credit

12.8 Bank Financing

12.9 Accounts Receivables

12.10 Summary

12.11 Glossary

12.12 Self Assessment Questions

12.13 Lesson End Questions

12.14 Suggested Readings

12.1 INTRODUCTION

Credit (from Latin credo transl. "I believe") is the trust which allows one party to provide resources to another party where that second party does not reimburse the first party immediately (thereby generating a debt), but instead arranges either to repay or return those resources (or other materials of equal value) at a later date. The resources provided may be financial (e.g. granting a loan), or they may consist of goods or services (e.g. consumer credit). Credit encompasses any form of deferred payment. Credit is extended by a creditor, also known as a lender, to a debtor, also known as a borrower.

Credit does not necessarily require money. The credit concept can be applied in barter economies as well, based on the direct exchange of goods and services. However, in modern societies credit is usually denominated by a unit of account. Unlike money, credit itself cannot act as a unit of account.

Movements of financial capital are normally dependent on either credit or equity transfers. Credit is in turn dependent on the reputation or creditworthiness of the entity which takes responsibility for the funds. Credit is also traded in financial markets. The purest form is the credit default swap market, which is essentially a traded market in credit insurance. A credit default swap represents the price at which two parties exchange this risk – the protection "seller" takes the risk of default of the credit in return for a payment, commonly denoted in basis points (one basis point is 1/100 of a percent) of the notional amount to be referenced, while the protection "buyer" pays this premium and in the case of default of the underlying (a loan, bond or other receivable), delivers this receivable to the protection seller and receives from the seller the par amount (that is, is made whole)

The extent and pattern of trade credit within an industry depend on a number of factors, including the average rate of turnover of stock, the nature of the goods involved—e.g., their perishability—the relative sizes of the buying and selling firms, and the degree of competition. If inventories of goods turn over quickly, for example, it is likely that a large amount of very short-term credit will be extended. Longer-term credit will be extended for goods with slow rates of turnover. As would be expected, large companies are likely to be net lenders to smaller ones.

The cost of extending trade credit may be explicit in the terms of sale if they include a discount granted for immediate payment. An invoice for Rs. 500 due in 30 days, for example, may specify a discount of 2 percent or Rs. 10 if paid within 10 days (denoted as 2/10, net 30). Even in cases in which it is not so apparent, a cost for the use of funds until the due date is borne by the buyer, by the seller, or by both.

12.2 OBJECTIVES :-

After completion of this lesson, you should be able to

- understand the concept of Trade Credit
- understand the sources for Trade Credit
- understand the concept of Trade Credit Insurance
- understand the advantages & disadvantages of trade credit

12.3 CONCEPT OF TRADE CREDIT

Trade credit is the largest use of capital for a majority of business to business (B2B) sellers in the United States and is a critical source of capital for a majority of all businesses. For example, Wal-Mart, the largest retailer in the world, has used trade credit as a larger source of capital than bank borrowings; trade credit for Wal-Mart is 8 times the amount of capital invested by shareholders.

For many borrowers in the developing world, trade credit serves as a valuable source of alternative data for personal and small business loans.

There are many forms of trade credit in common use. Various industries use various specialized forms. They all have, in common, the collaboration of businesses to make efficient use of capital to accomplish various business objectives.

For many businesses, trade credit is an essential tool for financing growth. Trade credit is the credit extended to you by suppliers who let you buy now and pay later. Any time you take delivery of materials, equipment or other valuables without paying cash on the spot, you're using trade credit.

When you're first starting your business, however, suppliers most likely aren't going to offer you trade credit. They're going to want to make every order c.o.d. (cash or check on delivery) or paid by credit card in advance until you've established that you can pay your bills on time. While this is a fairly normal practice, you can still try and negotiate trade credit with suppliers. One of the things that will help you in these negotiations is a properly prepared financial plan.

When you visit your supplier to set up your order during your start up period, ask to speak directly to the owner of the business if it's a small company. If it's a larger business, ask to speak to the CFO or any other person who approves credit. Introduce yourself. Show the officer the financial plan you've prepared. Tell the owner or financial officer about your business, and explain that you need to get your first orders on credit in order to launch your venture.

Depending on the terms available from your suppliers, the cost of trade credit can be quite high. For example, assume you make a purchase from a supplier who decides to extend credit to you. The terms the supplier offers you are two-percent cash discount with 10 days and a net date of 30 days. Essentially, the suppliers is saying that if you pay within 10 days, the purchase price will be discounted by two percent. On the other hand, by forfeiting the two-percent discount, you're able to use your money for 20 more days. On an annualized basis, this is actually costing you 36 percent of the total cost of the items you are purchasing from this supplier (360 (20 days = 18 times per year without discount; 18 (2 percent discount = 36 percent discount missed.)

Cash discounts aren't the only factor you have to consider in the equation. There are also late-payment or delinquency penalties should you extend payment beyond the agreed-upon terms. These can usually run between one and two percent on a monthly basis. If you miss your net payment date for an entire year, that can cost you as much as 12 to 24 percent in penalty interest.

Effective use of trade credit requires intelligent planning to avoid unnecessary costs through forfeiture of cash discounts or the incurring of delinquency penalties. But every business should take full advantage of trade that is available without additional cost in order to reduce its need for capital from other sources.

12.3.1 Example of Trade Credit :

The operator of an ice cream stand may sign a franchising agreement, under which the distributor agrees to provide ice cream stock under the terms "Net 60" with a ten percent discount on payment within 30 days, and a 20% discount on payment within 10 days. This means that the operator has 60 days to pay the invoice in full. If sales are good within the first week, the operator may be able to send a cheque for all or part of the invoice, and make an extra 20% on the ice cream sold. However, if sales are slow, leading to a month of low cash flow, then the operator may decide to pay within 30 days, obtaining a 10% discount, or use the money another 30 days and pay the full invoice amount within 60 days.

The ice cream distributor can do the same thing. Receiving trade credit from milk and sugar suppliers on terms of Net 30, 2% discount if paid within ten days, means they are apparently taking a loss or disadvantageous position in this web of trade credit balances. First, they have a substantial markup on the ingredients and other costs of production of the ice cream they sell to the operator. There are many reasons and ways to manage trade credit terms for the benefit of a business. The ice cream distributor may be well-capitalized either from the owners' investment or from accumulated profits, and may be looking to expand his markets. They may be aggressive in attempting to locate new customers or to help them get established. It is

not on their interests for customers to go out of business from cash flow instabilities, so their financial terms aim to accomplish two things:

1. Allow startup ice cream parlors the ability to mismanage their investment in inventory for a while, while learning their markets, without having a dramatic negative balance in their bank account which could put them out of business. This is in effect, a short term business loan made to help expand the distributor's market and customer base.

2. By tracking who pays, and when, the distributor can see potential problems developing and take steps to reduce or increase the allowed amount of trade credit he extends to prospering or exposure to losses from customers going bankrupt who would never pay for the ice cream delivered.

12.4 SOURCES OF TRADE CREDIT

Supplier

Companies purchase economics resources—such as buildings or equipment—from suppliers. Rather than pay for these resources at the time of purchase, suppliers offer trade credit to sell goods or services on account. Buyers may undergo a short credit check by suppliers. This check is a mere formality to ensure the company has a decent financial standing and pays its bills on time. Suppliers generally offer 30 days for companies to pay outstanding account balances before minor charging fees or interest is on the account. Suppliers may also offer discounts to buyers who pay outstanding balances early. Discounts are usually one to two percent of the outstanding balance.

Vendors

Vendors sell goods or services to businesses that may not be essential to the production process. Advertising, office supplies, maintenance and utilities are common vendor services. Many vendors offer trade credit similar to suppliers. However, vendors do not usually offer discounts to businesses that pay their bills early. Vendors will

charge fees or interest on outstanding balances not paid in a timely manner. Fees and interest may be more significant, since vendors may offer goods or services consistently to businesses.

Employment Agencies

Temporary employment agencies offer businesses an interesting type of trade credit. Businesses hire employees through temp agencies without paying for the service. Temp agencies may only require businesses to pay for the employment service on a bi-weekly or monthly basis. Other than these payments, businesses do not usually pay temp agencies for services. Business must pay a premium for using temp employment agencies. The benefits of trade credit and not managing payroll taxes are key features of temp employment agencies.

12.5 TRADE CREDIT INSURANCE

Trade credit insurance, business credit insurance, **export credit insurance**, or **credit insurance** is an insurance policy and a risk management product offered by private insurance companies and governmental export credit agencies to business entities wishing to protect their accounts receivable from loss due to credit risks such as protracted default, insolvency or bankruptcy. This insurance product is a type of property & casualty insurance, and should not be confused with such products as credit life or credit disability insurance, which individuals obtain to protect against the risk of loss of income needed to pay debts. Trade Credit Insurance can include a component of political risk insurance which is offered by the same insurers to insure the risk of non-payment by foreign buyers due to currency issues, political unrest, expropriation etc.

This points to the major role trade credit insurance plays in facilitating international trade. Trade credit is offered by vendors to their customers as an alternative to prepayment or cash on delivery terms, providing time for the customer to generate income from sales to pay for the product or service. This requires the vendor to assume non-payment risk. In a local or domestic situation as well as in

an export transaction, the risk increases when laws, customs communications and customer's reputation are not fully understood. In addition to increased risk of non-payment, international trade presents the problem of the time between product shipment and its availability for sale. The account receivable is like a loan and represents capital invested, and often borrowed, by the vendor. But this is not a secure asset until it is paid. If the customer's debt is credit insured the large, risky asset becomes more secure, like an insured building. This asset may then be viewed as collateral by lending institutions and a loan based upon it used to defray the expenses of the transaction and to produce more products. Trade credit insurance is, therefore, a trade finance tool.

Trade credit insurance is purchased by business entities to insure their accounts receivable from loss due to the insolvency of the debtors. The product is not available to individuals. The cost (premium) for this is usually charged monthly, and are calculated as a percentage of sales for that month or as a percentage of all outstanding receivables.

Trade credit insurance usually covers a portfolio of buyers and pays an agreed percentage of an invoice or receivable that remains unpaid as a result of protracted default, insolvency or bankruptcy. Policy holders must apply a credit limit on each of their buyers for the sales to that buyer to be insured. The premium rate reflects the average credit risk of the insured portfolio of buyers. In addition, credit insurance can also cover single transactions or trade with only one buyer.

12.5.1 History of Trade Insurance Credit

Trade credit insurance was born at the end of nineteenth century, but it was mostly developed in Western Europe between the First and Second World Wars. Several companies were founded in many countries; some of them also managed the political risks of export on behalf of their state.

Following the privatisation of the short-term side of the UK's Export Credits Guarantee Department in 1991, a concentration of the trade credit insurance market took place and three groups now account for over 85% of the global credit insurance

market. These main players focused on Western Europe, but rapidly expanded towards Eastern Europe, Asia and the Americas:

- Euler Hermes, merger of the two credit insurance companies of the Allianz Group. Euler Hermes is the world's number one credit insurance provider.
- Atradius, a merger between NCM and Gerling Kreditversicherung. Later renamed Atradius after it was demerged from the Gerling insurance group.
- Coface. Formerly a French government sponsored institution established in 1946, this company is now part of the Natixis group.

Many variations of trade credit insurance have evolved ranging from coverage that can be cancelled or reduced at an insurers discretion, to coverage that cannot be cancelled or reduced by the insurer during the policy period. Other programs may allow the policy holder to act as the underwriter.

While trade credit insurance is often mostly known for protecting foreign or export accounts receivable, there has always been a large segment of the market that uses Trade Credit Insurance for domestic accounts receivable protection as well. Domestic trade credit insurance provides companies with the protection they need as their customer base consolidates creating larger receivables to fewer customers. This further creates a larger exposure and greater risk if a customer does not pay their accounts. The addition of new insurers in this area have increased the availability of domestic cover for companies.

Many businesses found that their insurers withdrew trade credit insurance during the late-2000s financial crisis, foreseeing large losses if they continued to underwrite sales to failing businesses. This led to accusations that the insurers were deepening and prolonging the recession, as businesses could not afford the risk of making sales without the insurance, and therefore contracted in size or had to close. Insurers countered these criticisms by claiming that they were not the cause of the crisis, but were responding to economic reality and ringing the alarm bells.

In 2009, the UK government set up a short-term £5 billion Trade Credit Top-up emergency fund. However, this was considered a failure, as the take-up was very low.

12.6 ADVANTAGES OF TAKING TRADE CREDIT

Available Capital

A main advantage to the buyer with a trade account is that the company does not have to pay cash up front, and therefore retains its cash in the short-term for other capital needs. Companies have ongoing expenses and investment decisions to make. By delaying payment on purchases for a short period, the company can more aptly take care of its immediate cash needs while having time to plan for payment.

Immediate Replenishment

Just as consumers rely on credit cards when immediate needs come up and cash is not available, businesses have needs that include inventory and supply replenishment. If a manufacturing has a rush order of a large volume of products and low cash on hand, it needs a trade account to purchase raw materials for use in production. In essence, the trade account helps prevent delays in business activity and work performance.

More Business

For suppliers that offer trade accounts, they benefit through more business than they would get otherwise. A buyer in desperate need of supplies or inventory would have to go with a supplier offering purchases on account as opposed to one that only accepts cash payments. Additionally, if a supplier offers purchases on account, a buyer is more likely to make larger volume purchases in a given situation because of the flexibility of paying later. This is especially true if costs are relatively low and the buyer wants to take advantage of the low price.

Costs

When contemplating buying or selling on account, also consider the disadvantages. A main disadvantage of trade accounts are high costs, according to "Entrepreneur" magazine. Often, if you pay within 10 days, you can get a 2-percent discount. Within 30 days, you typically pay the invoice amount. It is when you get beyond 30 days that you typically pay interest as well as late fees if you miss payment deadlines. "Entrepreneur" notes an annualized cost of 12 to 24 percent over invoice amount if you delay payment for too long. Key to making trade credit work is either getting the discount or optimizing cash use for 30 days.

12.7 DISADVANTAGES OF TRADE CREDIT

More Sales

From the perspective of the creditor, or supplier, trade credit should induce more sales over time by allowing customers to make purchases without immediate cash. This flexibility in purchasing methods also encourages customers to make larger purchases when prices are right than they might if they had to pay cash up front. Along with higher sales volume, trade credit often produces interest fees and late payment fees for creditors, which increases revenue.

No Cash

From the resellers perspective, the ability to buy on credit makes it possible to buy needed inventory even when cash balances are low. Having cash to pay off long-term debt and other more urgent and immediate expenses is critical. The ability to delay cash requirements for supplies and inventory helps preserve cash for these purposes. Buyers may want to ramp up the volume of purchases at a time when demand is higher, and a trade account makes it more feasible to do so.

Bad Debt

The potential risk to the supplier when offering trade credit is bad debt. If buyers do not pay off their debt, and in a timely manner, it has negative cash effects on

the supplier. Companies eventually have to write off unpaid accounts as bad debt, which lowers their profits. Accounts that remain unpaid for a long period of time still have negative effects, though. This means the supplier has to wait to collect cash which it needs to pay its own bills.

High Costs

If buyers are not careful in the way they use trade credit, they can end up paying much higher costs for inventory. Many companies offer a 2-percent discount if you pay within 10 days, but payments received after 30 days usually include late-payment fees and interest that begins accruing. In its overview of trade credit, "Entrepreneur" notes that purchases on account can cost between 12 to 24 percent extra in interest fees if the business does not pay within the typical 30-day net payment term.

12.8 BANK FINANCING

A commercial bank is a business organization which deals in money i.e. lending and borrowing of money. They perform all types of functions like accepting deposits, advancing loans, credit creation and agency functions. Besides these usual functions, one of the most important functions of banks is to finance working capital requirement of firms. Short term advances forms major part of advance portfolio of banks. In determining short term requirements of a firm, the bank takes into account its sales and production plans and desirable level of current assets. The amount approved by the bank for the firm's working capital requirement is called credit limit. Thus, it is maximum fund which a firm can obtain from the bank. In the case of firms with seasonal businesses, the bank may approve separate limits for 'peak season' and 'non-peak season'. These advances were usually given against the security of the current assets of the borrowing firm.

Usually, the bank credit is available in the following forms:

- **Cash Credit :**

Under this facility, the bank specifies a predetermined limit and the borrower is allowed to withdraw funds from the bank up to that sanctioned credit limit against a bond or other security. However, the borrower cannot borrow the entire sanctioned credit in lump sum; he can draw it periodically to the extent of his requirements. Similarly, repayment can be made whenever desired during the period. There is no commitment charge involved and interest is payable on the amount actually utilized by the borrower and not on the sanctioned limit.

- **Over Draft**

Under this arrangement, the borrower is allowed to withdraw funds in excess of the actual credit balance in his current account up to a certain specified limit during a stipulated period against a security. Within the stipulated limits any number of withdrawals is permitted by the bank. Overdraft facility is generally available against the securities of life insurance policies, fixed deposits receipts, Government securities, shares and debentures, etc. of the corporate sector. Interest is charged on the amount actually withdrawn by the borrower, subject to some minimum (commitment) charges.

- **Banker's Acceptances**

Acceptance financing has been used for decades as a form of bank loan. The ability to fix rates for periods of up to 180 days protects a borrower from adverse movements in interest rates up to six months. Banks offer banker's acceptances in a wide range of maturities to match customers' sales cycles and payment terms. Traditionally, importers used banker's acceptances to finance imports into the United States. Today acceptance financing is used to finance a wide- range of activity such as imports, exports, domestic shipments, domestic purchases, and commodity warehousing of readily marketable products.

- **Discounting**

Banker's acceptances provide a deferred payment option for a buyer but little benefit for a seller. Banker's acceptances can be discounted to the seller freeing up funds to the seller and providing an additional income opportunity for the discounting bank. The fees and charges for discounting banker's acceptances can be paid for by either the buyer or the seller. The accepted draft is discounted to the seller who receives a discounted amount from the bank discounting the draft. If the buyer agrees to pay for the discount fees and charges, the seller will receive the full amount of the draft, which is the reason it is important to establish who is responsible for these fees and charges in the negotiation process prior to fixing the product price. It is important to note that discounting can be done by either the buyer's or the seller's bank. It is possible that neither will be interested in discounting the draft, but in most cases both are available and should be confirmed before the transaction is finalized between the buyer and the seller. Whether the buyer, the seller, or their banks furnish the financing under letters of credit depends on a number of factors:

- relative negotiating position of the buyer and the seller
- availability of financing in the buyer's and seller's countries
- relative interest rates in the buyer's and seller's countries
- relative need of the buyer and seller for financing

- **Letter of Credit**

Letter of Credit also known as Documentary Credit is a widely used term to make payment secure in domestic and international trade. The document is issued by a financial organization at the buyer request. Buyer also provide the necessary instructions in preparing the document.

The International Chamber of Commerce (ICC) in the Uniform Custom and Practice for Documentary Credit (UCPDC) defines L/C as:

“An arrangement, however named or described, whereby a bank (the Issuing bank) acting at the request and on the instructions of a customer (the Applicant) or on its own behalf :

1. Is to make a payment to or to the order third party (the beneficiary) or is to accept bills of exchange (drafts) drawn by the beneficiary.
2. Authorised another bank to effect such payments or to accept and pay such bills of exchange (draft).
3. Authorised another bank to negotiate against stipulated documents provided that the terms are complied with.

A key principle underlying letter of credit (L/C) is that banks deal only in documents and not in goods. The decision to pay under a letter of credit will be based entirely on whether the documents presented to the bank appear on their face to be in accordance with the terms and conditions of the letter of credit.

Parties to Letters of Credit

Accepting Bank

The bank named in a term (usance) Letter of Credit on which drafts are drawn that has agreed to accept the draft. By accepting the draft, the Drawee Bank signifies its commitment to pay the face amount at maturity to anyone who presents it at maturity. After accepting the draft, the Drawee Bank becomes the Accepting Bank.

Advising Bank

The bank to which the Issuing Bank forwards the Letter of Credit with instructions to notify the Exporter (Beneficiary).

“Available with” Bank

The bank authorized in the Letter of Credit to effect payment under, accept or negotiate the Letter of Credit.

Confirming Bank

The bank which, at the request of the Issuing Bank, adds its confirmation to the Letter of Credit. In doing so, the Confirming Bank undertakes to make payment to the Exporter upon presentation of documents under the Letter of Credit.

Drawee Bank

The bank named in the Letter of Credit on which the drafts are to be drawn.

Exporter/Beneficiary/Seller

The party that has contracted to sell goods.

Importer/Applicant/Buyer

The party that has contracted to buy goods.

Issuing Bank

The bank issuing the Letter of Credit on behalf of the Importer (Buyer).

Reimbursing Bank

The bank designated in the Letter of Credit to reimburse the “available with” Bank which submits payment claims under the Letter of Credit.

Transferring Bank

The bank authorized by the Issuing Bank to transfer all or part of the Letter of Credit to another party at the Beneficiary’s request

Types of Letter of Credit

1. **Revocable Letter of Credit L/C**

   A revocable letter of credit may be revoked or modified for any reason, at any time by the issuing bank without notification. It is rarely used in international trade and not considered satisfactory for the exporters but has an advantage over that of the importers and the issuing bank.

   There is no provision for confirming revocable credits as per terms of UCPDC, Hence they cannot be confirmed. It should be indicated in L/C that the credit is revocable. if there is no such indication the credit will be deemed as irrevocable.

2. **Irrevocable Letter of Credit L/C**

   In this case it is not possible to revoked or amended a credit without the agreement of the issuing bank, the confirming bank, and the beneficiary. Form an exporters point of view it is believed to be more beneficial. An irrevocable letter of credit from the issuing bank insures the beneficiary that if the required documents are presented and the terms and conditions are complied with, payment will be made.

3. **Confirmed Letter of Credit L/C**

   Confirmed Letter of Credit is a special type of L/c in which another bank apart from the issuing bank has added its guarantee. Although, the cost of confirming by two banks makes it costlier, this type of L/c is more beneficial for the beneficiary as it doubles the guarantee.

4. **Sight Credit and Usance Credit L/C**

   Sight credit states that the payments would be made by the issuing bank at sight, on demand or on presentation. In case of usance credit, draft are drawn on the issuing bank or the correspondent bank at specified usance period.

The credit will indicate whether the usance draft is to be drawn on the issuing bank or in the case of confirmed credit on the confirming bank.

5. **Back to Back Letter of Credit L/C**

Back to Back Letter of Credit is also termed as Countervailing Credit. A credit is known as back to back credit when a L/c is opened with security of another L/c.

A back to back credit which can also be referred as credit and counter credit is actually a method of financing both sides of a transaction in which a middleman buys goods from one customer and sells them to another.

The practical use of this Credit is seen when L/c is opened by the ultimate buyer in favour of a particular beneficiary, who may not be the actual supplier/ manufacturer offering the main credit with near identical terms in favour as security and will be able to obtain reimbursement by presenting the documents received under back to back credit under the main L/c.

The need for such credits arises mainly when:

1. The ultimate buyer not ready for a transferable credit
2. The Beneficiary do not want to disclose the source of supply to the openers.
3. The manufacturer demands on payment against documents for goods but the beneficiary of credit is short of the funds

6. **Transferable Letter ofCredit L/C**

A transferable documentary credit is a type of credit under which the first beneficiary which is usually a middleman may request the nominated bank to transfer credit in whole or in part to the second beneficiary.

The L/c does state clearly mentions the margins of the first beneficiary and unless it is specified the L/c cannot be treated as transferable. It can only be used when the company is selling the product of a third party and the proper care has to be taken about the exit policy for the money transactions that take place.

7. **Standby Letter of Credit L/C**

   Initially used by the banks in the United States, the standby letter of credit is very much similar in nature to a bank guarantee. The main objective of issuing such a credit is to secure bank loans. Standby credits are usually issued by the applicant's bank in the applicant's country and advised to the beneficiary by a bank in the beneficiary's country.

   Unlike a traditional letter of credit where the beneficiary obtains payment against documents evidencing performance, the standby letter of credit allow a beneficiary to obtains payment from a bank even when the applicant for the credit has failed to perform as per bond.

   A standby letter of credit is subject to "Uniform Customs and Practice for Documentary Credit" (UCP), International Chamber of Commerce Publication No 500, 1993 Revision, or "International Standby Practices" (ISP), International Chamber of Commerce Publication No 590, 1998.

Steps Innovled in Letter of Credit

The following is a step-by-step description of a typical Letter of Credit transaction:

1. An Importer (Buyer) and Exporter (Seller) agree on a purchase and sale of goods where payment is made by Letter of Credit.

2. The Importer completes an application requesting its bank (Issuing Bank) to issue a Letter of Credit in favour of the Exporter. Note that the Importer must have a line of credit with the Issuing Bank in order to request that a Letter of Credit be issued.

3. The Issuing Bank issues the Letter of Credit and sends it to the Advising Bank by telecommunication or registered mail in accordance with the Importer's instructions. A request may be included for the Advising Bank to add its confirmation. The Advising Bank is typically located in the country where the Exporter carries on business and may be the Exporter's bank but it does not have be.

4. The Advising Bank will verify the Letter of Credit for authenticity and send a copy to the Exporter.

5. The Exporter examines the Letter of Credit to ensure:

   a) it corresponds to the terms and conditions in the purchase and sale agreement;

   b) documents stipulated in the Letter of Credit can be produced; and

   c) The terms and conditions of the Letter of Credit may be fulfilled.

6. If the Exporter is unable to comply with any term or condition of the Letter of Credit or if the Letter of Credit differs from the purchase and sale agreement, the Exporter should immediately notify the Importer and request an amendment to the Letter of Credit.

7. When all parties agree to the amendments, they are incorporated into the terms of the Letter of Credit and advised to the Exporter through the Advising Bank. It is recommended that the Exporter does not make any shipments against the Letter of Credit until the required amendments have been received.

8. The Exporter arranges for shipment of the goods, prepares and/or obtains the documents specified in the Letter of Credit and makes demand under the Letter of Credit by presenting the documents within the stated period and before the expiry date to the "available with" Bank. This may be the Advising/ Confirming Bank. That bank checks the documents against the Letter of Credit

and forwards them to the Issuing Bank. The drawing is negotiated, paid or accepted as the case may be.

9. The Issuing Bank examines the documents to ensure they comply with the Letter of Credit terms and conditions. The Issuing Bank obtains payment from the Importer for payment already made to the "available with" or the Confirming Bank.

10. Documents are delivered to the Importer to allow them to take possession of the goods from the transport company. The trade cycle is complete as the Importer has received its goods and the Exporter has obtained payment.

Advantages and Disadvantages of Letter of Credit

Advantages to the Importer

- Importer is assured that the Exporter will be paid only if all terms and conditions of the Letter of Credit have been met.
- Importer is able to negotiate more favourable trade terms with the Exporter when payment by Letter of Credit is offered.

Disadvantages to the Importer

- A Letter of Credit does not offer protection to the Importer against the Exporter shipping inferior quality goods and/or a lesser quantity of goods. Consequently, it is important that the Importer performs the appropriate due diligence to assess the reputation of the Exporter. If the Exporter acts fraudulently, the only recourse available to the Importer is through legal proceedings
- It is necessary for the Importer to have a line of credit with a bank before the bank is able to issue a Letter of Credit. The amount outstanding under each Letter of Credit issued is applied against this line of credit from the date of issuance until final payment.

Advantages to the Exporter

- The risk of payment relies upon the creditworthiness of the Issuing Bank and the political risk of the Issuing Bank's domicile, and not the creditworthiness of the Importer.
- Exporter agrees in advance to all requirements for payment under the Letter of Credit. If the Letter of Credit is not issued as agreed, the Exporter is not obligated to ship against it.
- Exporter can further reduce foreign political and bank credit risk by requesting confirmation of the Letter of Credit by a Canadian bank.

Disadvantages to the Exporter

- Documents must be prepared and presented in strict compliance with the requirements stipulated in the Letter of Credit.
- Some Importers may not be able to open Letters of Credit due to the lack of credit facilities with their bank which consequently inhibits export growth.

12.9 ACCOUNTS RECEIVABLES

Accounts receivable is money owed to a business by its clients (customers or debtors) and shown on its balance sheet as an asset. It is one of a series of accounting transactions dealing with the billing of a customer for goods and services that the customer has ordered. These may be distinguished from notes receivable, which are debts created through formal legal instruments called promissory notes.

Accounts receivable represents money owed by entities to the firm on the sale of products or services on credit. In most business entities, accounts receivable is typically executed by generating an invoice and either mailing or electronically delivering it to the customer, who, in turn, must pay it within an established timeframe, called credit terms or payment terms.

The accounts receivable departments use the sales ledger, because a sales ledger normally records:

- The sales a business has made
- The amount of money received for goods or services
- The amount of money owed at the end of each month varies (debtors)
- The accounts receivable team is in charge of receiving funds on behalf of a company and applying it towards their current pending balances.

Collections and cashiering teams are part of the accounts receivable department. While the collections department seeks the debtor, the cashiering team applies the monies received.

Payment Terms

An example of a common payment term is Net 30 days, which means that payment is due at the end of 30 days from the date of invoice. The debtor is free to pay before the due date; businesses can offer a discount for early payment. Other common payment terms include *Net 45*, *Net 60* and 30 days end of month. The creditor may be able to charge late fees or interest if the amount is not paid by the due date.

Booking a receivable is accomplished by a simple accounting transaction; however, the process of maintaining and collecting payments on the accounts receivable subsidiary account balances can be a full-time proposition. Depending on the industry in practice, accounts receivable payments can be received up to 10 – 15 days after the due date has been reached. These types of payment practices are sometimes developed by industry standards, corporate policy, or because of the financial condition of the client.

Since not all customer debts will be collected, businesses typically estimate the amount of and then record an allowance for doubtful accounts which appears on

the balance sheet as a contra account that offsets total accounts receivable. When accounts receivable are not paid, some companies turn them over to third party collection agencies or collection attorneys who will attempt to recover the debt via negotiating payment plans, settlement offers or pursuing other legal action.

Outstanding advances are part of accounts receivable if a company gets an order from its customers with payment terms agreed upon in advance. Since billing is done to claim the advances several times, this area of collectible is not reflected in accounts receivables. Ideally, since advance payment occurs within a mutually agreed-upon term, it is the responsibility of the accounts department to periodically take out the statement showing advance collectible and should be provided to sales & marketing for collection of advances. The payment of accounts receivable can be protected either by a letter of credit or by Trade Credit Insurance.

Accounts Receivable Age Analysis

The Accounts Receivable Age Analysis Printout, also known as the Debtors Book is divided in categories for current, 30 days, 60 days, 90 days, 120 days, 150 days and 180 days and overdue that are produced in Modern Accounting Systems. The printout is mostly known as an Aged Trial Balance or ATB for short. The printout is done in the order of the Chart of Accounts for the Accounts Receivable and/or Debtors Book. The option to include Zero Balances outstanding or to specifically leave it out is also possible in the printout features.

Book Keeping

On a company's balance sheet, accounts receivable is the money owed to that company by entities outside of the company. The receivables owed by the company's customers are called trade receivables. Account receivables are classified as current assets assuming that they are due within one calendar year or fiscal year. To record a journal entry for a sale on account, one must debit a receivable and credit a revenue account. When the customer pays off their accounts, one debits cash and credits the receivable in the journal entry. The ending balance on the trial balance sheet for accounts receivable is usually a debit.

Business organizations which have become too large to perform such tasks by hand (or small ones that could but prefer not to do them by hand) will generally use accounting software on a computer to perform this task.

Companies have two methods available to them for measuring the net value of accounts receivable, which is generally computed by subtracting the balance of an allowance account from the accounts receivable account.

The first method is the allowance method, which establishes a contra-asset account, allowance for doubtful accounts, or bad debt provision, that has the effect of reducing the balance for accounts receivable. The amount of the bad debt provision can be computed in two ways, either (1) by reviewing each individual debt and deciding whether it is doubtful (a specific provision); or (2) by providing for a fixed percentage (e.g. 2%) of total debtors (a general provision). The change in the bad debt provision from year to year is posted to the bad debt expense account in the income statement.

The second method is the direct write-off method. It is simpler than the allowance method in that it allows for one simple entry to reduce accounts receivable to its net realizable value. The entry would consist of debiting a bad debt expense account and crediting the respective accounts receivable in the sales ledger.

The two methods are not mutually exclusive, and some businesses will have a provision for doubtful debts, writing off specific debts that they know to be bad (for example, if the debtor has gone into liquidation.)

Special Uses

Companies can use their accounts receivable as collateral when obtaining a loan (asset-based lending). They may also sell them through factoring or on an exchange. Pools or portfolios of accounts receivable can be sold in capital markets through securitization.

For tax reporting purposes, a general provision for bad debts is not an allowable deduction from profit - a business can only get relief for specific debtors

that have gone bad. However, for financial reporting purposes, companies may choose to have a general provision against bad debts consistent with their past experience of customer payments, in order to avoid over-stating debtors in the balance sheet.

12.10 SUMMARY

Trade credit simply means that a vendor extends you credit terms, giving you extra time to pay or giving a discount for early payment. An agreement where a customer can purchase goods on account (without paying cash), paying the supplier at a later date. Usually when the goods are delivered, a trade credit is given for a specific amount of days - 30, 60 or 90. Jewelry businesses sometimes extend credit to 180 days or longer. Basically, this is a credit a company gives to another for the purchase of goods and services.Using trade credit does four things for your new business:

1. First, it helps you buy the things you need without having to go to a bank and use personal funds as collateral.
2. Second, and more important, it gives you a business credit rating to use when you need to go to a bank for a loan.
3. Third, it allows you to establish business credit so you have a better chance of getting a bank loan.
4. Fourth, you can reserve the bank financing for capital improvements that will generate more returns.

12.11 GLOSSARY

- **Collateral:** Property or other assets that a borrower offers a lender to secure a loan.
- **Entrepreneur:** An individual who, rather than working as an employee, runs a small business and assumes all the risk and reward of a given business venture, idea, or good or service offered for sale.

- **Creditworthiness:** An assessment of the likelihood that a borrower will default on their debt obligations.

12.12 SELF ASSESSMENT QUESTIONS

1. What is Trade Credit ?

____

____

2. How Supplier & Vendor act as a source of trade credit ?

____

____

3. Explain Trade credit with the help of an example ?

____

____

4. What are the advantages of taking the trade credit ?

____

____

5. What is trade credit insurance ?

____

____

6. Fill in the blanks :

a) __________________ is an insurance policy and a risk management product offered by private insurance companies and governmental export credit

agencies to business entities wishing to protect their accounts receivable from loss due to credit risks such as protracted default, insolvency or bankruptcy.

b) A main disadvantage of trade accounts is _______________.

c) _________________ is the world's number one credit insurance provider.

12.13 LESSON END QUESTIONS

1. What is trade credit? How important is trade credit for a business in today's world ?

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____

2. What are the advantages and disadvantages of trade credit ?

____

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3. What is trade credit insurance? Briefly describe the history of trade credit insurance ?

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4. What are the different sources of trade credit ?

____

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12.14 SUGGESTED READINGS

- Khan, M. Y. and Jain, P. K., (2010), Financial Management: Text and Problems, New Delhi, Tata McGraw Hill Publishing Company Limited, 4th Edition.
- Pandey, I. M., (2011), Financial Management, New Delhi, Vikas Publishing House Private Limited, 8th Edition.

UNIT - III

SHORT TERM FINANCE AND WORKING CAPITAL

LESSON No. 13

Concept and Functions of Factoring

Concept of Working Capital Management

Structure :

13.1 Introduction

13.2 Objectives

13.3 Concept of Factoring

13.4 Types of Factoring

13.5 Advantages and Disadvantages of Factoring

13.5.1 Advantages of Factoring

13.5.2 Disadvantagesof Factoring

13.6 Functions of Factoring

13.7 Concept of working capital management

13.8 Summary

13.9 Glossary

13.10 Self Assessment Questions

13.11 Lesson End Exercise

13.12 Suggested Readings

13.1 INTRODUCTION

Factoring is a service of financial nature involving the conversion of credit bills into cash. Accounts receivables, bills recoverable and other credit dues resulting from credit sales appear, in the books of accounts as book credits. Here the risk of credit, risk of credit worthiness of the debtor and as number of incidental and consequential risks are involved. These risks are taken by the factor which purchase these credit receivables without recourse and collects them when due. These balance-sheet items are replaced by cash received from the factoring agent. Factoring is also known as Invoice Agent or purchase and discount of all "receivables".

Working capital can be understood as a measure of both a company's efficiency and its short term financial health. For a layman, it simply means the difference between the current assets and current liabilities. It is the firm's holdings of current, or short-term, assets (such as cash).

Working capital is generally divided in two types, viz. gross working capital and net working capital. Gross Working Capital (GWC) is nothing but the total current or circulating assets. Net working capital, NWC (current assets minus current liabilities), provides an accurate assessment of the liquidity position of firm with the liquidity-profitability dilemma solidly authenticated in the financial scheme of obligations which mature within a twelve-month period.

As we have seen, the two main components of the working capital are assets and liabilities. First, short-term, or current liabilities constitute the portion of funds which have been planned for and raised. Since management must be concerned with proper financial structure, these and other funds must be raised judiciously. Short-term or current assets constitute a part of the asset investment decision and require diligent review by the firm's executives.

13.2 OBJECTIVES

After going through this lesson, you should be able to:

- Describe the concept of factoring.
- Explain the functions of factoring.
- Recognise the advantages and disadvantages of factoring
- Highlight the meaning of working capital management.

13.3 CONCEPT OF FACTORING

Factoring is a financial service in which the business entity sells its bill receivables to a third party at a discount in order to raise funds. It differs from invoice discounting. The concept of invoice discounting involves, getting the invoice discounted at a certain rate to get the funds, whereas the concept of factoring is broader. Factoring involves the selling of all the accounts receivable to an outside agency. Such an agency is called a factor.

The seller makes the sale of goods or services and generates invoices for the same. The business then sells all its invoices to a third party called the factor. The factor pays the seller, after deducting some discount on the invoice value. The rate of discount in factoring ranges from 2 to 6 percent. However, the factor does not make the payment of all invoices immediately to the seller. Rather, it pays only up to 75 to 80 percent of the invoice value after deducting the discount. The remaining 20 to 25 percent of the invoice value is paid after the factor receives the payments from the seller's customers. It is called factor reserve or factoring, receivables factoring or debtor financing, is when a company buys a debt or invoice from another company. Factoring is also seen as a form of invoice discounting in many markets and is very similar but just within a different context. In this purchase, accounts receivable are discounted in order to allow the buyer to make a profit upon the settlement of the debt. Essentially factoring transfers the ownership of accounts to another party that then chases up the debt.

In other words, factoring implies a financial arrangement between the factor and client, in which the firm (client) gets advances in return for receivables, from a financial institution (factor). It is a financing technique, in which there is an outright selling of trade debts by a firm to a third party, i.e. factor, at discounted prices.

Factoring is a financial alternative, in financing and management of account receivables. It states the terms and conditions of the sale in the factoring agreement. In other words, factoring is a relationship between the factor and the client, in which the factor purchases the client's account receivables and pay up to 80% (sometimes 90%) of the sum immediately, at the time of entering into the agreement. The factor pays the balance sum, i.e. 20% of the amount which includes finance cost and operating cost, to the client when the customer pays the obligation.

13.4 TYPES OF FACTORING

- **Recourse and Non-recourse Factoring**: In this type of arrangement, the financial institution, can resort to the firm, when the debts are not recoverable. So, the credit risk associated with the trade debts are not assumed by the factor. On the other hand, in non-recourse factoring, the factor cannot recourse to the firm, in case the debt turn out to be irrecoverable.

- **Disclosed and Undisclosed Factoring**: The factoring in which the factor's name is indicated in the invoice by the supplier of the goods or services asking the purchaser to pay the factor, is called disclosed factoring. Conversely, the form of factoring in which the name of the factor is not mentioned in the invoice issued by the manufacturer. In such a case, the factor maintains sales ledger of the client and the debt is realized in the name of the firm. However, the control is in the hands of the factor.

- **Domestic and Export Factoring**: When the three parties to factoring, i.e. customer, clients, and factor, reside in the same country, then this is called as domestic factoring. Export factoring, or otherwise known as cross-border factoring is one in which there are four parties involved, i.e. exporter (client),

the importer (customer), export factor and import factor. This is also termed as the two-factor system.

- **Advance and Maturity Factoring**: In advance factoring, the factor gives an advance to the client, against the uncollected receivables.

In maturity factoring, the factoring agency does not provide any advance to the firm. Instead, the bank collects the sum from the customer and pays to the firm, either on the date on which the amount is collected from the customers or on a guaranteed payment date.

13.5 ADVANTAGES AND DISADVANTAGES OF FACTORING

13.5.1 Advantages of Factoring

Factoring provides various benefits to the clients, banks and customers. We shall dis-cuss the benefits of factoring hereunder:

A. Benefits to the Clients

The following are the advantages of factoring service to the clients:

1. The client or seller can convert accounts receivables into cash without bothering about sales ledger administration even repayment in some cases.

2. Factoring ensures a definite pattern of cash inflows.

3. Continuous Factoring virtually eliminates the need for the credit department. That is why receivable financing through Factoring is gaining popularity as useful source of financing short term fund requirements of business enterprises because of the inherent advantage of flexibility it affords to the borrowing firm. The seller firm may continue to get finance on its receivables on a more or less automatic basis. If its sales expand or contract, it can vary the financing proportionately.

4. Unlike an unsecured loan, compensating balances are not required in this case. Another advantage consists of relieving the borrowing firm of substantial credit

and collection costs and further to certain extent from a considerable part of cash management.

5. In export sales, difficulties of credit assessment and debt collection are more pro-nounced. Availing of Professional factoring services is more advantageous.

6. Under factoring arrangement, regular cash inflow at periodical intervals is assured. This helps, short term fund flow and availing of discounts from suppliers.

7. Firms engaged in a highly seasonal business may submit the peak loan of receivables to the Factor for credit review and approval as a cheaper alternative to expanding its own credit department.

8. Finally, when credit is necessary and cannot be obtained elsewhere either because of tight money conditions or poor financial position, the Factoring of re-ceivables will be more appropriate.

B. Benefits to the Customers

The following are the advantages of Factoring service to the customers:

1. The customer is relieved of maintaining record relating to credit sales customers a/c, reminders to debtors, initiating recovery measures, etc. This saves substantial administration expenditure.

2. Factoring as a professional approach in collection of debts inculcates discipline in cash management among customers.

3. Buyers have no need to accept any bill.

4. Buyers will have adequate credit period for payment.

5. Factoring will facilitate credit purchases.

6. Saving on bank charges and expenses.

7. No documentation problems; only a simple undertaking agreeing to make payment directly to factor is required.

8. Factor furnishes periodical statement of outstanding invoices drawn on the buyers.

C. Benefits to the Banks

The following are the advantages of Factoring service to the banks:

1. Factoring provides the banks an integrated receivables management.

2. Factoring improves the service efficiency of the banks through closer follow up of credit sales.

3. Factoring provides increasing cash flow and liquidity to the banks.

4. Factoring improves the quality of the advances made by the banks by reducing the turnover of receivables and by increasing operating cycles.

5. Factoring enhances the profits through cash discounts on purchase.

6. Factoring safeguards as insurance against non-performing assets of the banks. In this, all proceeds of factored bills are credited to bank; hence bank account will not become non-performing assets for shortage of credits.

13.5.2 Disadvantages of Factoring

The following are the disadvantages:

- Factor collecting the money on behalf of the company can lead to stress in the company and the client relationships.
- The cost of factoring is very high.
- Bad behavior of factor with the debtors can hamper the goodwill of the company.

- Factors often avoid taking responsibility for risky debtors. So the burden of managing such debtor is always in the company.
- The company needs to show all the details about company customers and sales to factor.

Thus, factoring forms an important part of a business, especially those businesses which are big in size. However, if used wisely and to the benefit of the company, it can help the business to grow significantly.

13.6 FUNCTIONS OF FACTORING

1. Maintenance of Sales Ledger :

A factor maintains sales ledger for his client firm. An invoice is sent by the client to the customer, a copy of which is marked to the factor. The client need not maintain individual sales ledgers for his customers. On the basis of the sales ledger, the factor reports to the client about the current status of his receivables, as also receipt of payments from the customers and as part of a package, may generate other useful information. With the help of these reports, the client firm can review its credit and collection policies more effectively.

2. Collection of Accounts Receivables:

Under factoring arrangement, a factor undertakes the responsibility of collecting the receivables for his client. Thus, the client firm is relieved of the rigours of collecting debts and is thereby enabled to concentrate on improving the purchase, production, marketing and other managerial aspects of the business. With the help of trained manpower backed by infrastructural facilities a factor systematically undertakes follow up measure and makes timely demand in the debtors to pay amounts. Normally, debtors are more responsive to demands or reminders from a factor as they would not like to go down in the esteem of credit institution as a factor.

3. Credit Control and Credit Protection:

Another useful service rendered by a factor is credit control and protection. As a factor maintains extensive information records (generally computerized) about the financial standing and credit rating of individual customers and their track record of payments, he is able to advise its client on whether to extend credit to a buyer or not and if it is to be extended the amount of the credit and the period there-for. Further, the factor establishes credit limits for individual customers indicating the extent to which he is prepared to accept the client's receivables on such customers without recourse to the client. This specialised service of a factor assists clients to handle a far greater volume of business with confidence than would have been possible otherwise.

In addition, factor provides credit protection to his client by purchasing without recourse to him every debt of approved customers (within the stipulated credit limit) and assumes the risk of default in payment by customers only in case of customers' financial inability to pay.

4. Advisory Functions:

At times, factors render certain advisory services to their clients. Thus, as a credit specialist a factor undertakes comprehensive studies of economic conditions and trends and thus is in a position to advise its clients of impending developments in their respective industries. Many factors employ individuals with extensive manufacturing experience who can even advise on work load analysis, machinery replacement programmes and other technical aspects of a client's business. Factors also help their clients in choosing suitable sales agents/seasoned personnel because of their close relationship with various individuals and non-factored organizations. Thus, as a financial system combining all the related services, factoring offers a distinct solution to the problems posed by working capital tied in trade debts.

13.7 CONCEPT OF WORKING CAPITAL MANAGEMENT

Working capital management is the way a company manages the relationship between assets and liabilities in the short term. Simply put, working capital management is how a company manages its money for day to day operations as well as any immediate debt obligations. While managing working capital, the company has to manage accounts receivable, accounts payable, inventory and cash. The goal of working capital management is to have adequate cash flow for continued operations and have the most productive usage of resources.

Working capital management entails the control and monitoring of all components of working capital, i.e., cash, marketable securities, debtors (receivables) and stocks (inventories) and creditors (payables). Finance manager has to pay particular attention to the levels of current assets and their financing. To decide the levels and financing of current assets, the risk return trade off must be taken into account.

Working Capital Management involves managing the balance between firm's short-term assets and its short-term liabilities. The goal of working capital management is to ensure that the firm is able to continue its operations and that it has sufficient cash flow to satisfy both maturing short-term debts and upcoming operational expenses. The interaction between current assets and current liabilities is, therefore, the main theme of the theory of working capital management. There are many aspects of working capital management which makes it an important function of financial management.

- **Time:** Working capital management requires much of the finance manager's time.
- **Investment:** Working capital represents a large portion of the total investment in assets.
- **Credibility:** Working capital management has great significance for all firms, but it is very critical for small firms.

- **Growth:** The need for working capital is directly related to the firm's growth.

There are a few calculations we have to discuss in regards to working capital management. To calculate working capital, a company would take current assets and subtract current liabilities.

Working capital efficiency is determined by calculating the working capital ratio. This ratio is a key indicator in the company's financial health. The working capital efficiency is calculated by taking current assets divided by current liabilities. If the result of the calculation is less than 1.0, then it is taken as a sign that the company's having financial issues. If the result of the calculation is greater than 1.0 but less than 2.0, then the company is in good financial health. If the calculation yields a result greater than 2.0, then company may not be making an effective use of its assets.

The next calculation we need to understand is receivables turnover. This is a calculation of how many times an account is created and collected during the reporting period. Receivables turnover is calculated by dividing the total revenue by average receivables. That was a long way to say how many times orders are being created and invoiced during the reporting period.

The last calculation we need to understand for working capital management is the inventory turnover ratio. The inventory turnover ratio is calculated by costs of goods sold divided by the average inventory costs. If the results are less than 1.0 then the company is not moving enough inventory.

13.8 SUMMARY

Factoring, receivables factoring or debtor financing, is when a company buys a debt or invoice from another company. Factoring is also seen as a form of invoice discounting in many markets and is very similar but just within a different context. In this purchase, accounts receivable are discounted in order to allow the buyer to make a profit upon the settlement of the debt. Essentially factoring transfers the ownership of accounts to another party that then chases up the debt.

Factoring therefore relieves the first party of a debt for less than the total amount providing them with working capital to continue trading, while the buyer, or factor, chases up the debt for the full amount and profits when it is paid. The factor is required to pay additional fees, typically a small percentage, once the debt has been settled. The factor may also offer a discount to the indebted party. Factoring is a very common method used by exporters to help accelerate their cash flow. The process enables the exporter to draw up to 80% of the sales invoice's value at the point of delivery of the goods and when the sales invoice is raised.

13.9 GLOSSARY

- **Working capital:** It is 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.
- **Financial Institution:** Financial institution is an institution that provides financial services for its clients or members. Most financial institutions are regulated by the government.
- **Gross working capital:** It is the sum of a company's current assets (assets that are convertible to cash within a year or less). Gross working capital includes assets such as cash, accounts receivable, inventory, short-term investments, and marketable securities.
- **Cash flow:** It is the net amount of cash and cash-equivalents being transferred into and out of a business. At the most fundamental level, a company's ability to create value for shareholders is determined by its ability to generate positive cash flows, or more specifically, maximize long-term free cash flow.
- **Investment Management:** Investment management is the professional asset management of various securities (shares, bonds

and other securities) and assets (e.g., real estate) in order to meet specified investment goals for the benefit of the investors. Investors may be institutions (insurance companies, pension funds, corporations, charities, educational establishments etc.) or private investors (both directly via investment contracts and more commonly via collective investment schemes e.g. mutual funds or exchange-traded funds).

13.10 SELF ASSESSMENT QUESTIONS

1. What is factoring? Explain the functions of factoring.

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2. Explain the concept of working capital management.

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13.11 LESSON END EXERCISE

1. Discuss the advantages and disadvantages of factoring.

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2. Explain the concept of gross and net working capital.

13.12 SUGGESTED READINGS

- Pandey, I. M., Financial Management, Vikas Publishing House, New Delhi.
- Gupta and Sharma, Management Accounting-Kalyani Publishers
- Guthmann and Dougall, Corporate Financial Policy, Pentice Hall.
- Babu, G. Ramesh (2005), "Indian Financial System", 1st Edition, Himalayan Publishing House, Mumbai.
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UNIT -III

SHORT TERM FINANCE AND WORKING CAPITAL

LESSON No. 14

Working Capital Cycle, Approaches of Working Capital Financing and Differentent components of Working Capital Management

Structure :

14.1 Introduction

14.2 Objectives

14.3 Meaning of Working Capital Cycle

14.4 How to Shorten Working Capital Cycle?

14.5 Approaches of Working Capital Financing

14.6 Components of Working Capital Management

14.7 Summary

14.8 Glossary

14.9 Self Assessment Questions

14.10 Lesson End Exercise

14.11 Suggested Readings

14.1 INTRODUCTION

Working capital cycle refers to the time taken by an organization to convert its net current assets and current liabilities into cash. It reflects the ability and efficiency of the organization to manage its short-term liquidity position. In other words, the working capital cycle (calculated in days) is the time duration between buying goods to manufacture products and generation of cash revenue on selling the products. The shorter the working capital cycle, the faster the company is able to free up its cash stuck in working capital. If the working capital cycle is too long, then the capital gets locked in the operational cycle without earning any returns. Therefore, a business tries to shorten the working capital cycles to improve the short-term liquidity condition and increase their business efficiency. e working capital cycle focuses on management of four key elements viz. cash, receivables (debtors), payables (creditors) and inventory (stock). A business needs to have complete control over these four items in order to have a fairly controlled and efficient working capital cycle. Efficient management of working capital ensures profitability and overall financial health for businesses. Working capital is the cash that companies use to operate and conduct their organizations. Effective working capital management ensures that a company always maintains sufficient cash flow to meet its short-term operating costs and short-term debt obligations. The elements of working capital that investors and analysts assess to evaluate a company determine a company's cash flow. These elements are money coming in, money going out, and the management of inventory.

14.2 OBJECTIVES

After going through this lesson, you should be able to:

- Understand the concept of working capital cycle
- List out the components of working capital management
- Be familiar with the approaches of working capital financing

14.3 MEANING OF WORKING CAPITAL CYCLE

The working capital cycle is a measure of how quickly a business can turn its current assets into cash. Understanding how it works can help small business owners like you manage their company's cash flow, improve efficiency, and make money faster. In this chapter, we'll provide a breakdown of what a working capital cycle is, what affects it, and how it can affect your small business's finances. We'll also provide tips on how we should manage the working capital cycle and make it work for the business. To understand net working capital, we should know what the current assets are. Current assets can be converted to cash in a short-period. In financial parlance, "current" or "short-term" typically refers to one year. A business's current assets might include inventory, accounts receivables, prepaid expenses, or short-term investments. They don't include long-term assets, such as real estate or equipment.

The firm's current liabilities are its debts and obligations within the same period. These might be bills to vendors, payroll, or serving loans. Working capital is the current assets net of current liabilities. In other words, working capital is the assets you have after paying your bills, at least in the short-term. Essentially, the working capital cycle begins when assets are obtained to start the operating cycle and ends when the sale of a product or service is converted to cash.

Ultimately, the working capital ratio that determines can afford short-term expenses, so it's imperative that we monitor our business's finances. One way to do this is to keep a balance sheet, which is a statement of the business's assets, capital, and liabilities. Referring to the balance sheet frequently will enable to review how much positive working capital the have, so company that it can adjust payment cycles or other factors.

Therefore we can say that the working capital cycle (WCC) is the amount of time it takes to turn the net current assets and current liabilities into cash. The longer the cycle is, the longer a business is tying up capital in its working capital without earning a return on it. Therefore, companies strive to reduce its working capital cycle by collecting receivables quicker or sometimes stretching accounts payable.

Let us assume following details for a company that is in the manufacturing sector. A company takes raw materials on credit and has to pay back to its creditors in few days (say 30 days in our example). This is also called as average payables period which is can be calculated as the ratio of creditors to credit purchases.

Average payable period = average creditors / credit purchases X 365.

This means that the company enjoys a credit period of 30 days on the purchase of raw materials used for the production of the final good.

The company takes "x" number of days to sell off its inventory; the "x" here is nothing but inventory turnover ratio converted into a number of days instead of the number of times. Assuming average inventory of $ 5000 and average sales of $ 18000, the inventory turnover ratio amounts to $ 5000 / $ 18000 X 365 = 102 days approximately.

It takes some time for the company to convert its credit sales into cash due to the credit management policy incorporated by the company in terms of the credit period extended to customers. Assuming outstanding debtors of $ 9000 and a total credit sale amounting to $ 60,000 the average collection period can be calculated as

Average collection period = average debtors/ Total Credit Sales X 365

= $ 9000 / $ 60000 X 365

= 55 days approximately

Based on the above information, we infer that

- The company has to pay back its creditors within 30 days.
- For inventory to convert to sales, it takes roughly 102 days
- Conversion of receivables (debtors) to cash, on an average, takes 55 days

The working capital cycle for the company can be calculated as given below:

Working Capital Cycle = Inventory turnover in days + debtors turnover in days– creditors turnover

= 102 + 55 -30= 127 days

This implies that the company has its cash locked in for a period of 127 days and would need funding from some source to let the operations continue as creditors need to be paid off in 30 days. Assuming the company had to make all cash payments for its raw material requirement, there wouldn't be any creditors and the working capital cycle would then be 102 + 55 = 157days.

14.4 HOW TO SHORTEN WORKING CAPITAL CYCLE?

Every company would like to keep its working capital cycle as short as possible. A shorter working capital cycle can be achieved by focusing on individual aspects of the working capital cycle. Let us see how this works:

A company can aim to shorten its working capital cycle by:

Reducing the credit period given to its customers and thereby reducing the average collection period. Giving cash discount can also help improve the debtor's turnover ratio or average collection period amid various other ways.

The company can try to improve/streamline its process of manufacturing and focus on various ways to increase sales to reduce the time taken for inventory to convert to sales. The earlier the stock clearance better is the working capital cycle.

A better negotiation to increase the credit period from suppliers of raw material and goods required for production can also aid reduction in the working capital cycle.

While the average collection period and credit period from suppliers aid in shortening the working capital cycle, the initial prime focus of the business should be to reduce the time taken for inventory to convert to sales. If the time taken is very long it could imply that the business is not able to generate sales for the goods produced and more and more capital gets locked in inventory. Either the business should try and

reduce the time or should reduce the amount of inventory thereby reducing the amount locked in working capital. In other words, if the business is not able to reduce its working capital cycle and has higher inventory levels, it should aim at reducing inventory levels and reduce the amount locked in the working capital keeping the cycle time length same.

Most businesses cannot finance the operating cycle (average collection period + inventory turnover in days) with accounts payable financing alone. This shortfall can be managed by the business either out of profits accumulated over time, borrowed funds or by both.

14.5 APPROACHES OF WORKING CAPITAL FINANCING

Depending on the mix of short and long term financing, there are three basic approaches. They are:

- Matching approach/Hedging approach
- Conservative approach
- Aggressive approach

- **Matching or Hedging Approach**

The term hedging is very often used in the sense of risk reducing investment strategy involving transactions of a simultaneous but opposing nature so that the loss arising out of one transaction is likely to offset in the other due to the financing mix. The term hedging can be said to refer to the process of matching maturities of debt with the maturities of financial needs. That is why it is called matching approach. According to this approach, the maturity of the sources of funds should match the nature of the assets to be financed. For analytical purpose Current assets can be broadly classified into:

- Those, which require certain amount for given level of operation and hence do not vary over time.
- Those, which fluctuates over time.

This approach suggests that long-term funds should be used to finance the fixed portion of Current Assets requirements as spelt out in a manner similar to the financing of fixed assets. The purely temporary requirement that is the seasonal variation over and above the permanent financing needs should be appropriately financed with short-term funds or Current Liabilities.

This is a meticulous strategy of financing the working capital with moderate risk and profitability. In this strategy, each of the assets would be financed by a debt instrument of almost the same maturity. It means if the asset is maturing after 30 days, the payment of the debt which has financed it will also have its due date of payment after almost 30 days. Hedging strategy works on the cardinal principle of financing i.e. utilizing long-term sources for financing long-term assets i.e. fixed assets and a part of permanent working capital and temporary working capital are financed by short-term sources of finance.

Long Term Funds will Finance = FA + PWC

Short Term Funds will Finance = TWC

- **Conservative Approach**

The financing policy of the firm is said to be conservative when it depends more on long-term funds for financing needs. Under this approach, the firm finances its permanent assets and also a part of temporary Current Assets with long-term financing. In the periods when the firm has no need for temporary Current Assets, the idle long term funds can be invested in tradable securities to conserve liquidity. As the name suggests, it is a conservative strategy of financing the working capital with low risk and low profitability. In this strategy, apart from the fixed assets and permanent

current assets, a part of temporary working capital is also financed by long-term financing sources. It has the lowest liquidity risk at the cost of higher interest outlay.

Long Term Funds will Finance = FA + PWC + Part of TWC

Short Term Funds will Finance = Remaining Part of TWC

- **Aggressive Approach**

A firm may be said to be adopting an aggressive policy when it used more of short-term financing than warranted by the matching plan. Under this approach, the firm finances a part of its permanent Current Assets with short-term financing. Some extremely aggressive firms may even finance a part of their fixed assets with short-term financing. Relatively more the use of short-term financing makes the firm more risky.

Hence, we can say that this strategy is the most aggressive strategy out of all the three. The complete focus of the strategy is in profitability. It is a high-risk high profitability strategy. In this strategy, the dearer funds i.e. long term funds are utilized only to finance fixed assets and a part of the permanent working capital. Complete temporary working capital and a part of permanent working capital also are financed by the short-term funds. It saves the interest cost at the cost of high risk

14.6 COMPONENTS OF WORKING CAPITAL MANAGEMENT

Working capital in common parlance is the difference between current assets and current liabilities. Current assets usually consist of cash, marketable securities, receivables and inventory. A major component of current liabilities, on the other hand, is the payables. Management of working capital refers to the practices and techniques designed to control all the items of current assets and current liabilities. In the ordinary sense, working capital management is the function that involves effective and efficient use of all the components of current assets and current liabilities in order to minimize total cost.

I. Cash Management:

Cash is one of the important components of current assets. It is needed for performing all the activities of a firm, i.e. from acquisition of raw materials to marketing of finished goods. Therefore it is essential for a firm to maintain an adequate cash balance. One of the important functions of a finance manager is to match the inflows and outflows of cash so as to maintain adequate cash.

With reference to cash management cash has two meanings—ready cash and near cash. Currency notes, coins, bank balances are the examples of ready cash where as market-able securities, treasury bills, etc. are the examples of near cash. Management of cash means management of both ready cash as well as near cash.

Reasons for Holding Cash:

John Maynard Keynes identified the following three reasons for holding cash:

- **Transaction Motive:** This refers to holding of cash to meet routine payments such as purchases, wages, operating expenses, etc.
- **Precautionary Motive:** This refers to holding of cash to meet unexpected demands for cash such as to meet the extra cash payment for purchase of raw materials due to increase in cost of raw materials.
- **Speculative Motive:** This refers to holding of cash to take advantage of favorable market conditions such as to purchase excess quantity of raw materials for getting a handsome discount.

II. Receivables Management:

The term receivable is defined as any claim for money owed to the firm from customers arising from sale of goods or services in normal course of business. The term account receivable represents sundry debtors of a firm. It is one of the significant components of working capital next to cash and inventories.

The total volume of accounts receivable depends on its credit sale and debt collection policy—these two significantly influence the requirement of working capital. Liberal credit policy increases the vol-ume of sales but at the same time it also increases the investment in receivables. Therefore, examination of costs and benefits associated with credit policy is one of the important tasks of a finance manager.

i. **Cost of Maintaining Accounts Receivables:** The following are costs associated with maintaining accounts receivables:

Capital Cost: There is a time gap between the sale of goods and payment by debtors during which time the firm has to arrange funds for meeting their obligations like payment for raw materials, wages, etc. This additional financing involves some cost, known as capital cost. Collection Cost: Collection costs are the administrative costs incurred by the firm for collecting money from the debtors.

Default Cost: Default cost is the cost that arises from bad debt losses.

Delinquency Cost: These costs arise for extending credit to defaulting customers. Such costs are legal charges, costs involved in putting extra effort for collection, costs associated with sending reminders, etc.

III. Inventory Management:

Inventory constitutes a major part of total working capital. Efficient management of inventory results in maximization of earnings of the shareholders. Efficient inventory management consists of managing two conflicting objectives: Minimization of investment in inventory on the one hand; and maintenance of the smooth flow of raw materials for production and sales on the other.

Therefore the objective of a finance manager is to calculate the level of inventory where these conflicting interests are reconciled. Like cash, a firm holds inventory for transaction, precautionary and speculative motives.

- **Inventory Costs:** Besides purchase costs, inventory costs are of two types: Ordering costs and carrying costs.
- **Ordering Cost:** These costs include variable costs associated with acquisition of materials, like transportation costs, inspection costs, etc. This cost is also known as set-up cost.
- **Carrying Costs:** These costs include costs associated with holding the inventory such as storage charges, interest on capital, etc.

IV. Accounts Payable Management:

Payables or creditors are one of the important components of working capital. Payables provide a spontaneous source of financing of working capital. Payable management is very closely related with the cash management. Effective payable management leads to steady supply of materials to a firm as well as enhances its reputation. It is generally considered as a relatively cheap source of finance as suppliers rarely charge any interest on the amount owed. However, trade creditors will have a cost as a result of loss of enjoying cash discount on cash purchases.

14.7 SUMMARY

The Working Capital Cycle for a business is the length of time it takes to convert the total net working capital (current assets less current liabilities) into cash. Businesses typically try to manage this cycle by selling inventory quickly, collecting revenue from customers quickly, and paying bills slowly to optimize cash flow. A positive working capital cycle balances incoming and outgoing payments to minimize net working capital and maximize free cash flow. For example, a company that pays its suppliers in 30 days but takes 60 days to collect its receivables has a working capital cycle of 30 days. This 30-day cycle usually needs to be funded through a bank operating line, and the interest on this financing is a carrying cost that reduces the company's profitability. Growing businesses require cash, and being able to free up cash by shortening the working capital cycle is the most inexpensive way to grow.

Sophisticated buyers closely review a target's working capital cycle because it provides them with an idea of the management's effectiveness at managing their balance sheet and generating free cash flow.

Traditionally, investors, creditors and bankers have considered working capital as a critical element to watch, as important as the financial position portrayed in the balance sheet and the profitability shown in the income statement. Working capital is a measure of the company's efficiency and short term financial health. It refers to that part of the company's capital, which is required for financing short-term or current assets such a cash marketable securities, debtors and inventories. It is a company's surplus of current assets over current liabilities, which measures the extent to which it can finance any increase in turnover from other fund sources. Funds thus, invested in current assets keep revolving and are constantly converted into cash and this cash flow is again used in exchange for other current assets. That is why working capital is also known as revolving or circulating capital or short-term capital. Working capital management represents the relationship between a firm's short-term assets and its short-term liabilities. The goal of working capital management is to ensure that a company can afford its day-to-day operating expenses while, at the same time, investing the company's assets in the most productive way. A well-run firm manages its short-term debt and current and future operational expenses through its management of working capital, the components of which are inventories, accounts receivable, accounts payable, and cash.

14.8 GLOSSARY

- **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 the best effect.
- **Overdraft**: An overdraft occurs when money is withdrawn from a bank account and the available balance goes below zero. In this situation the account is said to be **"overdrawn / overdraft".**

- **Positive working capital:** Positive working capital is the excess of current assets over current liabilities. In other words, when the net working capital is a positive figure, it is said that the firm has a positive working capital. It is the situation when the short-term receivable of a company is more than its short-term payables.
- **Negative working capital:** Negative working capital is when a company's current liabilities exceed its current assets. This means that the liabilities that need to be paid within one year exceed the current assets that are monetizable over the same period.

14.9 SELF ASSESSMENT QUESTIONS

1. Explain the concept of working capital cycle ?

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2. Examine the components of working capital management ?

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14.10 LESSON END EXERCISE

1. How to Shorten Working Capital Cycle ?

2. Discuss the approaches of working capital financing ?

14.11 SUGGESTED READINGS

- Pandey, I. M., Financial Management, Vikas Publishing House, New Delhi.
- Gupta and Sharma, Management Accounting-Kalyani Publishers

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UNIT -III

SHORT TERM FINANCE AND WORKING CAPITAL

LESSON No. 15

Inventory Management, Cash Management, Receivable Management, Credit Policies, Credit Terms, Collection Policies

Structure :

15.1 Introduction

15.2 Objectives

15.3 Meaning of Inventory Management

15.3.1 Objectives of Inventory Management

15.3.2 Techniques of Inventory Management

15.4 Meaning of Cash Management

15.4.1 Models of Cash Management

15.5 Receivables Management

15.6 Credit Policy

15.6.1 Credit Terms

15.6.2 Credit Standard

15.6.3 Collection policy or collection efforts

15.7 Summary

15.8 Glossary

15.9 Self Assessment Questions

15.10 Lesson End Exercise

15.11 Suggested Readings

15.1 INTRODUCTION

Inventory is a necessary evil that every organization would have to maintain for various purposes. Optimum inventory management is the goal of every inventory planner. Over inventory or under inventory both cause financial impact and health of the business as well as effect business opportunities. Inventory holding is resorted to by organizations as hedge against various external and internal factors, as precaution, as opportunity, as a need and for speculative purposes. Inventory management is a systematic approach to sourcing, storing, and selling inventory—both raw materials (components) and finished goods (products). In business terms, inventory management means the right stock, at the right levels, in the right place, at the right time, and at the right cost as well as price.

Cash management as the word suggests is the optimum utilization of cash to ensure maximum liquidity and maximum profitability. It refers to the proper collection, disbursement, and investment of cash.

A firm's credit policy is the set of principles on the basis of which it determines who it will lend money to or gives credit (the ability to pay for goods or services at a later date).

15.2 OBJECTIVES

After going through this lesson, you should be able to:

- Explain the meaning of inventory management

- List out the techniques of inventory management
- Be acquainted with the models of cash management
- Understand the concept of receivables management

15.3 MEANING OF INVENTORY MANAGEMENT

Inventory refers to the stockpile of the product a firm is offering for sale and the components that make up the product.' In short, inventory is such type of assets which will be disposed of in future in the ordinary course of the business.

In other words, 'Inventory" is used to designate the aggregate of those items of tangible assets which are:

(i) Held of sale in ordinary course of the business;

(ii) In the process of production for such sale; or

(iii) To be currently consumed in the production of goods or services to be available for sale.

Thus, it means and includes :

(i) Raw Materials & Stores — (Consumable): It contains items which are purchased by the firm from others.

(ii) Work-in-Progress — (Convertible): It consists of items which are currently used in the production process. These are semi-finished goods that are held at various stage of production in multi-stage production process.

(iii) Finished goods — (Saleable): It represents final or completed products which are available for sale.

In financial management, however, inventory is defined as the sum total of raw materials, work-in-progress and finished products although it depends largely upon the type of business. For Example, in case of manufacturing concern, inventory will

mean and include all the three groups stated above while, in case of a trading concern, it will represent only the finished goods. Manufacturing concerns hold inventories to give flexibility between production and sales. That is why, it is the duty of the financial manager to see whether increase in inventories results in increased earnings and to minimize the level of inventories, as well. As such, if inventories are reduced as a result of sale, the funds so generated may be used for different purposes. As a part of your supply chain, inventory management includes aspects such as controlling and overseeing purchases — from suppliers as well as customers — maintaining the storage of stock, controlling the amount of product for sale, and order fulfillment. Naturally, your company's precise inventory management meaning will vary based on the types of products you sell and the channels you sell them through. But as long as those basic ingredients are present, you'll have a solid foundation to build upon. Small-to-medium businesses (SMBs) often use Excel, Google Sheets, or other manual tools to keep track of inventory databases and make decisions about ordering. With these systems, the procedures of inventory management extend beyond basic reordering and stock monitoring to encompass everything from end-to-end production and business management to lead time and demand forecasting to metrics, reports, and even accounting.

15.3.1 Objectives of Inventory Management

Efficient inventory management should result in the maximization of the owner's wealth. For this purpose, a firm should neither hold excessive inventories nor hold inadequate inventories, i.e., it should hold the optimum level of inventory. The optimum level of inventory investment lies between the point of excessive and inadequate levels. In other words, there must not be an over investment or under investment in inventories. The dangers of over investment in inventories are:

(i) Funds of the firm are tied-up unnecessarily;

(ii) It creates loss of profit;

(iii) Excessive carrying cost and risk of liquidity increases.

As such, the opportunity cost and carrying costs (viz. cost of storage, handling, insurance etc.) increase proportionately. No doubt, these costs will impair the profitability of the firm. Excessive investment in raw materials will prove the same result except at the time of inflation and scarcity. Similar results may also be noticed for the over investment in work-in-progress since it is very difficult to sell. Similarly, many difficulties will appear to dispose of excessive finished goods since time lengthens (viz., the goods may be sold at low price etc.). Moreover, for carrying excessive inventory physical deterioration of the same may occur while in storage. From the above, it becomes crystal clear that there must not be an over investment in inventories. Similarly, inadequate level of inventories is not also free from snags.

The consequences are:

(i) Production may shut-down;

(ii) Commitment for the delivery may not be possible;

(iii) Inadequate raw material and work-in-progress will create frequent production interruption;

(iv) Customers may shift to the competitor if their demands are not met up regularly, etc.

Thus, the objective of inventory management is to maintain its optimum level in the following manner:

(a) To ensure a continuous supply of materials to facilitate uninterrupted pro-duction.

(b) To maintain sufficient stocks of raw materials during short-supply;

(c) To maintain sufficient finished goods for efficient customer service;

(d) To minimise the carrying cost; and

(e) To maintain the optimum level of investment in inventories.

15.3.2 Techniques of Inventory Management

The techniques or the tools generally used to effect control over the inventory are the following:

1. Budgetary techniques for inventory planning
2. A-B-C. System of inventory control
3. Economic Order Quantity (E.O.Q.) i.e., how much to purchase at one time economically
4. VED Analysis
5 Perpetual inventory system and the system of store verification
6. Fixation of Stock Level
7. Control Ratios

1. **Budgetary Techniques:** For the purchase of raw materials and stocks, what we required is a purchase Budged to be prepared in terms of quantities and values involved. The sales stipulated as per sales Budget of the corresponding period generally works out to be the key factor to decide the production quantum during the budget period, which ultimately decides the purchases to be made and the inventories to be planned.

2. **A-B-C Analysis: ABC Analysis:** ABC System: In this technique, the items of inventory are classified according to the value of usage. Materials are classified as A, B and C according to their value. Items in class 'A' constitute the most important class of inventories so far as the proportion in the total value of inventory is concerned. The 'A' items constitute roughly about 5-10% of the total items while its value may be about 80% of the total value of the inventory.

Items in class 'B' constitute intermediate position. These items may be about 20-25% of the total items while the usage value may be about 15% of the total value. Items in class 'C' are the most negligible in value, about 65-75% of the total quantity but the value may be about 5% of the total usage value of the inventory. The numbers given above are just indicative, actual numbers may vary from situation to situation. The principle to be followed is that the high value items should be controlled more carefully while items having small value though large in numbers can be controlled periodically.

3. **Economics Order Quantity:** Economics order quantity represents the size of the order for which both order, ordering and carrying costs together are minimum. If purchases are made in large quantities, inventory carrying cost will be high. If the order size is small, ordering cost will be high. Hence, it is necessary to determine the order quantity for which ordering and carrying costs are minimum.

4. **VED Analysis:** VED- Vital, Essential, Desirable- analysis is used primarily for control of spare parts. The spare, parts can be divided into three categories – vital, essential or desirable – keeping in view the critically to production.

5. **Perpetual Inventory System:** Perpetual Inventory system means continuous stock taking. CIMA defines perpetual inventory system as 'the recording as they occur of receipts, issues and the resulting balances of individual items of stock in either quantity or quantity and value'. Under this system, a continuous record of receipt and issue of materials is maintained by the stores department and the information about the stock of materials is always available. Entries in the Bin Card and the Stores Ledger are made after every receipt and issue and the balance is reconciled on regular basis with the physical stock. The main advantage of this system is that it avoids disruptions in the production caused by periodic stock taking.

   Similarly it helps in having a detailed and more reliable check on the stocks. The stock records are more reliable and stock discrepancies are investigated

and appropriate action is taken immediately. Salient Features of Perpetual Inventory System:

i) It requires more efforts to maintain inventory under this method.

ii) Quantity balances shown by the store ledger and bin cards are reconciled.

iii) A number of items are physically checked systematically and by rotation.

iv) The method is comparatively costly as compared to periodical inventory system.

v) Store ledger and bin cards keeps inventory record up-to date and decent.

vi) The method applies to those concerns usually that sell high-value items (Such as car, personal computer, equipments etc.) not at a large quantity as compared to items under periodic system.

vii) Causes for difference between physical balances and book balances can be explored.

viii) Making corrective entries in case of discrepancies.

6) Fixation of stock level: The object of fixing stock levels for each item of material is to maintain required quantity of materials in the store and thereby the expenses may be reduced. The different stock levels are: (1) Minimum stock level (2) Maximum stock level (3) Reorder stock level

a. **Minimum stock level:** It represents the minimum quantity of an item of material to be kept in the store at any time. Material should not be allowed to fall below this level. If the stock goes below this level, production may be held up for want of materials. This stock is also known as safety stock level or buffer stock.

b. **Maximum stock level:** It is the stock level above which stock should not be allowed to rise. This is the maximum quantity of stock of raw materials which can be had in the stock. It is goes above, it will be overstocking.

c. **Reorder stock level**: It is the point at which the storekeeper should initiate purchase requisition for fresh supply. This level lies between the maximum level and the minimum level.

7) Control Ratios: The control ratios are mainly two:

a) Inventory Turnover Ratio which we have studied and

b) Input-output Ratio.

Inventory Turnover: Inventory Turnover is a ratio of the value of the materials consumed during a period to the average value of inventory held during that period.

If the inventory turnover rate in terms of value of materials is high, or if the length of the inventory turnover period is short, the material is said to be fast moving. So if the rate of consumption is fast or if the inventory turnover rate is good, it is a healthy measure of efficiency of materials control, as the capital employed is properly utilized.

ii. Input-Output Ratio: The Input-output Ratio is the ratio of the raw material put into manufacture and the standard raw materials content of the actual output. This ratio enables one to find out whether the usage of the materials is favourable or not. A standard ratio of input of materials and output of material should be determined and the actual ratio should be compared with the standard ratio.

15.4 MEANING OF CASH MANAGEMENT

Cash management is the art of managing a firm's short-term resources to sustain its ongoing activities and to optimize its liquidity. It refers to how a firm intends to identify its short-term cash position, make use of its excess cash, and handle shortfalls in cash required to meet immediate needs. the entrepreneur has not considered such issues, it may undermine the company's long-term prospects—and even its short-term stability. The short-term cash position is of much more significance to a small firm than it is to a well- established large firm. Even small mismatches in cash position can threaten the very survival of a new venture. Entrepreneurs should be thinking about liquidity from day one, but most forget to ponder on it because they have got some other issues on their minds. As long as there is enough money in the bank account, entrepreneurs do not give much thought to cash management. That can leave them vulnerable to all kinds of cash-flow problems. The most important elements of cash management are as follows:

1. Efficient utilization of current assets and current liabilities throughout each phase of the business cycle.
2. Systematic planning, management, and monitoring of the company's collec-tions and disbursements.
3. The collection, management, and dissemination of information to enable ef-fective use of available funds.

The simple rule of cash management is to maximize cash flows. Often, there are ways for you to improve your cash position simply by making certain that your billing and collection systems are operating as efficiently as possible. It may aims to bring cash into the company as quickly as possible by billing promptly, aggressively following up on overdue amounts, and even exploring possibilities of collecting advances and deposits from customers. Then hold onto your cash as long as possible by managing your payables. That means, take as much time as you are allowed to pay your firm's bills but be careful to avoid late fees or interest charges.

If you have a good control on the cash flow in your venture, it will free you from continually worrying about cash and will allow you to concentrate on other important aspects of the business. Some major benefits of good cash management are given here:

1. Increases the possibility that your business never runs out of cash.
2. Eliminates the constant worry associated with not knowing your current and future cash position.
3. Improved relationships with your vendors as a result of good payment practices
4. The ability to foresee cash flow problems long before they actually happen

15.4.1 Models of Cash Management

The top two cash management models are:

1. Baumol's EOQ Model of Cash Management
2. Miller-Orr Cash Management Model.

Baumol's EOQ Model of Cash Management:

William J. Baumol (1952) suggested that cash may be managed in the same way as any other inventory and that the inventory model could reasonably reflect the cost – volume relationships as well as the cash flows. In this way, the economic order quantity (EOQ) model of inventory management could be applied to cash management. It provides a useful conceptual foundation for the cash management problem. In the model, the carrying cost of holding cash-namely the interest forgone on marketable securities is balanced against the fixed cost of transferring marketable securities to cash, or vice- versa. The Baumol model finds a correct balance by combining holding cost and transaction costs, so as to minimize the total cost of holding cash. According to the model, optimum cash level is that level of cash where the carrying costs and

transaction costs are the minimum. The carrying costs refers to the cost of holding cash i.e. interest forgone on marketable securities. The transaction cost refers to the cost involved in getting the marketable securities converted into cash and vice versa.

Assumptions:

The Baumol's model holds good if the following assumptions are fulfilled:

(a) The rate of cash usage is constant and known with certainty. The model has limited use in times of uncertainty and firms whose cash flows are discontinuous or bumpy.

(b) The surplus cash is invested into marketable securities and those securities are again disposed of to convert them again into cash. Such purchase and sale transactions involve certain costs like clerical, brokerage, registration and other costs. The cost to be incurred for each such transaction is assumed to be constant/fixed. In practice, it would be difficult to calculate the exact transaction cost.

(c) By holding cash balance, the firm is would incur the opportunity cost of interest forgone by not investing in marketable securities. Such holding cost per annum is assumed to be constant.

(d) The short-term marketable securities can be freely bought and sold. Existence of free market for marketable securities is a prerequisite of the Baumol model.

Limitations:

The important limitations in Baumol's model are as follows:

(i) The model can be applied only when the payments position can be reasonably assessed.

(ii) Degree of uncertainty is high in predicting the cash flow transactions.

(iii) The model merely suggests only the optimal balance under a set of assumptions. But in actual situation it may not hold good.

Nevertheless it does offer a conceptual framework and can be used with caution as a benchmark.

2. Miller-Orr Cash Management Model:

Miller and Orr model (1966) assumes that the cashflow of the firm is assumed to be stochastic, i.e. different amounts of cash payments are made on different points of time. It is assumed that the movements in cash balance occur randomly. Miller and Orr suggested a model with control limits, which sets control points for time and size of transfers between an Investment Account and Cash Account. The model asserts that transfer money into or out of the account to return the balance to a predetermined 'normal point whenever the actual balance went outside a lower or upper limit. The lower limit would be set by management, and the upper limit and return points by way of formulae which assume that cash inflows and outflows are random, their dispersion usually being assumed to repeat a pattern exhibited in the past.

The model specifies the following two control limits:

h = Upper control limit, beyond the cash balance should not be carried.

0 = Lower control limit, sets the lower limit of cash balance, i.e. the firm should maintain cash resources atleast to the extent of lower limit.

z = Return point for cash balance

The Miller-Orr model, will work as follows:

(i) When cash balance touched the upper control limit (h), securities are bought to the extent of Rs. (h-z).

(ii) Then the new cash balance is z.

(iii) When cash balance touches lower control limit (o), marketable securities to the extent of Rs. (z-o) will be sold.

(iv) Then the new cash balance again return to point z.

Assumptions:

The basic assumptions of the model are:

(a) The major assumption with this model is that there is no underlying trend in cash balance over time.

(b) The optimal values of 'h' and 'z' depend not only on opportunity costs, but also on the degree of likely fluctuations in cash balances.

The model can be used in times of uncertainty and random cash flows. It is based on the principle that control limits can be set which when reached trigger off a transaction. The control limits are based on the day-to-day variability in cash flows and the fixed costs of buying and selling government securities. The higher the variability in cash flows and transaction cost, the wider and higher the control limits will be. Conversely, the higher the interest rate, the lower and closer they will become. Within the control limits, the cash balance fluctuates unpredictably. When it hits an upper or lower limit, action is taken by buying or selling securities to restore the balance to its normal level within the control points. In applying the model one must set the lower limit for the cash balance. This could be zero or some minimum safety margin above zero.

15.5 RECEIVABLES MANAGEMENT

Receivables management, also termed as credit management, deals with the formulation of credit policy, in terms of liberal or restrictive, concerning credit standard and credit period, the discount offered for early payment and the collection policy and procedures undertaken. It does so in such a way that taken together these policy variables determines an optimal level of investment in receivables where the return on that investment is maximum to the firm. The credit period extended by business firm

usually ranges from 15 to 60 days. When goods are sold on credit, finished goods get converted into accounts receivable (trade debtors) in the books of the seller. In the books of the buyer, the obligation arising from credit purchase is represented as accounts payable (trade creditors). "Accounts receivable is the total of all credit extended by a firm to its customer." A firm's investment in account receivable depends upon how much it sells on credit and how long it takes to collect receivable. Accounts receivable (or sundry debtors) constitute the 3rd most important assets category for business firm after plant and equipment and inventories and also constitute the 2nd most important current assets category for business firm after inventories. Poor management of accounts receivables are: neglect of various overdue account, sharp rise in the bad debt expense, and the collection of debts expense and taking the discount by customers even though they pay after the discount date and even after the net date. Since accounts receivable represent a sizable investment on the part of most firms in the case of public enterprises in India it forms 16 to 20 per cent of current assets. Efficient management of these accounts can provide considerable saving to the firm.

Factors involving in Receivable management:

1. The terms of credit granted to customers deemed creditworthy.
2. The policies and practices of the firm in determining which customers are to be granted credit.
3. The paying practices of credit customers.
4. The vigor of the sellers, collection policies and practice.
5. The volume of credit sales.

15.6 CREDIT POLICY

The first stage of credit sales is to decide policy in which most important variable is whether credit sales should be made or not and if yes to what extent i.e. what percentage of sales should be done on cash and what percentage on

credit. The discussion with cement companies marketing and finance department clearly suggest that the credit policy is more dependent upon market forces and less on company specially in periods when there is excessive competition which has happened a number of times in the history of cement industry after decontrol and manufactures have been forced to provide credit if they wanted full utilization of capacity. If in the market there is practice of providing credit, those companies who do not fall in line have lower sales and so lower utilization of instilled capacity. The management has to weigh whether it should avoid risk of realization and problem of arranging funds for larger sales on credit or decide for reduced capacity utilization thereby resulting in higher cost per tonne of cement produced.

Actually the policy should be based on cost benefit analysis of these factors but often policy is decided without detailed calculations. In actual practice when one waits to push sales the marketing department pressurizes the management to provide liberal credit to buyers to realize sales targets. Credit policy refers to those decision variables that influence the amount of trade credit i.e. the investment in receivables. The firm's investment in receivable are affected by general economic conditions, industry norms, pace of technological change, competition etc. Though the firm has no control on these factors, yet they have a great impact on it and it can certainly influence the level of trade credit through its credit policy within their constraints imposed externally. The purpose of any commercial enterprise is the earning of profit. Credit itself is utilized to increase sales, but sales must return a profit. Further, whenever some external factors change, the firm can accordingly adopt its credit policy. R.J. Chambers says, "The responsibility to administer credit and collection policies may be assigned to a financial executive or marketing executive or both of them jointly depending upon the original structure and the objectives of the firm."

Different types of credit policy are:

1. **Loose or Expansive Credit Policy**– Firms following this policy tend to sell on credit to customers very liberally. Credits are granted even to those whose credit worthiness is not proved, not known and are doubtful.

Advantages of Loose or Expansive Credit Policy: (i) Increase in Sales (higher sales), (ii) Increase in profit (higher profit), Disadvantages of Loose or Expansive Credit Policy: (i) Heavy bad/debts. (ii) Problem of liquidity (iii) Increase in cost of credit management.

2. **Tight or Restrictive Credit Policy**– Firms following this policy are very selective in extending credit. They sell on credit, only to those customers who had proved credit worthiness.

Advantages of Tight of Restrictive Credit Policy:

(i) Minimize cost. (ii) Minimize chances of bad debts. (iii) Higher sales in long run. (iv) Higher profit in long run. (v) Do not pose the serious problem of liquidity. Disadvantages of Tight or Restrictive Credit Policy: (i) Restrict Sales. (ii) Restrict Profit Margin.

Aspects of Credit Policy:

15.6.1 Credit Terms

(a) Credit Period

(b) Cash Discounts

(i) **Credit terms** – The stipulations under which the firm sells on credit to its customers are called credit terms.

(a) **Credit Period** – The time duration for which credit is extended to the customers is referred to as credit period. It is the length of time for customers under which they are allowed to pay for their purchases. It is generally varies between 15-60 days. When a firm does not extend any credit the credit period would obviously be zero. It is generally stated in terms of a net date, for example, if firm allows 30 days of credit with no discount to induce early payments credit then its credit terms are stated at 'net 30'. Usually the credit period of the firm is

governed by industry norms, but firms can extend credit for longer duration to stimulate sales. If the firm's bad debts build up, it may tighten up its credit policy as against the industry norms. According to Martin H. Seidhen, "Credit period is the duration of time for which trade credit is extended. During this period the overdue amount must be paid by the customer. The length of credit period directly affects the volume of investment in receivables and indirectly the net worth of the company. A long credit period may blast sales but it also increase investment in receivables and lowers the quality of trade credit."

(b) **Cash Discounts –** It is the another aspect of credit terms. Many firms offer to grant cash discount to their customers in order to induce them to pay their bill early. The cash discount terms indicate the rate of discount and the period for which discount has been offered. If a customer does not avail this offer, he is expected to make the payment by the net date. In the words of **Martin H. Seiden** "Cash Discount prevents debtors from using trade credit as a source of Working Capital." Liberalizing the cash discount policy may mean that the discount percentage is increased and or the discount period is lengthened. Such an action tends to enhance sales (because the discount is regarded as price reduction), reduce the average collection period (as customers pay promptly). Cash Discount is a premium on payment of debts before due date and not a compensation for the so - called prompt payment.

15.6.2 Credit Standard

The credit standard followed by the firm has an impact of sales and receivables. The sales and receivables level are likely to be high, if the credit standard of the firm are relatively low. In contrast, if the firm has relatively low credit standard, the sales and receivables level are expected to be relatively high. The firms credit standard are influenced by three "C" of credit.

(a) **Character** – the willingness of the customers to pay,

(b) **Capacity** – the ability of the customers to pay, and

(c) **Condition –** the prevailing economic conditions. Normally a firm should lower its credit standards to the extent profitability of increased sales exceed the associated costs. The cost arising due to credit standard realization are administrative cost of supervising additional accounts and servicing increased volume of receivables, bad debt losses, production and selling cost and cost resulting from the slower average collection period. The extent to which credit standard can be liberalized should depend upon the matching between the profits arising due to increased sales and cost to be incurred on the increased sales.

15.6.3 Collection policies or collection efforts.

This policy is needed because all customers do not pay the firm's bill in time. There are certain customers who are slow payers and some are non-payers. Therefore the collection policy should aim at accelerating collections from slow payers and non-payers and reducing bad debt losses. According to **R.K. Mishra,** "A collection policy should always emphasize promptness, regularity and systematization in collection efforts. It will have a psychological effect upon the customers, in that, it will make them realize the attitude of the seller towards the obligations granted." The collection programme of the firm aimed at timely collection of receivables, any consist of many things like monitoring the state of receivable, despatch of letter to customers whose due date is approaching, telegraphic and telephone advice to customers around the due date, threat of legal action to overdue accounts, legal action against overdue accounts. The firm has to be very cautious in taking the steps in order to collect from the slow paying customers. If the firm is strict in its collection policy with the permanent customers, who are temporarily slow payers due to their economic conditions, they will get offended and may shift to competitors and the firm may loose its permanent business. In following an optimal collection policy the firm should compare the cost and benefits. The optimal

credit policy will maximize the profit and will consistent with the objective of maximizing the value of the firm.

15.7 SUMMARY

Inventory management helps in maintaining a trade off between carrying costs and ordering costs which results into minimizing the total cost of inventory. Inventory management facilitates maintaining adequate inventory for smooth production and sales operations. Inventory management avoids the stock-out problem that a firm otherwise would face in the lack of proper inventory management. It suggests the proper inventory control system to be applied by a firm to avoid losses, damages and misuses. Inventory management is the practice of planning, directing and controlling inventory so that it contributes to the business' profitability. It can help business be more profitable by lowering their cost of goods sold and/or by increasing sales. It is making sure that items are available when customers call for it, but not too much stock so that inventory turnover goals are met.

15.8 GLOSSARY

- **Inventory Management:** Inventory management is the art and science of managing to have the right product, at the right time and place, in exactly the right amount, at the best possible price.
- **Inventory:** Inventory is also known as an itemized list of goods or valuables, with their estimated worth; specifically, the annual account of stock taken in any business.
- **Cash management:** It is the art of managing a firm's short-term resources to sustain its ongoing activities and to optimize its liquidity. It refers to how a firm intends to identify its short-term cash position, make use of its excess cash, and handle shortfalls in cash required to meet immediate needs

- **Credit:** Credit is an agreement whereby a financial institution agrees to lend a borrower a maximum amount of money over a given time period.
- **Cash Reserve Ratio**: Cash reserve ratio is a central bank regulation that sets the minimum fraction of customer deposits and notes that each commercial bank must hold as reserves (rather than lend out). These required reserves are normally in the form of cash stored physically in a bank vault (vault cash) or deposits made with a central bank. The required reserve ratio is sometimes used as a tool in monetary policy, influencing the country's borrowing and interest rates by changing the amount of funds available for banks to make loans with.
- **Statutory Liquidity Ratio**: Statutory Liquidity Ratio refers to the amount that the commercial banks require to maintain in the form of gold or govt. approved securities before providing credit to the customers. Here by approved securities we mean, bond and shares of different companies. Statutory Liquidity Ratio is determined and maintained by the Reserve Bank of India in order to control the expansion of bank credit.

15.9 SELF ASSESSMENT QUESTIONS

1. Define Inventory management. Explain the various techniques of inventory management.

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2. Discuss the models of cash management.

15.10 LESSON END EXERCISE

1. What is receivables management ?

2. Explain in detail the credit terms?

15.11 SUGGESTED READINGS

- Pandey, I. M., Financial Management, Vikas Publishing House, New Delhi.
- Gupta and Sharma, Management Accounting-Kalyani Publishers
- Guthmann and Dougall, Corporate Financial Policy, Pentice Hall.
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UNIT -1V

MANAGEMENT OF SURPLUS AND DIVIDEND POLICIES

LESSON No. 16

Concept of retained earnings; Advantages and Disadvantages of retained earnings

Structure :

16.1 Introduction

16.2 Objectives

16.3 Concept of retained earnings

16.4 Features of retained earnings

16.5 Objectives of retained earnings

16.6 Advantages of retained earnings

16.7 Disadvantages of retained earnings

16.8 Determinants of retained earnings

16.9 Summary

16.10 Glossary

16.11 Self Assessment Questions

16.12 Lesson End Exercise

16.13 Suggested Readings

16.1 INTRODUCTION

Retained earnings is the cumulative amount of earnings since the corporation was formed minus the cumulative amount of dividends that were declared. Retained earnings are the corporation's past earnings that have not been distributed as dividends to its stockholders.

The amount of a corporation's retained earnings is reported as a separate line within the stockholders' equity section of the balance sheet. However, the past earnings that have not been distributed as dividends to the stockholders will likely be reinvested in additional income-producing assets or used to reduce the corporation's liabilities.

At the end of an accounting year, the balances in a corporation's revenue, gain, expense, and loss accounts are used to compute the year's net income. Those account balances are then transferred to the retained earnings account. When the year's revenues and gains exceed the expenses and losses, the corporation will have a positive net income which causes the balance in the retained earnings account to increase. (If the corporation's revenues and gains for the year are less than the expenses and losses, the result is a net loss that reduces the normal credit balance in the Retained Earnings account.) The balance in the Retained Earnings account is also decreased when the corporation declares a cash dividend.

The normal balance in a profitable corporation's retained earnings account is a credit balance. This is logical since the revenue accounts have credit balances and expense accounts have debit balances. If the balance in the retained earnings account has a debit balance, this negative amount of retained earnings may be described as deficit or accumulated deficit.

16.2 OBJECTIVES

After going through this lesson, you should be able to:

- Explain the meaning of retained earnings
- Illustrates the characteristics of retained earnings

- Define the advantages of retained earnings
- Understand the disadvantages of retained earnings

16.3 CONCEPT OF RETAINED EARNINGS

Retained earnings are the profits that a company has earned to date, less any dividends or other distributions paid to investors. This amount is adjusted whenever there is an entry to the accounting records that impacts a revenue or expense account. A large retained earnings balance implies a financially healthy organization. The formula for **ending** retained earnings is:.Beginning retained earnings + Profits/losses - Dividends = Ending retained earnings

A company that has experienced more losses than gains to date, or which has distributed more dividends than it had in the retained earnings balance, will have a negative balance in the retained earnings account. If so, this negative balance is called an accumulated deficit. The retained earnings balance or accumulated deficit balance is reported in the stockholders' equity section of a company's balance sheet.

A growing company normally avoids dividend payments, so that it can use its retained earnings to fund additional growth of the business in such areas as working capital, capital expenditures, acquisitions, research and development, and marketing. It may also elect to use retained earnings to pay off debt, rather than to pay dividends. Another possibility is that retained earnings may be held in reserve in expectation of future losses, such as from the sale of a subsidiary or the expected outcome of a lawsuit.

As a company reaches maturity and its growth slows, it has less need for its retained earnings, and so is more inclined to distribute some portion of it to investors in the form of dividends. The same situation may arise if a company implements strong working capital policies to reduce its cash requirements.

When evaluating the amount of retained earnings that a company has on its balance sheet, consider the following points :

- **Age of the company**: An older company will have more time to decide to compile more retained earnings.
- **Dividend policy:** A company that routinely issues dividends will have fewer retained earnings.
- **Profitability**: A high profit percentage eventually yields a large amount of retained earnings, subject to the two preceding points.
- **Cyclical industry:** When a business is in an industry that is highly cyclical, management may need to build up large retained earnings reserves during the profitable part of the cycle in order to protect it during downturns.

Generally, retained earnings are considered as cost free source of financing. It is because neither dividend nor interest is payable on retained profit. However, this statement is not true. Shareholders of the company that retains more profit expect more income in future than the shareholders of the company that pay more dividend and retains less profit. Therefore, there is an opportunity cost of retained earnings. In other words, retained earnings is not a cost free source of financing. The cost of retained earning must be at least equal to shareholders rate of return on re-investment of dividend paid by the company.

16.4 FEATURES OF RETAINED EARNINGS

The important features of retained earnings as a source of internal financing have been summarized below:

1. Cost of Financing:

It is the general belief that retained earnings have no cost to the company.

2. **Floatation Cost:**

Unlike other sources of financing, the use of retained earnings helps avoid issue- related costs.

3. **Control:**

Use of retained earnings avoids the possibility of change/dilution of the control of existing shareholders that results from issue of new issues.

4. **Legal Formalities:**

Use of retained earnings does not require compliance of any legal formalities. It just requires a resolution to be passed in the annual general meeting of the company.

16.5 OBJECTIVES OF RETAINED EARNINGS

Retained earning are an internal source of finance for any company. Actually is not a method of raising finance, but it is called as accumulation of profits by a company for its expansion and diversification activities. Retained earnings are called under different names such as self finance, inter finance, and plugging back of profits. As prescribed by the central government, a part (not exceeding 10%) of the net profits after tax of a financial year have to be compulsorily transferred to reserve by a company before declaring dividends for the year.

Under the retained earnings sources of finance, a reasonable part of the total profits is transferred to various reserves such as general reserve, replacement fund, reserve for repairs and renewals, reserve funds and secrete reserves, etc.

Retained earnings or profits are ploughed back for the following purposes:

1. Purchasing new assets required for betterment, development and expansion of the company.
2. Replacing the old assets which have become obsolete.

3. Meeting the working capital needs of the company.

4. Repayment of the old debts of the company.

16.6 ADVANTAGES OF RETAINED EARNINGS

Retained earnings consist of the following important advantages:

1. **Useful for expansion and diversification:** Retained earnings are most useful for expansion and diversification of the business activities.

2. **Economical sources of finance:** Retained earnings are one of the least costly sources of finance since it does not involve any floatation cost as in the case of raising of funds by issuing different types of securities.

3. **No fixed obligation:** If the companies use equity finance they have to pay dividend and if the companies use debt finance, they have to pay interest. But if the company uses retained earnings as sources of finance, they need not pay any fixed obligation regarding the payment of dividend or interest.

4. **Flexible sources:** Retained earnings allow the financial structure to remain completely flexible. The company need not raise loans for further requirements, if it has retained earnings.

5. **Increase the share value:** When the company uses the retained earnings as the sources of finance for their financial requirements, the cost of capital is very cheaper than the other sources of finance; Hence, the value of the share will increase.

6. **Avoid excessive tax:** Retained earnings provide opportunities for evasion of excessive tax in a company when it has small number of shareholders.

7. **Increase earning capacity:** Retained earnings consist of least cost of capital and also it is most suitable to those companies which go for diversification and expansion.

16.7 DISADVANTAGES OF RETAINED EARNINGS

Retained earnings also have certain disadvantages:

1. **Misuses:** The management by manipulating the value of the shares in the stock market can misuse the retained earnings.

2. **Leads to monopolies:** Excessive use of retained earnings leads to monopolistic attitude of the company.

3. **Over capitalization:** Retained earnings lead to over capitalization, because if the company uses more and more retained earnings, it leads to insufficient source of finance.

4. **Tax evasion:** Retained earnings lead to tax evasion. Since, the company reduces tax burden through the retained earnings.

5. **Dissatisfaction:** If the company uses retained earnings as sources of finance, the shareholder can't get more dividends. So, the shareholder does not like to use the retained earnings as source of finance in all situations.

16.8 DETERMINANTS OF RETAINED EARNINGS

Determinants of ploughing back of profits or retained earnings are discussed under the following heads:

(a) **Total earnings of the enterprise:** The question of saving can arise only when there are sufficient profits. So larger the earnings larger the savings, it is a common principle of financial management.

(b) **Taxation policy of the government:** The report submitted by Taxation Enquiry Commission has brought into light that taxation policy of the Government tells upon it the taxes are levied at high rates. Hence, it is also an important determinant of corporate savings.

(c) Dividend Policy: It is policy adapted by the top management (board of directors) in regards to distribution of profits. A conservative dividend policy is essential for having good accumulation of corporate savings. But, dividend policy is highly influenced by the income expectation of shareholders and by general environment prevailing in the country.

(d) Government Attitudes and Control: Government is not only a silent spectator but a regulatory body of economic system of the country. Its policies, control order and regulatory instructions-all compel the organizations to work in that very direction for example compulsory Deposit Scheme which had been in force.

(e) Other Factors: Other factors affecting the retained earnings are:

i. Tradition of industry.

ii. General economic and social environment prevailing in the country.

iii. Managerial attitudes and philosophy, etc.

16.9 SUMMARY

Like an individual, companies too, set aside a part of their profit to meet future requirements. The portion of profits not distributed among the shareholders but retained and used in business is called retained earnings. It is also referred to as ploughing back of profit. This is one of the important sources of internal financing used for fixed as well as working capital. Retained earnings increase the value of shareholders in case of a growing firm.

Retained earnings are the portion of a business's profits that are not distributed as dividends to shareholders but instead are reserved for reinvestment back into the business. Normally, these funds are used for working capital and fixed asset purchases (capital expenditures) or allotted for paying off debt obligations. Retained earnings

are reported on the balance sheet under the shareholder's equity section at the end of each accounting period. To calculate retained earnings, the beginning retained Earnings balance is added to the net income or loss and then dividend payouts are subtracted. A summary report called a statement of retained earnings is also maintained, outlining the changes in retained earnings for a specific period.

16.10 GLOSSARY

- **Economic growth**: Economic growth is the increase in the amount of the goods and services produced by an economy over time. It is conventionally measured as the percent rate of increase in real gross domestic product, or real GDP.
- **Retained earnings**: Retained Earnings are the portion of a business's profits that are not distributed as dividends to shareholders but instead are reserved for reinvestment back into the business

16.11 SELF ASSESSMENT QUESTIONS

1. State and explain the meaning of retained earnings and how to calculate it?

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2. What are the objectives of retained earnings ?

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16.12 LESSON END EXERCISE

1. Discuss the advantages and disadvantages of retained earnings ?

2. Explain the determinants affecting the decisions regarding the retained earnings ?

16.13 SUGGESTED READINGS

- Pandey, I. M., Financial Management, Vikas Publishing House, New Delhi.
- Gupta and Sharma, Management Accounting-Kalyani Publishers
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- Hampton, John, Financial Decision Making, Pentice Hall, New Delhi.

UNIT -1V

MANAGEMENT OF SURPLUS AND DIVIDEND POLICIES:

LESSON No. 17

Concept of Dividend, Fixed dividend policy and Payout Ratio

Structure :

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17.1 INTRODUCTION

The concept of **"Dividend Policy"** implies that companies through their Board of Directors evolve a defined pattern of dividend payments which has a bearing on further action. In other words, the dividend policy of a firm refers to the views and practices of the management with regard to distribution of earnings to the shareholders in the form of dividends.

Dividends are paid out of profits. These could either be profits of the current year or the accumulated profits of the past. Dividends are paid quarterly, half yearly or annually. When paid quarterly or half yearly they are referred to as interim dividend. Dividend is expressed as a percentage of Face Value and is referred to as dividend rate.

When the dividend amount is expressed as a percentage of market price, it is called dividend yield, while expressed as a percentage of earnings is known as dividend payout. Hence, dividend yield is the ratio of dividend per share to market price per share and dividend payout is the ratio of dividend per share to earnings per share. Dividend policy determines the division of Earnings between payment to shareholders and Retained earnings.

17.2 OBJECTIVES

After going through this lesson, you should be able to:

- Explain the meaning of dividend
- Be acquainted with the different types of dividend
- Appreciate the various dividend policy
- Be familiar fixed dividend policy

17.3 CONCEPT OF DIVIDEND

Dividend is the payment by a company to its shareholders out of its distributable profit. In other words, dividend is paid to the shareholders out of the revenue profits earned by it in the ordinary course of business.

Dividend represents that part of the profit of a firm which is distributed to the shareholders. The com-pany declares the amount of dividend at its shareholders' meeting. Shareholders will get dividends in proportion to their shareholding in the company. Dividend may be in the form of cash or non-cash, i.e. bonus shares. Dividend decision is the financing decision of a business. It is the distribution of revenue profit to the shareholders in proportion to their holdings.

A dividend is that portion of profits and surplus funds of a company which has actually set aside by a valid act of the company for distribution among its shareholders.

According to **ICAI**, "Dividend is the distribution to the shareholders of a company from the reserves and profits."

In the words of **S.M. Shah**, "Dividend is a part of divisible profits of a business company which is distributed to the shareholders."

In the event of adequacy or absence of profits in any year, a company may declare dividend out of surplus subject to the fulfillment of the following conditions, namely:-

(1) The rate of dividend declared shall not exceed the average of the rates at which dividend was declared by it in the three (five) years immediately preceding that year:

Provided that this sub-rule shall not apply to a company, which has not declared any dividend in each of the three preceding financial year.

(2) The total amount to be drawn from such accumulated profits shall not exceed one-tenth of the sum of its paid-up share capital and free reserves as appearing

in the latest tenth of the sum of its paid-up share capital and free reserves as appearing in the latest audited financial statement.

(3) The amount so drawn shall first be utilised to set off the losses incurred in the financial year in which dividend is declared before any dividend in respect of equity shares is declared.

(4) The balance of reserves after such withdrawal shall not fall below fifteen per cent of its paid up share capital as appearing in the latest audited financial statement.

(5) No company shall declare dividend unless carried over previous losses and depreciation not provided in previous year are set off against profit of the company of the current year the loss or depreciation, whichever is less, in previous years is set off against the profit of the company for the year for which dividend is declared or paid.

17.4 TYPES OF DIVIDEND

A dividend is generally considered to be a cash payment issued to the holders of company stock. However, there are several types of dividends, some of which do not involve the payment of cash to shareholders. These dividend types are:

- **Cash dividend.** The cash dividend is by far the most common of the dividend types used. On the date of declaration, the board of directors resolves to pay a certain dividend amount in cash to those investors holding the company's stock on a specific date. The date of record is the date on which dividends are assigned to the holders of the company's stock. On the date of payment, the company issues dividend payments.

- **Stock dividend**. A stock dividend is the issuance by a company of its common stock to its common shareholders without any consideration. If the company issues less than 25 percent of the total

number of previously outstanding shares, then treat the transaction as a stock dividend. If the transaction is for a greater proportion of the previously outstanding shares, then treat the transaction as a stock split. To record a stock dividend, transfer from retained earnings to the capital stock and additional paid-in capital accounts an amount equal to the fair value of the additional shares issued. The fair value of the additional shares issued is based on their fair market value when the dividend is declared.

- **Property dividend.** A company may issue a non-monetary dividend to investors, rather than making a cash or stock payment. Record this distribution at the fair market value of the assets distributed. Since the fair market value is likely to vary somewhat from the book value of the assets, the company will likely record the variance as a gain or loss. This accounting rule can sometimes lead a business to deliberately issue property dividends in order to alter their taxable and/or reported income.

- **Scrip dividend**. A company may not have sufficient funds to issue dividends in the near future, so instead it issues a scrip dividend, which is essentially a promissory note (which may or may not include interest) to pay shareholders at a later date. This dividend creates a note payable.

- **Liquidating dividend**. When the board of directors wishes to return the capital originally contributed by shareholders as a dividend, it is called a liquidating dividend, and may be a precursor to shutting down the business. The accounting for a liquidating dividend is similar to the entries for a cash dividend, except that the funds are considered to come from the additional paid-in capital account.

EXAMPLE

Cash Dividend Example

- On February 1, ABC International's board of directors declares a cash dividend of $0.50 per share on the company's 2,000,000 outstanding shares, to be paid on June 1 to all shareholders of record on April 1. On February 1, the company records this entry:

	Debit	Credit
Retained earnings	1,000,000	
Dividends payable		1,000,000

- On June 1, ABC pays the dividends, and records the transaction with this entry :

	Debit	Credit
Dividends payable	1,000,000	
Cash		1,000,000

Stock Dividend Example

- ABC International declares a stock dividend to its shareholders of 10,000 shares. The fair value of the stock is $5.00, and its par value is $1. ABC records the following entry:

	Debit	Credit
Retained earnings	50,000	
Common stock, $1 par value		10,000
Additional paid-in capital		40,000

Property Dividend Example

- ABC International's board of directors elects to declare a special issuance of 500 identical, signed prints by Pablo Picasso, which the company has stored in a vault for a number of years. The company originally acquired the prints for $500,000, and they have a fair market value as of the date of dividend declaration of $4,000,000. ABC records the following entry as of the date of declaration to record the change in value of the assets, as well as the liability to pay the dividends:

	Debit	Credit
Long-term investments – artwork	3,500,000	
Gain on appreciation of artwork		3,500,000

	Debit	Credit
Retained earnings	4,000,000	
Dividends payable		4,000,000

- On the dividend payment date, ABC records the following entry to record the payment transaction :

	Debit	Credit
Dividends payable	4,000,000	
Long-term investments – artwork		4,000,000

- **Scrip Dividend Example**

  ABC International declares a $250,000 scrip dividend to its shareholders that has a 10 percent interest rate. At the dividend declaration date, it records the following entry :

	Debit	Credit
Retained earnings	250,000	
Notes payable		250,000

- The date of payment is one year later, so that ABC has accrued $25,000 in interest expense on the notes payable. On the payment date (assuming no prior accrual of the interest expense), ABC records the payment transaction with this entry :

	Debit	Credit
Notes payable	250,000	
Interest expense	25,000	
Cash		275,000

Liquidating Dividend Example

- ABC International's board of directors declares a liquidating dividend of $1,600,000. It records the dividend declaration with this entry:

	Debit	Credit
Additional paid-in capital	1,600,000	
Dividends payable		1,600,000

- On the dividend payment date, ABC records the following entry to record the payment transaction :

	Debit	Credit
Dividends payable	1,600,000	
Cash		1,600,000

17.5 TYPES OF DIVIDEND POLICY

Since, management of earnings means allocation of earnings among dividends and plough of profits. The term 'dividend' refers to that portion of company's net earnings that is paid out to the equity shareholders (not for preference shareholders, since they are entitled to have a fixed rate of dividend). Dividend policy of a firm decides the portion of earnings is to be paid as dividends to ordinary shareholders and the portion that is ploughed back in the firm for investment purpose. The total net earnings of equity may be paid as dividends (100% dividend payout ratio), which may consequently result in slower growth and lower market price or a part of net earnings may be paid as dividends, higher capital gains and higher market price. When a company uses a part of its net earnings for dividend payments then, the remaining

earnings are retained. Thus, there is an inverse relationship between retained earnings and payment of cash dividend-the larger the cash dividends and lesser the retention, smaller the cash dividends and larger retentions. Hence, the alternative use of net earnings or net profit dividends and retained earnings are competitive and conflicting.

Dividend decision affects the value of the firm. The cash available for the payment of dividends is affected by the firm's investment decision, and financing decision. A decision, which is related to investment leads to less cash available for payment of dividends. Thus, there is a relation between investment decision and financing decision. Distribution of net earnings between dividends and retention would obviously affect owners' wealth. Now the company is in dilemma which alternative is consistent to maximise shareholders wealth. The firm has to pay dividends to shareholders if dividends lead to the maximisation of wealth for them, otherwise the company should retain them for financing profitable investment opportunities.

Pay Out Ratio

The payout ratio is a financial metric showing the proportion of earnings a company pays to shareholders in the form of dividends, expressed as a percentage of the company's total earnings. On some occasions, the payout ratio refers to the dividends paid out as a percentage of a company's cash flow. The payout ratio is also known as the dividend payout ratio. Every company pays a portion of its earnings to its shareholders in the form of dividends. This percentage of a company's earnings or cash flow that goes out to shareholders is denoted by the payout ratio.

Types of Dividend Policies

The firm's dividend policy is formulated with two basic objectives in mind – providing for sufficient financing and maximizing the wealth of the firm's shareholders. Three of the more commonly used dividend policies are:

1. Payout Ratio Dividend Policy
2. Regular Dividend Policy
3. Low Regular and Extra-dividend Policy

17.5.1 Payout Ratio Dividend Policy

The dividend payout ratio is the ratio of the total amount of dividends paid out to shareholders relative to the net income of the company. It is the percentage of earnings paid to shareholders in dividends. The amount that is not paid to shareholders is retained by the company to pay off debt or to reinvest in core operations. It is sometimes simply referred to as the 'payout ratio.'

The dividend payout ratio provides an indication of how much money a company is returning to shareholders versus how much it is keeping on hand to reinvest in growth, pay off debt, or add to cash reserves (retained earnings). The dividend payout ratio is the proportion of earnings paid out as dividends to shareholders, typically expressed as a percentage. Some companies pay out all their earnings to shareholders, while some only pay out a portion of their earnings. If a company pays out some of its earnings as dividends, the remaining portion is retained by the business. To measure the level of earnings retained, the retention ratio is calculated.

Several considerations go into interpreting the dividend payout ratio, most importantly the company's level of maturity. A new, growth-oriented company that aims to expand, develop new products, and move into new markets would be expected to reinvest most or all of its earnings and could be forgiven for having a low or even zero payout ratio. Several considerations go into interpreting the dividend payout ratio, most importantly the company's level of maturity. A new, growth-oriented company that aims to expand, develop new products, and move into new markets would be expected to reinvest most or all of its earnings and could be forgiven for having a low or even zero payout ratio. The payout ratio is 0% for companies that do not pay dividends and is 100% for companies that pay out their entire net income as dividends.

On the other hand, an older, established company that returns a pittance to shareholders would test investors' patience and could tempt activists to intervene. In 2012 and after nearly twenty years since its last paid dividend, Apple (AAPL) began

to pay a dividend when the new CEO felt the company's enormous cash flow made a 0% payout ratio difficult to justify. Since it implies that a company has moved past its initial growth stage, a high payout ratio means share prices are unlikely to appreciate rapidly. The payout ratio is also useful for assessing a dividend's sustainability. Companies are extremely reluctant to cut dividends since it can drive the stock price down and reflect poorly on management's abilities. If a company's payout ratio is over 100%, it is returning more money to shareholders than it is earning and will probably be forced to lower the dividend or stop paying it altogether. That result is not inevitable, however. A company endures a bad year without suspending payouts, and it is often in their interest to do so. It is therefore important to consider future earnings expectations and calculate a forward-looking payout ratio to contextualize the backward-looking one. Long-term trends in the payout ratio also matter. A steadily rising ratio could indicate a healthy, maturing business, but a spiking one could mean the dividend is heading into unsustainable territory. The retention ratio is a converse concept to the dividend payout ratio. The dividend payout ratio evaluates the percentage of profits earned that a company pays out to its shareholders, while the retention ratio represents the percentage of profits earned that are retained by or reinvested in the company.

17.5.2 Fixed Dividend Policy

The term stability of dividend means consistency or lack of variability in the stream of dividend payments, even though the amount of dividend may fluctuate from year to year. A business with a fixed dividend policy pays out a steady dividend every given period, regardless of the volatility in the market. The exact amount of dividends that are paid out depends on the long-term earnings of the company. The dividend's growth is in line with the company's long-term earnings. Under a stable dividend policy, it is common for companies to distribute dividends every quarter, with the payout in line with the quarterly earnings of the company. However, it can also be paid out annually or semi-annually. The stable dividend policy is one of the most popular policies because the company's volatility is not reflected in the dividend payout.

Shareholders can be certain that they will receive a dividend payment at least once a year.

A dividend is a reward that a company gives to its shareholders for investing in the company. The dividends can be distributed in many different ways, such as cash payment or through stock shares. The board of directors of a company decides how much of a dividend to give out and how to time the redistribution of profits. One of the most important decisions made by the shareholders in the company is the dividend policy they need to follow. At the highest level, a company faces two decisions: retain profits or distribute them to the shareholders. Sometimes, the company may choose to retain the profits in the company for a variety of reasons, such as potential investment opportunities for the company, future earnings, flotation costs, tax liabilities, or other considerations that restrict the company from paying out a dividend. After the company makes a decision on what they should do with the profits, the next step is to create the dividend policy. The dividend policy acts as a tool for the company to attract investors and receive preferential treatment in the financial markets. The investors' preferences also play a key role in deciding the type of dividend policy to use. The tax policy of the country also determines if the shareholder would want to receive the stock in cash or as stock repurchase options.

Implementation of the Stable Dividend Policy

The payout ratio is a financial metric showing the proportion of earnings a company pays shareholders in the form of dividends, expressed as a percentage of the company's total earnings. On some occasions, the payout ratio refers to the dividends paid out as a percentage of a company's cash flow. The payout ratio is also known as the dividend payout ratio. Every company pays a portion of its earnings to its shareholders in the form of dividends. This percentage of a company's earnings or cash flow that goes out to shareholders is denoted by the payout ratio.

1. Constant payout ratio

This is when a certain specified percentage of the company's earnings is distributed to shareholders as dividends. Many companies prefer the constant

payout policy as it makes it easier for management to decide how much of the earnings should be retained.

2. Constant dividend per share

The company distributes a fixed amount of cash dividends. It creates a reserve that allows them to pay a fixed dividend even when earnings are low or there are losses. The constant dividend policy is more suited for companies whose earnings remain stable over a number of years.

3. Combination of the two policies

Under a combination of the policies, the company distributes a fixed amount of regular dividend in addition to an extra dividend that is paid in line with its earnings. The combination policy allows the management to be flexible and is a good option for companies whose earnings constantly fluctuate.

4. Stable Dividend Policy and Target Payout Ratio

The stable dividend policy can also be defined by the target payout ratio. The target payout ratio represents the percentage of earnings that the company chooses to distribute to shareholders in the long term. As per the model, the earnings of the company are expected to rise if the dividend payout ratio is below the target dividend payout ratio. An investor can calculate the estimated future dividend as follows:

Expected Future Dividend = Current Dividend + (Expected Increase in EPS x Target Payout Ratio x Adjustment Factor)

The company decides to pay a certain amount of dividend every year, consistently, whether more or less. Some investors may be more interested in a source of income for today rather than capital appreciation. This serves as an assurance to those investors who depend on dividend as a source of income.

The stability of dividend policy is helpful to the shareholders and the company in the following ways:

i. Confidence among shareholders- Payment of regular and stable dividend may help in building confidence in the minds of investors regarding regularity of dividends.

ii. Investors' desire for current income- There are many investors like retired persons, salaried people, and other fixed income group may prefer to receive income regularly to meet their living expenses. Such investors prefer a company with stable dividend policy.

iii. Institutional investors- Investments are made not only by individuals but also by institutions. Normally the institutional investors prefer to invest in shares of those companies, which pay dividends regularly.

iv. Stability in market price of shares- Stable dividend policy may also help a company in maintaining stability in the market price of its shares.

v. Rising additional finance- A stable dividend policy is also advantageous to company in rising external finance.

vi. Spreading of ownership of outstanding share- Stable dividend policy may also help in spreading the ownership of shares more widely among small investors.

vii. Reduces the chances of Loss of control- Because of the spreading of ownership for outstanding shares among the large number of small investors the chances of Loss of control by the present management over the company are reduced.

viii. Market for debentures and preferences shares- A stable dividend policy also helps the company in marketing of outstanding shares and debentures

17.5.3 Low Regular and Extra Dividend Policy

Some firms have the policy of low regular and extra dividend, meaning the firms keep the regular earnings as low as possible which is supplemented by additional dividend when earnings are higher than normal in a given period. By terming the

additional dividend as extra dividend, the firms avoid giving shareholders false hopes. This policy is especially common among companies that experience cyclical shifts in earnings

17.6 SUMMARY

The dividend is one of the important ways in which the companies communicate the financial health and the shareholder value. Through a distribution from their earnings, companies indicate a positive future and a strong performance. The ability and the willingness of a company to pay stable dividends over a good period of time and even increase them steadily gives a good picture about the fundamentals of the company. Dividend policies are one of the important decisions taken by the company. Several factors affect the payout policy of the company, which includes various types of dividends model as well as repurchasing shares. Dividend policies can be framed as per the requirements of the companies. Shares repurchases are becoming more relevant and common in the recent times. Dividend policy of a company is the strategy followed to decide the amount of dividends and the timing of the payments. There are various factors that frame a dividend policy of the company. Availability of better investment opportunities, estimated volatility of future earnings, tax considerations, financial flexibility, flotation costs, and various other legal restrictions affect a company's dividend policy

17.7 GLOSSARY

- **Capital Formation:** Capital formation has in more recent times been used in financial economics to refer to savings drives, setting up financial institutions, fiscal measures, public borrowing, development of capital markets, privatization of financial institutions, and development of secondary markets. In this usage, it refers to any method for increasing the amount of capital owned or under one's control, or any method in utilising or mobilising capital resources for investment purposes.

- **Dividend:** The term dividend refers to that part of profits of a company which is distributed by the company among its shareholders. It is the reward of the shareholders for investments made by them in the shares of the company. The investors are interested in earning maximum return to maximize their wealth.
- **Profitability:** Profitability is the primary goal of all business ventures. Without profitability the business will not survive in the long run. So measuring current and past profitability and projecting future profitability is very important. Profitability is measured with income and expenses. Income is money generated from the activities of the business

17.8 SELF ASSESSMENT QUESTIONS

1. What is dividend? What are the features of dividend ?

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2. Discuss the types of dividend.

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17.9 LESSON END EXERCISE

1. Describe the different types of dividend policy.

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17.10 SUGGESTED READINGS

- Pandey, I. M., Financial Management, Vikas Publishing House, New Delhi.
- Gupta and Sharma, Management Accounting-Kalyani Publishers
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- Babu, G. Ramesh (2005), "Indian Financial System", 1st Edition, Himalayan Publishing House, Mumbai.
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- Hampton, John, Financial Decision Making, Pentice Hall, New Delhi.

UNIT -1V

MANAGEMENT OF SURPLUS AND DIVIDEND POLICIES:

LESSON No. 18

Models of Dividend: Walter Model and Gordon Model

Structure:

18.1 Introduction

18.2 Objectives

18.3 Advantages of Paying Dividends

18.4 Disadvantages of Paying Dividends

18.5 Dividend Policy

18.6 Models of Dividend Decisions

18.6.1 Walter's Model

18.6.2 Gordon's Model

18.7 Summary

18.8 Glossary

18.9 Self Assessment Questions

18.10 Lesson End Exercise

18.11 Suggested Readings

18.1 INTRODUCTION

Dividend refers to a reward, cash or otherwise, that a company gives to its shareholders. Dividends can be issued in various forms, such as cash payment, stocks or any other form. A company's dividend is decided by its board of directors and it requires the shareholders' approval. However, it is not obligatory for a company to pay dividend. Dividend is usually a part of the profit that the company shares with its shareholders.

After paying its creditors, a company can use part or whole of the residual profits to reward its shareholders as dividends. However, when firms face cash shortage or when it needs cash for reinvestments, it can also skip paying dividends. When a company announces dividend, it also fixes a record date and all shareholders who are registered as of that date become eligible to get dividend payout in proportion to their shareholding. The company usually mails the cheques to shareholders within in a week or so. Stocks are normally bought or sold with dividend until two business days ahead of the record date and then they turn ex-dividend. Dividend-paying firms in India fell from 24 per cent in 2001 to almost 16 per cent in 2009 before rising to 19 percent in 2010.

In the US, some of the companies like Sun Microsystems, Cisco and Oracle do not pay dividends and reinvest their total profit in the business itself. Dividend payment usually does not affect the fundamental value of a company's share price. Companies with high growth rate and at an early stage of their ventures rarely pay dividends as they prefer to reinvest most of their profit to help sustain the higher growth and expansion. On the other hand, established companies try to offer regular dividends to reward loyal investors.

18.2 OBJECTIVES

After going through this lesson, you should be able to:

- Give explanation of dividend policy

- List out the advantages and disadvantages of paying dividends
- Understand the theories of Dividend decisions
- Be familiar with the Walter's and Gordon's Model

18.3 ADVANTAGES OF PAYING DIVIDENDS

Paying dividends to investors has several advantages, both for the investors and the company:

The advantages of paying dividends are discussed as under:

- **Investor Preference For Dividends**

  The investors are more interested in a company that pays stable dividends. This assures them of a reliable source of earnings, even if the market price of the share dips.

- **Bird-In-Hand Fallacy**

  This theory states that the shareholders prefer the certainty of dividends in comparison to the possibility of higher capital gains in future.

- **Stability**

  Investors prefer companies that have a track record of paying dividends as it reflects positively on its stability. This indicates predictable earnings to investors and thus, makes the company a good investment.

- **Benefits Without Selling**

  Investors invested in dividend-paying stocks do not have to sell their shares to participate in the growth of the stock. They reap the monetary benefits without selling the stock.

- **Temporary Excess Cash**

  A mature company may not have attractive avenues to reinvest the cash or may have fewer expenses related to R&D and expansion. In such a scenario, investors prefer that a company distributes the excess cash so that they can reinvest the money for higher returns somewhere else.

- **Information Signalling**

  When a company announces the dividend payments, it gives a strong signal about the future prospects of the company. Companies can also take advantage of the additional publicity they get during this time.

18.4 DISADVANTAGES OF PAYING DIVIDENDS

Paying dividends also has several disadvantages. The disadvantages of paying dividends are discussed as under :

- **Clientele Effect**

  If a dividend-paying company is unable to pay dividends for a certain period of time, it may result in loss of old clientele who preferred regular dividends. These investors may sell-off the stock in short term.

- **Decreased Retained Earnings**

  When a company pays dividends, it decreases its retained earnings. Debt obligations and unexpected expenses can rise if the company does not have enough cash.

- **Limits Company's Growth Paying Dividends Results in**

  Paying dividends result in the reduction of usable cash which may limit the company's growth. The company will have less money to invest in the business growth.

- **Logistics**

  The payment of dividends requires a lot of record-keeping at the company's end. The company has to ensure that the right owner of the share receives the dividend.

  Since dividends are important for keeping the investors happy, a company should decide upon the time and the form of dividends diligently. It should also keep in the mind the advantages and the disadvantages of the dividends before framing a dividend policy.

18.5 DIVIDEND POLICY

Dividend policy is an important element in financial management. This policy is associated with financial policies about paying cash dividend in the present or paying an increased dividend at a later stage. The term dividend denotes to that portion of profit which is distributed among the proprietors/shareholders of the firm. Whether to issue dividends, and what amount, is determined primarily on the basis of the company's unappropriated profit (excess cash) and influenced by the company's long-term generating revenues.

The word 'dividend' is derived from the Latin word "Dividendum" which means "that which is to be divided". This distribution is made out of the profits remained after deducting all expenses, providing for taxation, and shifting reasonable amount to reserve from the total income of the company. Institute of Chartered Accountants of India defined dividend as "a distribution to shareholders out of profits or reserves available for this purpose"

A company cannot announce dividend unless there is:

- Sufficient profits
- Board of Directors recommendation
- An acceptance of the shareholders in the annual general meeting.

The term dividend policy denotes to the policy regarding quantum of profits to be distributed as dividend. The concept of dividend policy implies that companies through their Board of Directors evolve a pattern of dividend payments, which has a bearing on future action. According to **Weston and Brigham**, "Dividend policy determines the division of earnings between payments to shareholders and retained earning". **Gitman** stated that "The firm's dividend policy represents a plan of action to be followed whenever the dividend decision must be made. The dividend policy of any company governs the amount of earnings is paid to shareholders by way of dividends and what proportion is ploughed back in the firm for reinvestment purposes. If a firm's capital budgeting decision is independent of its dividend policy, a higher dividend payment will call for a greater dependence on external financing. Consequently, the dividend policy has a bearing on the choice of financing. From other perspective, firm's capital budgeting decision is dependent on its dividend decision; a higher dividend payment will cause reduction of its capital budget and vice versa. In such case, the dividend policy has a bearing on the capital budgeting decision. The dividends are decided by the firm's board of directors and paid to the shareholders who are registered on the "record date".

18.6 MODELS OF DIVIDEND DECISIONS

Dividend is that portion of net profits which is distributed among the shareholders. The dividend decision of the firm is of crucial importance for the finance manager since it determines the amount to be distributed among shareholders and the amount of profit to be retained in the business. Retained earnings are very important for the growth of the firm. Shareholders may also expect the company to pay more dividends. So both the growth of company and higher dividend distribution are in conflict. So the dividend decision has to be taken in the light of wealth maximisation objective. This requires a very good balance between dividends and retention of earnings.

A financial manager may treat the dividend decision in the following two ways :

1) **As a long term financing decision:-** When dividend is treated as a source of finance, the firm will pay dividend only when it does not have profitable investment opportunities. But the firm can also pay dividends and raise an equal amount by the issue of shares. But this does not make any sense.

2) **As a wealth maximisation decision:-** Payment of current dividend has a positive impact on the share price. So to maximise the price per share, the firm must pay more and more dividends.

Dividend and Valuation

There are conflicting opinions as far as the impact of dividend decision on the value of the firm. According to one school of thought, dividends are relevant to the valuation of the firm. Others opine that dividends does not affect the value of the firm and market price per share of the company.

Relevant Theory

If the choice of the dividend policy affects the value of a firm, it is considered as relevant. In that case a change in the dividend payout ratio will be followed by a change in the market value of the firm. If the dividend is relevant, there must be an optimum payout ratio. Optimum payout ratio is that ratio which gives highest market value per share. According to this concept, dividend policy is considered as it affects the value of the firm. Dividend relevance implies that shareholders prefer current dividend and there is no direct relationship between dividend policy and value of the firm. Relevance of dividend concept is supported by two eminent persons like **Walter and Gordon.**

18.6.1 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 maximise the wealth of shareholders. The

investment policy of a firm cannot be separated from its dividend policy and both are, according to Walter, interlinked. The choice of an appropriate dividend policy affects the value of an enterprise.

That is, in other words, an optimum dividend policy will have to be determined by the relationship of r and k. In short, a firm should retain its earnings if the return on investment exceeds the cost of capital and in the opposite case, it should distribute its earnings to the shareholders.

His proposition may be summed up as under:

(a) When r > k (Growth Firms):

When $r > k$, it implies that a firm has adequate profitable investment oppor-tunities, i.e., it can earn more what the investors expect. They are called growth firms. The optimum dividend policy, in case of those firms, may be given by a D/P ratio (Dividend pay-out ratio) of 0. It means a firm should retain its entire earnings within itself and as such, the market value of the share will be maximised.

(b) When r<k (Declining Firms):

On the contrary, when $r<k$, it indicates that a firm does not have profitable investment opportunities to invest their earnings. They are known as declining firms. In this case, rate of return from new investment (r) is less than the required rate of return or cost of capital (k), and as such, retention is not at all profitable.

The investors will be better-off if earnings are paid to them by way of dividend and they will earn a higher rate of return by investing such amounts elsewhere. In that case, the market price of a share will be maximised by the payment of the entire earnings by way of dividends amongst the investors. There will be an optimum dividend policy when D/P ratio is 100%.

(c) When r = k (Normal Firms)

If r = k, it means there is no one optimum dividend policy and it is not a matter whether earnings are distributed or retained due to the fact that all D/P ratios, ranging from 0 to 100, the market price of shares will remain constant.

In other words, when the profitable investment opportunities are not available, the return from investment (r) is equal to the cost of capital (k), i.e., when r = k, the dividend policy does not affect the market price of a share.

Assumptions:

Walter's model is based on the following assumptions:

(i) All financing through retained earnings is done by the firm, i.e., external sources of funds, like, debt or new equity capital is not being used;

(ii) It assumes that the internal rate of return (r) and cost of capital (k) are constant;

(iii) It assumes that key variables do not change, viz., beginning earnings per share, E, and dividend per share, D, may be changed in the model in order to determine results, but any given value of E and D are assumed to remain constant in determining a given value;

(iv) All earnings are either re-invested internally immediately or distributed by way of dividends;

(v) The firm has perpetual or very long life.

Professor Walter has evolved a mathematical formula in order to arrive at the appropriate dividend decision to determine the market price of a share which is reproduced as under:

where, P = Market price per share;

D = Dividend per share;

E = Earning per share;

r = Internal rate of return;

k = Cost of capital or capitalization rate.

In this proposition it is evident that the optimal D/P ratio is determined by varying 'D' until and unless one receives the maximum market price per share Criticisms:

Walter's model has been criticized on the following grounds since some of its assumptions are unrealistic in real world situation:

They are:

(i) Walter assumes that all investments are financed only be retained earnings and not by external financing which is seldom true in real world situation and which ignores the benefits of optimum capital structure. Not only that, even when a firm reaches the optimum capital structure level, the same should also be maintained in future. In this context, it can be concluded that Walter's model is applicable only in limited cases.

(ii) Walter also assumes that the internal rate of return (r) of a firm will remain constant which also stands against real world situation. Because, when more invest-ment proposals are taken, r also generally declines.

(iii) Finally, this model also assumes that the cost of capital, k, remains constant which also does not hold good in real world situation. Because if the risk pattern of a firm changes there is a corresponding change in cost of capital, k, also. Thus, Walter's model ignores the effect of risk on the value of the firm by assuming that the cost of capital is constant.

18.6.2 GORDON'S MODEL:

Another theory on relevance of dividend has been developed by Myron Gordon. Gordon's model is based on the following assumptions:

(i) The firm is an all-equity firm;

(ii) No external financing is available or used. Only retained earnings are used to finance the investment programmes;

(iii) The internal rate of return, r, and the capitalization rate or cost of capital, k, is constant;

(iv) The firm has perpetual or long life;

(v) Corporate taxes do not exist;

(vi) The retention ratio, b, once decided upon is constant. Thus the growth rate, $g = br$, is also constant;

(vii) $k > br = g$.

According to Gordon's model, the market value of a share is equal to the present value of an infinite future stream of dividends.

Thus,

Gordon clearly states the relationship between internal rate of return, r, and the cost of capital, k. He also contends that dividend policy depends on the profitable investment opportunities.

However, his proposition may be summed up as under:

(a) When $r > k$ (Growth Firms):

When $r > A$, the value per share P increases since the retention ratio, b, increases, i.e., P increases with decrease in dividend pay-out ratio. In short, under this condition, the firm should distribute smaller dividends and should retain higher earnings.

(b) When $r < k$ (Declining Firms):

When $r < k$, the value per share P decreases since the retention ratio b, increases, i.e., P increases with increase in dividend pay-out ratio. It can be proved that the value of b increases, the value of the share continuously falls.

If the internal rate of return is smaller than k, which is equal to the rate available in the market, profit retention clearly becomes undesirable from the shareholders' viewpoint. Each additional rupee retained reduces the amount of funds that shareholders could invest at a higher rate elsewhere and thus it further reduces the value of the company's share.

(c) When $r = k$ (Normal Firms):

When $r = k$, the value of the firm is not affected by dividend policy and is equal to the book value of assets, i.e., when $r = k$, dividend policy is irrelevant.

It implies that under competitive conditions, k must be equal to the rate of return, r, available to investors in comparable shares in such a manner that any funds distributed as dividends may be invested in the market at the rate which is equal to the internal rate of return of the firm.

Consequently, shareholders can neither lose nor gain by any change in the company's dividend policy and the market value of the shares must remain unchanged.

Dividend and Uncertainty:

It has already been explained while defining Gordon's model that when all the assumptions are present and when $r = k$, the dividend policy is irrelevant.

If assump-tions are modified in order to conform with practical utility, Gordon assumes that even when r = k, dividend policy affects the value of shares which is based on the assumption that under conditions of uncertainty, investors tend to discount distant dividends at a higher rate than they discount near dividends.

That is, there is a twofold assumption, viz:

(a) investors are risk-averse, and

(b) they put a premium on certain return while discount uncertain returns.

Because, the investors are rational and are risk averse, as such, they prefer near dividends than future dividends. This argument is described as a bird-in-the-hand argument which was put forward by Krishnan in the following words.

"Of two stocks with identical earnings, record, prospectus, but the one paying a larger dividend than the other, the former will undoubtedly command a higher price merely because stockholders prefer present to future values.

Myopic vision plays a part in the price-making process. Stockholders often act upon the principle that a bird in the hand is worth than .two in the bushes and for this reason are willing to pay a premium for the stock with the higher dividend rate, just as they discount the one with the lower rate."

In short, a bird in the hand is better than two in the bushes oh the ground that what is available in hand (at present) is preferable to what will be available in future. On the basis of this argument, Gordon reveals that the future is no doubt uncertain and as such, the more distant the future the more uncertain it will be.

Thus, if dividend policy is considered in the context of uncertainty, the cost of capital (discount rate) cannot be assumed to be constant, i.e., it will increase with uncertainty.

Since investors prefer to avoid uncertainty and they are willing to pay higher price for the share which pays higher current dividend (all other things being constant), the appropriate discount rate will be increased with the retention rate .

Therefore, distant dividends will be discounted at a higher rate than the near dividends. The above argument (i.e., the investors prefer for current dividends to future dividends) is not even free from certain criticisms.

That is, this may not be proved to be true in all cases due to low capital gains tax, particularly applicable to the investors who are in high-tax brackets, i.e., they may have a preference for capital gains (which is caused by high retention) than the current dividends so available.

18.7 SUMMARY

Some of the major different theories of dividend in financial management are as follows: Walter's model, Gordon's model and Modigliani and Miller's hypothesis. On the relationship between dividend and the value of the firm, different theories have been advanced. Professor James E. Walterargues 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 maximise the wealth of shareholders. Walter's model is quite useful to show the effects of dividend policy on an all equity firm under different assumptions about the rate of return. However, the simplified nature of the model can lead to conclusions which are net true in general, though true for Walter's model. One very popular model explicitly relating the market value of the firm to dividend policy is developed by Myron Gordon. 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.

18.8 GLOSSARY

- **Payout Ratio:** The ratio of dividend to earnings is known as payout ratio.
- **Profit:** It is the excess of the revenue over the expenses on conducting the operations.
- **Dividend Policy:** It decides the portion of earnings to be paid as dividends to ordinary shareholders and what portion is ploughed back in the firm for investment purpose.

18.9 SELF ASSESSMENT QUESTIONS

1. What is Dividend Policy? What are the advantages and disadvantages of paying dividends ?

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2. Discuss the main assumptions of Gordon's Models of Dividend decisions ?

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18.10 LESSON END EXERCISE

1. What are the major problems of Walter's model of dividend decisions?

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2. Explain in detail two models for relevance of dividend concept which is supported by two eminent persons like Walter and Gordon.

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18.11 SUGGESTED READINGS

- Pandey, I. M., Financial Management, Vikas Publishing House, New Delhi.
- Gupta and Sharma, Management Accounting-Kalyani Publishers
- Guthmann and Dougall, Corporate Financial Policy, Pentice Hall.
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UNIT -1V

MANAGEMENT OF SURPLUS AND DIVIDEND POLICIES:

LESSON No. 19

Models of Dividend: MM Hypothesis of Irrelevance of Dividend

Structure :

19.1 Introduction

19.2 Objectives

19.3 Modigliani and Miller (MM) Model / Irrelevance of Dividend

19.3.1 Assumptions of Modigliani and Miller's hypothesis

19.3.2 Criticism of Modigliani and Miller's hypothesis

19.4 Summary

19.5 Glossary

19.6 Self Assessment Questions

19.7 Lesson End Exercise

19.8 Suggested Readings

19.1 INTRODUCTION

Portion of profits of the company allocated to holders of shares in the company in the form of return on investment to shareholders or dividend includes any interim dividend. Maintaining the capital intact and taking out the surplus of current period's receipts over expenses. Dividend policy denotes to the decision of the board concerning distribution of residual earnings to its shareholders. The main objective of a finance manager is to maximize the wealth of the shareholders. Payment of dividend leads to increase in the price of shares on the one hand but leads to a crux in liquid resources for financing of prospective projects. There is an inverse relationship between dividend payment and retained earnings. On the basis of relationship between dividend and the value of the firm, different theories have been advanced. Some of the major different theories of dividend in financial management are Walter's model, Gordon's model and Modigliani and Miller's hypothesis.

19.2 OBJECTIVES

After going through this lesson, you should be able to:

- Describe the concept and definitions of Dividend Policy
- Understand the assumptions of Modigliani and Miller's hypothesis
- Be familiar with the relevance of Modigliani and Miller's hypothesis
- Comprehend the criticism of Modigliani and Miller's hypothesis

19.3 MODIGLIANI AND MILLER (MM) MODEL / IRRELEVANCE OF DIVIDEND

Modigliani – Miller theory is a major proponent of 'Dividend Irrelevance' notion. According to this concept, investors do not pay any importance to the dividend history of a company and thus, dividends are irrelevant in calculating the valuation of a company. This theory is in direct contrast to the 'Dividend Relevance' theory which deems dividends to be important in the valuation of a company.

Modigliani – Miller theory was proposed by Franco Modigliani and Merton Miller in 1961. They were the pioneers in suggesting that dividends and capital gains are equivalent when an investor considers returns on investment. The only thing that impacts the valuation of a company is its earnings, which is a direct result of the company's investment policy and the future prospects. So, according to this theory, once the investment policy is known to the investor, he will not need any additional input on the dividend history of the company. The investment decision is, thus, dependent on the investment policy of the company and not on the dividend policy.

According to Modigliani and Miller (MM), 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. MM maintains that dividend policy has no effect on the share prices of the firm. What matters, according to them, is the investment policy through which the firm can increase its earnings and thereby the value of the firm given the investment decision of the firm, the dividend decision – splitting the earnings into packages of retentions and dividends – is a matter of detail and does not matter. Under conditions of perfect capital markets, rational investors, absence of tax discrimination between dividend income and capital appreciation, given the firm's investment policy, its dividend policy may have no influence on the market price of shares. 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.

19.3.1 Assumptions of Modigliani and Miller's hypothesis

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 = Kt 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

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 MM assumption since there are no risk differences.

From the above MM 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. Therefore, dividend and investment policies are not confounded in M – M model, like Walter's and Gordon's models.

19.3.2 Criticism of MM Hypothesis

It has already been stated in earlier paragraphs that MM hypothesis is actually based on some assumptions. Under these assumptions, no doubt, the conclusion which is derived is logically sound and consistent although they are not well-based.

For instance, the assumption of perfect capital market does not usually hold good in many countries. Since the assumptions are unrealistic in nature in real world situation, it lacks practical relevance which indicates that internal and external financing are not equivalent.

The shareholders/investors cannot be indifferent between dividends and capital gains as dividend policy itself affects their perceptions, which, in other words, proves that dividend policy is relevant.

As a result, MM hypothesis, is criticised on the following grounds:

(i) Tax Differential:

MM hypothesis assumes that taxes do not exist, in reality, it is impossible. On the contrary, the shareholders have to pay taxes on the dividend so received or on capital gains. We know that different tax rates are applicable to dividend and capital gains and tax rate on capital gains is comparatively low than the tax rate on dividend.

That is why, an investor should prefer the capital gains as against the dividend due to the fact that capital gains tax is comparatively less and such capital gains tax is payable only when the shares are actually sold in the market at a profit. In short, the cost of internal financing is cheaper as compared to cost of external financing. Thus, on account of tax advantages/differential, an investor will prefer a dividend policy with retention of earnings as compared to cash dividend.

(ii) Existence of Floatation Costs:

MM also assumes that both internal and external financing are equivalent. It indicates that if dividend is paid in cash, a firm is to raise external funds for its own investment opportunities. There will not be any difference in shareholders' wealth whether the firm retains its earnings or issues fresh shares provided there will not be any floatation cost.

But, in reality, floatation cost exists for issuing fresh shares, and there is no such cost if earnings are retained. As a result of the floatation cost, the external financing becomes costlier than internal financing. Therefore, if floatation costs are considered external and internal financing, i.e., fresh issue and retained earnings will never be equivalent.

(iii) Existence of Transaction Costs:

MM also assumes that whether the dividends are paid or not, the shareholders" wealth will be the same. When the dividends are not paid in cash to the

shareholder, he may desire current income and are as such, he can sell his shares.

When a shareholder sells his shares for the desire of his current income, there remain the transaction costs which are not considered by MM. Because, at the time of sale, a shareholder must have to incur some expenses by way of brokerage, commission, etc., which is again more for small sales. A shareholder will prefer dividends to capital gains in order to avoid the said difficulties and inconvenience.

(iii) Diversification:

MM considers that the discount rate should be the same whether a firm uses internal or external financing. But, practically, it does not so happen. If the shareholders desire to diversify their portfolios they would like to distribute earnings which they may be able to invest in such dividends in other firms. In such a case, shareholders/investors will be inclined to have a higher value of discount rate if internal financing is being used and vice-versa.

(v) Uncertainty:

According to MM hypothesis, dividend policy of a firm will be irrelevant even if uncertainty is considered. MM reveal that if the two firms have identical investment policies, business risks and expected future earnings, the market price of the two firms will be the same. This view is actually not accepted by some other authorities.

According to them, under conditions of uncertainty, dividends are relevant because, investors are risk-averters and as such, they prefer near dividends than future dividends since future dividends are discounted at a higher rate as dividends involve uncertainty. Thus, the value of the firm will be higher if dividend is paid earlier than when the firm follows a retention policy.

19.4 SUMMARY

According to MM, the dividend policy of a firm is irrelevant, as it does not affect the wealth of shareholders. The model which is based on certain assumptions, sidelined the importance of the dividend policy and its effect thereof on the share price of the firm. According to the theory the value of a firm depends solely on its earnings power resulting from the investment policy and not influenced by the manner in which its earnings are split between dividends and retained earnings. In other words, Modigliani and Miller approach states that the financing decision of a firm does not affect the market value of a firm in a perfect capital market. In other words, MM approach maintains that the average cost of capital does not change with change in the debt weighted equity mix or capital structures of the firm.

19.5 GLOSSARY

- **Flotation cost:** It is the total **cost** incurred by a company in offering its securities to the public. They arise from expenses such as underwriting fees, legal fees and registration fees.
- **Business risk:** It is the possibilities a company will have lower than anticipated profits or experience a loss rather than taking a profit. Business risk is influenced by numerous factors, like sales volume, per-unit price, input costs, competition, overall economic climate and government regulations.

19.6 SELF ASSESSMENT QUESTIONS

1. What are the assumptions of Modigliani and Miller's hypothesis?

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2. Explain the criticism of Modigliani and Miller's hypothesis.

19.7 LESSON END EXERCISE

1. Write a detailed note on Modigliani and Miller's model?

19.8 SUGGESTED READINGS

- Pandey, I. M., Financial Management, Vikas Publishing House, New Delhi.
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UNIT -1V

MANAGEMENT OF SURPLUS AND DIVIDEND POLICIES:

LESSON No. 20

Factors influencing Dividend Policy and Dividend Policy in Practice

Structure :

20.1 Introduction

20.2 Objectives

20.3 Factors Influencing dividend Policy of Company

20.4 Dividend Policy in Practice.

20.5 Summary

20.6 Glossary

20.7 Self Assessment Questions

20.8 Lesson End Exercise

20.9 Suggested Readings

20.1 INTRODUCTION

A company is raising funds from different sources, it includes debentures, preference shares and equity shares. Payment to debenture holders and to preference share holders are at a fixed rate. No commitment is made to equity share holders 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 is required to decide whether to pay dividend or not. If dividend is to be paid, then what amount to be paid is required to be decided. Again this decision will be taken in such a way so that it maximizes 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.

20.2 OBJECTIVES

After going through this lesson, you should be able to:

- Describe the meaning of dividend policy.
- Be familiar with factors affecting the divident policy decisions
- Understand the dividend policy in practice in India.

20.3 FACTORS INFLUENCING DIVIDEND POLICY OF A COMPANY

Following are the Factors Influencing Dividend Policy of a Company

1. Stability of Earnings:

Stability of earnings is one of the important factors influencing the dividend policy. If earnings are relatively stable, a firm is in a better position to predict what its future earnings will be and such companies are more likely to pay out a higher percentage of its earnings in dividends than a concern which has a fluctuating earnings. Generally, the concerns which deal in necessities suffer less from fluctuating incomes than those concern which deal with fancy or luxurious goods.

2. **Financing Policy of the Company:**

Dividend policy may be affected and influenced by financing policy of the company. If the company decides to meet its expenses from its earnings, then it will have to pay less dividend to shareholders. On the other hand, if the company feels, that outside borrowing is cheaper than internal financing, then it may decide to pay higher rate of dividend to its shareholder. Thus, the internal financing policy of the company influences the dividend policy of the business firm.

3. **Liquidity of Funds:**

The liquidity of funds is an important consideration in dividend decisions. According to Guthmann and Dougall, although it is customary to speak of paying dividends 'out of profits', a cash dividend only be paid from money in the bank. The presence of profit is an accounting phenomenon and a common legal requirement, with the cash and working capital position is also necessary in order to judge the ability of the corporation to pay a cash dividend.

Payment of dividend means, a cash outflow, and hence, the greater the cash position and liquidity of the firm is determined by the firm's investment and financing decisions. While the investment decisions determine the rate of asset expansion and the firm's needs for funds, the financing decisions determine the manner of financing.

4. **Dividend, Policy of Competitive Concerns:**

Another factor which influences, is the dividend policy of other competitive concerns in the market. If the other competing concerns, are paying higher rate of dividend than this concern, the shareholders may prefer to invest their money in those concerns rather than in this concern. Hence, every company will have to decide its dividend policy, by keeping in view the dividend policy of other competitive concerns in the market.

5. **Past Dividend Rates:**

If the firm is already existing, the dividend rate may be decided on the basis of dividends declared in the previous years. It is better for the concern to maintain stability in the rate of dividend and hence, generally the directors will have to keep in mind the rate of dividend declared in the past.

6. **Debt Obligation**

A firm which has incurred heavy indebtedness, is not in a position to pay higher dividends to shareholders. Earning retention is very important for such concerns which are following a programme of substantial debt reduction. On the other hand, if the company has no debt obligations, it can afford to pay higher rate of dividend.

7. **Ability to Borrow:**

Every company requires finance both for expansion programmes as well as for meeting unanticipated expenses. Hence, the companies have to borrow from the market, well established and large firms have better access to the capital market than new and small, firms and hence, they can pay higher rate of dividend. The new companies generally find it difficult to borrow from the market and hence they cannot afford to pay higher rate of dividend.

8. **Growth Needs of the Company:**

Another factor which influences the rate of dividend is the growth needs of the company. In case the company has already expanded considerably, it does not require funds for further expansions. On the other hand, if the company has expansion programmes, it would need more money for growth and development. Thus when money for expansion is not, needed, then it is easy for the company to declare higher rate of dividend.

9. Profit Rate:

Another important consideration for deciding the dividend is the profit rate of the firm. The internal profitability rate of the firm provides a basis for comparing the productivity of retained earnings to the alternative return which could be earned elsewhere. Thus, alternative investment opportunities also play an important role in dividend decisions.

10. Legal Requirements

While declaring dividend, the board of directors will have to consider the legal restriction. The Indian Companies Act, 1956, prescribes certain guidelines in respect of declaration and payment of dividends and they are to be strictly observed by the company for declaring dividends.

11. Policy of Control:

Policy of control is another important factor which influences dividend policy. If the company feels that no new shareholders should be added, then it will have to pay less dividends. Generally, it is felt, that new shareholders, can dilute the existing control of the management over the concern. Hence, if maintenance of existing control is an important consideration, the rate of dividend may be lower so that the company can meet its financial requirements from its retained earnings without issuing additional shares to the public.

12. Corporate Taxation Policy:

Corporate taxes affect the rate of dividends of the concern. High rates of taxation reduce the residual profits available for distribution to shareholders. Hence, the rate of dividend is affected. Further, in some circumstances, government puts dividend tax on distribution of dividends beyond a certain limit. This may also affect rate of dividend of the concern.

13. Tax Position of Shareholders:

The tax position of shareholders is another influencing factor on dividend decisions. In a company if a large number of shareholders have already high income from other sources and are bracketed in high income structure, they will not be interested in high dividends because the large part of the dividend income will go away by way of income tax. Hence, they prefer capital gains to cash gains, i.e., dividend capital gains here we mean capital benefit derived by the capitalisation of the reserves or issue of bonus share

Instead of receiving the dividend in the form of cash (whatever may be the per cent), the shareholders would like to get shares and increase their holding in the form of shares. This has certain benefits to shareholders. They get money by selling these extra shares received in proportion to their original shareholding.

This will be a capital gain for them. Of course, they have to pay tax on capital gains. But the capital gains tax will be less compared to the income-tax that they should have paid when cash dividend was declared and added to the personal income of the shareholders.

14. Effect of Trade Cycle:

Trade cycle also influences the dividend policy of the concern. For example, during the period of inflation, funds generated from depreciation may not be adequate to replace the assets. Consequently there is a need for retained earnings in order to preserve the earning power of the firm.

15. Attitude of the Interested Group:

A concern may have certain group of interested and powerful shareholders. These people have certain attitude towards payment of dividend and have a definite say in policy formulation regarding dividend payments. If they are not interested in higher rate of dividend, shareholders are not likely to get that.

On the other hand, if they are interested in higher rate of dividend, they will manage to make company declare higher rate of dividend even in the face of many odds

20.4 DIVIDEND POLICY IN PRACTICE

Some of the important dividend practices are: 1. A Fixed Rupee Amount of Dividend 2. Minimum Rupee amount with a step-up Feature 3. Fixed Percentage of Net Profit and 4. Dividends as a Fixed Percentage of Market Value.

1. A Fixed Rupee Amount of Dividend:

This policy emphasises the significance of regularity in dividends of a given size above everything else. Under this policy, there is no connection between dividends paid and current profits earned.

This policy tends to treat ordinary shareholders somewhat like preference shareholders and gives no particular consideration to the role played by the investment of retained earnings. The danger in using this policy is that if the dividend payments are too large and it takes a large portion of accumulated working capital, the company may not be able to withstand the shock of operating losses.

2. Minimum Rupee amount with a step-up Feature:

This policy is based on the proposal that the present shareholders want a regular rupee amount as dividend, however small it may be. But corporate profits are given more consideration in determining the dividends in this policy as compared to the policy mentioned above.

The small amount of the fixed dividend aims at reducing the chance of ever missing a dividend. This policy sets the dividend low enough so that there is little chance of a default but at the same time it allows a great deal of flexibility for paying higher dividends and does commit the business to adopt the larger

dividend may or may not be distributed depending on the capital growth plans of the management.

The emphasis is placed on internal financing and on establishing a broad foundation of equity capital for future borrowing. This is a popular policy for companies with fluctuating incomes because it provides managers with a policy guide without seriously restricting their freedom of decision-making.

Certain shareholders also like it because it allows them to plan on fixed amounts of cash and at the same time there is possibility of getting a reward by way of internal growth of their investment and possibly by higher market values for their shares when profits increase.

3. Fixed Percentage of Net Profit:

This is the most flexible dividend policy as it is related directly to net profits. Under this policy, dividends are a fixed percentage of profits which is called as the payout ratio and will fluctuate at exactly the same rate as profits. The first impulse may be to start a policy of this type because it is related to the ability to pay, measured by profits. But this policy leaves management with limited freedom for decision- making.

Internal financing with retained earnings becomes automatic and inverse to the payout ratio. For example, a 60% payout is a 40% pay in ratio and a 30% payout is a 70% pay in ratio. At any given payout ratio, the rupee amount of dividends and the rupee additions to retained earnings will both increase with the increasing rupee profits and decrease with decreasing rupee profits.

Policy requiring the distribution of dividend as a fixed percentage of net profits will provide a good amount of retained earnings in a profitable and growing business and make it easier to finance in the future as creditors and preference shareholders will be willing to extend funds on the prospect of an increase in equity.

But the picture will be different if the profits are declining. Therefore, it may be better in the interests of shareholders in the long run that corporate management increases the percentage of dividends when profits decline and decrease it as profits increase.

4. Dividends as a Fixed Percentage of Market Value:

As shareholders often translate their dividend income into the percentage returns of market price of their shares, financial managers, should relate dividends to the value of company's shares rather than to its profits. This requires first determining a typical rate of dividend return as a target rate.

The target may be the average dividend for the industry or it may be the rate paid by a closely competitive company. This policy singles out the market as the ideal valuation mechanism. No consideration is given here to the effect of dividends on internal investment conditions, or on prospects for future financing. It is based on the belief that management owned an obligation to the shareholders to adjust dividend payment with the rates paid by competitors and by the industry as a whole on their market investment value.

20.5 SUMMARY

The main consideration in determining the dividend policy is the objective of maximisation of wealth of shareholders. Thus, a firm should retain the earnings if it has profitable investment opportunities, giving a higher rate of return than the cost of retained earnings, otherwise it should pay them as dividends. It implies that a firm should treat retained earnings as the active decision variable, and the dividends as the passive residual.

In actual practice, however, we find that most firms determine the amount of dividends first, as an active decision variable, and the residue constitutes the retained earnings. In fact, there is no choice with the companies between paying dividends and not paying dividends Most of the companies believe that by following a stable dividend policy with a high pay-out ratio, they can maximise the market value of shares.

Moreover, the image of such companies is also improved in the market and the investors also favour such companies. The firms following this policy can, thus, successfully approach the market for raising additional funds for future expansion and growth, as and when required.

It has, therefore, been rightly said that theoretically, retained earnings should be treated as the active decision variable, and dividends as passive residual, but the practice does not conform to this in most cases.

It has been observed that the managements of Indian firms believe that dividend policy conveys information about the current and future prospects of the firm and thus affects its market value. They do consider the investor's preference for dividends and shareholder profile while designing the dividend policy. They also have a target dividend payout-ratio but want to pay stable dividends with growth.

20.6 GLOSSARY

- **Economy:** The state of a country or region in terms of the production and consumption of goods and services and the supply of money.
- **Shareholder:** A shareholder is an individual or institution that legally owns one or more shares of stock in a public or private corporation. Shareholders may be referred to as members of a corporation.

20.7 SELF ASSESSMENT QUESTIONS

1. What is dividend policy ?

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2. What are the factors affecting dividend policy ?

20.8 LESSON END EXERCISE

1. Write an essay on the dividend policy practicing in India ?

2. Why the dividend policy decisions are important for the company ?

20.9 SUGGESTED READINGS

- Pandey, I. M., Financial Management, Vikas Publishing House, New Delhi.
- Gupta and Sharma, Management Accounting-Kalyani Publishers
- Guthmann and Dougall, Corporate Financial Policy, Pentice Hall.
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- Desai, Vasant (2005), "The Indian Financial System and Development", 1st Edition, Himalayan Publishing House, Mumbai.
- Hampton, John, Financial Decision Making, Pentice Hall, New Delhi.