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SEMESTER- III ; Core Paper IV - FINANCIAL MANAGEMENT; Subject Code: 18BBA31C

UNIT-I

Finance Functions: Meaning ,Definition and Scope of finance – functions - Objectives of Financial Management - Profit Maximization and Wealth Maximization Source of Finance - Short term - Bank Sources - Long Term – Shares - Debentures, Preferred stock and Debt.

UNIT-II (Problem & Theory questions)

Financing decision: Cost of Capital - Cost of Specific Sources of capital - Equity Preferred stock - Debt - Reserves - Weighted Average Cost of Capital - Operating Leverage and Financial Leverage.

UNIT-III (Theory only)

Capital Structure - Factors influencing capital structure - Optimal Capital structure Dividend - Dividend policy: Meaning, Classification - Sources available for Dividends Dividend policy general, Determinants of dividend policy.

UNIT-IV (Theory only)Working capital management: Working capital management Concepts Importance - Determinants of Working capital Cash management: Motives for holding cash objectives and Strategies of Cash management - Receivables management: Objectives Cost of Credit Extension, Benefits - Credit policies - Credit terms Collection policies.

UNIT-V (Problems & Theory questions)

Capital budgeting: Meaning - objectives - Techniques of Capital budgeting - Pay back method - Net Present Value - Average Rate of Return - Internal Rate of Return. (Theory carries 80% and problem carries 20%)

Text Book:

R. K. Sharma & Shashi K Gupta - Financial Management, Kalyani Publishers

S.N. Maheswari - Management Accounting, Sultan Chand & sons, New Delhi
Reference Books:

Prasanna chandra - Financial Management, Tata McGraw-Hill Publishing Co.

Khan and Jain - Financial Management , Tata McGraw-Hill Publishing Co.

UNIT I

Subject Name	Subject Code	Semester	Prepared By
Financial Management	18BBA31C	III	Dr.K.Karthikai, Assistant Professor in BBA

IMPORTANCE OF FINANCE

Finance is regarded as the lifeblood of a business enterprise. This is because in the modern money-oriented economy finance is one of the basic foundations of all kinds of economic activities. It is the master key which provides access to all the sources for being employed in manufacturing and merchandising activities. It is said that business needs money to make more money. Hence, efficient management of every business enterprise is closely linked with efficient management of its finances.

MEANING OF BUSINESS FINANCE

In general, finance may be defined as the provision of money at the time it is wanted. However, as a management function .Finance function may be defined as the procurement of funds and their effective utilisation.

Definition

"Business finance is that business activity which is concerned with the acquisition and conservation of capital funds in meeting financial needs and overall objectives of a business enterprise."

"Business finance can broadly be defined as the activity concerned with planning, raising, controlling and administering of the funds tised in the business."

MEANING OF FINANCIAL MANAGEMENT

The business finance mainly involves raising of funds and their effective utilisation keeping in view the overall objectives of the firm. This requires great caution and wisdom on the part of management. The management makes use of various financial techniques, devices, etc., for administering the financial affairs of the firm in the most effective and efficient way.

According to Soloman, “Financial management is concerned with the efficient use of an important economic resource, namely, Capital Funds.” According to him “Financial management is concerned with the management decisions that result in the acquisition and financing of long-term and short-term credits for the firm. As such it deals with the situations that require selection of specific assets (or combination of liabilities) as well as the problem of size and growth of an enterprise. The analysis of these decisions is based on the expected inflows and outflows of funds and their effects upon managerial objectives.”

Thus, financial management is mainly concerned with the proper management of funds. The finance manager must see that the funds are procured in a manner that the risk, cost and control considerations are properly balanced in a given situation and there is optimum utilisation of funds.

OBJECTIVES OF FINANCIAL MANAGEMENT

The objectives of Financial Management can be put into two categories:
1. Basic objectives. 2. Other Objectives.

Basic Objectives

Traditionally the basic objectives of Financial Management have been (i)maintenance of liquid assets and (ii) maximisation of profitability of the firm, (iii) shareholders wealth maximisation rather than on profit maximisation.

Maintenance of Liquid Assets

Financial management aims at maintenance of adequate liquid assets with the firm to meet its obligations at all times. The investment in liquid assets has to be adequate-neither too low nor too excessive. The finance manager, has to maintain a balance between liquidity and profitability. There is an inverse relationship between the two. The more the assets are liquid, less they are profitable and vice versa.

Profit Maximisation

A business firm is a profit seeking organisation. Hence, profit maximisation is an important objective of financial management. However, the concept of profit maximisation has come under severe criticism, due to the following reasons:

It is Vague. It does not clarify which profits does it mean; whether short- term or long-term. Profits in the short-term may be quite different from those in the long-run.

It Ignores Timing. The concept of profit maximisation does not help in making a choice between projects giving different benefits spread over a period of time. The concept ignores the fact that a rupee recovered today is much more valuable than a rupee received tomorrow.

It Overlooks Quality Aspect of Future Activities. The business is not solely run with the objective of earning higher possible profits. Some firms place a high value on the growth of sales. They are willing to accept lower profits to gain stability provided by a large volume of sales. Other firms use a part of their profits to make contribution for socially productive purposes.

Maximisation of Wealth

Wealth maximisation is, considered to be the main objective of financial management. This objective is also consistent with the objective of maximising the economic welfare of the shareholders of a company. The value of a company's shares depends largely on its net worth which itself depends on earning per share (E.P.S.). The finance manager should, therefore, follow a policy which increases the earning per share in the long run.

Steps for Wealth Maximisation

In order to maximise wealth, a firm should take the following steps:

Avoid High Levels of Risks The firm should avoid such projects which involve high profits together with high risks. This is because accepting of such projects may be disastrous for the firm in the long run in case any factor goes wrong.

Pay Dividends Payment of regular dividends increases the firm's reputation and consequently the value of the firm's shares. While declaring dividends the market trends and the expectations of the shareholders must be kept in mind.

Maintain Growth in Sales The firm should have a large, stable and diversified volume of sales. This protects the firm from adverse consequences of recessions, changes in customers' preferences or fall in demand for the firm's products on account of other reasons. A firm should therefore consistently seek growth in sales by developing new markets, projects, etc.

Maintain Price of Firm's Equity Shares Maximisation of shareholders' wealth is closely connected with maximisation of the value of the firm's equity shares. The firm can take a number of steps to maintain the value of its equity shares at reasonable levels. For example, the management can encourage people to invest their savings in the firm's shares by explaining their actions. They can, by highlighting the firm's past performance and glorious future, create a new demand for firm's shares which will push up the value of its equity shares. Similarly adoption of sound investment policies will also considerably help in improving the image of the firm.

But the wealth maximisation objective cannot be carried too far. It is subject to certain **limitations.**

Social Responsibility The management cannot ignore its social responsibility, e.g., protecting the interest of the consumers, paying fair wages to workers, maintain proper working conditions, providing educational and physical facilities to their workers and involving themselves in environmental issues like clean air, water, etc. Some of the social actions are in the long run in the interests of the shareholders and may therefore be adopted. However,others. e.g., providing clean environment, may considerably reduce the firm's profitability and ultimately the shareholders' wealth.

Government Constraints On account of the growing concept of a welfare state, there are a number of statutory provisions which considerably reduce a firm's freedom to act. Restrictions imposed by the Government regarding establishment, expansion, closure, etc., of business firm may force the management to act in a manner which may not result in maximisation of shareholders' wealth.

In conclusion it can be said that a firm should follow the objective of wealth maximisation to the extent it is viable in the context of its social responsibility and constraints imposed by Government.

Other Objectives

Besides the above basic objectives, the following are the other objectives of financial management:

(i) Ensuring a fair return to shareholders.

(ii) Building up reserves for growth and expansion.

(iii) Ensuring maximum operational efficiency by efficient and effective utilisation of finances.

(iv) Ensuring financial discipline in the organisation.

FINANCE FUNCTION

Finance function is the most important of all business functions. It remains a focus of all activities. It is not possible to substitute or eliminate this function because the business will close down in the absence of finance. The need for money is continuous. It starts with the setting up of an enterprise and remains at all times. The development and expansion of business rather needs more commitment for funds. The funds will have to be raised from various sources. The sources will be selected in relation to the implications attached with them. The receiving of money is not enough, its utilisation is more important. The money once received will have to be returned also. If its use is proper then its return will be easy otherwise it will create difficulties for repayment. The management should have an idea of using the money profitably. It may be easy to raise funds but it may be difficult to repay them. The inflows and outflows of funds should be properly matched.

AIMS OF FINANCE FUNCTION

The aim of finance function is to arrange as much funds for the business as are required from time to time. This function has the following aims:

I**. Acquiring sufficient Funds.** The main aim of finance function is to the financial needs of an enterprise and then finding out suitable sources for raising them. The sources should match with the needs of the business| needed for longer periods then long term sources like share capital, debenture loans may be explored. A concern with longer gestation period should rely more on owner's funds instead of interest-bearing securities because profits may not be for some years.

2. **Proper Utilisation of Funds.** Though raising of funds is important but their effective utilisation is more important. The funds should be used in such a way maximum benefit is derived from it. The returns from their use should be more than their cost. It should be ensured that funds do not remain idle at any point of time. The funds committed to various operations should be effectively utilised. Those projects should be preferred which are beneficial to the business.

3. **Increasing Profitability**. The planning and control of finance function aims at increasing profitability of the concern. To increase profitability, sufficient funds will have to be invested. Finance function should be so planned that the concern neither suffers from inadequancy of funds nor wastes more funds than required. Finance function also requires matching of cost and returns from funds.

4. **Maximising Concern's Value**. Finance function also aims at maximising the value of the firm. It is generally said that a concern's value is linked with its profitability. Besides profits, the type of sources used for raising funds, the cost of funds, the condition of money market, the demand for products are some other considerations which also influence a firm's value.

SCOPE OR CONTENT OF FINANCE FUNCTION

The main objective of financial management is to arrange sufficient finances for meeting short-term and long-term needs. These funds are procured at minimum costs so that profitability of the business is maximised and hence the Financial Manager will have to concentrate on the following areas of finance function.

1. **Estimating Financial Requirements.** The first task of a financial manager is to estimate short-term and long-term financial requirements of his busisness. For this purpose, he will prepare a financial plan for present as well as for future. The amount required for purchasing fixed assets as well as needs of tunds for working capital will have to be ascertained. The estimations should be based on sound financial principles so that neither there are inadequate nor excess funds with the concern. The utilisation of lunds involves decision-making. So finance function covers financial planning, raising of funds, allocation of funds, financial control etc.

2. **Deciding Capital Structure**: "The Capital structure refers to the Kind and proportion of different securities for raising funds After deciding about the amount of funds, it has to be decided on which type of securities should be raised .It may be wise to finance fixed assets through long term debts. If gestation is longer, then share capital is most suitable. A decision about various sources for funds should be linked to the cost of raising funds. If cost of raising the funds as very high then such sources may not be useful for long.
3. **Selecting a Source of Finance**. After preparing a capital structure, an appropriate source of finance is selected. Various sources from which finance may be raised, include : share capital, debentures. Financial institutions, commercial banks, public deposits, etc. If finances

are needed for short periods then banks, public deposits and financial institutions may be appropriate ; on the other hand, if long-term finances are required then share capital and debentures may be useful. If management does not want to dilute ownership then debentures should be issued in preference to shares. The need, purpose, object and cost involved may be the factors influencing the selection of a suitable source of financing.

4. **Selecting a Pattern of Investment.** When funds have been procured then a decision about investment pattern is to be taken, the selection of an investment pattern is related to the use of funds. The funds will have to be spent first on fixed assets and then an appropriate portion will be retained for Working Capital. Even in various categories of assets, a decision about the type of fixed or other assets will be essential. While selecting a plant and machinery, even different categories of them may be available. The decision-making techniques such as Capital Budgeting, Opportunity Cost Analysis. etc. may be applied in making decisions about capital expenditures, While spending on various assets, the principles of safety, profitability and liquidity should not be ignored. A balance should be struck even in these principles.

5. **Proper Cash Management.** Cash management is also an important task of Finance Manager. He has to assess various cash needs at different times and then make arrangements for arranging cash. Cash may be required to (a) purchase raw materials, (b) make payments to creditors, (c) meet Wage bills (d) meet day-to-day expenses.The usual sources of cash may be: (a) Cash sales, (b) Collection of debts, (c) Short term arrangements with banks, etc. The cash management should be such that neither there is a shortage of it nor it is idle. Any shortage of cash will damage the credit worthiness of the enterprise. The idle cash with the business will mean that it is not properly usedA proper idea on sources of cash inflow may also enable to assess the utility of various sources. Some sources May not be providing that much cash which we should have thought. All this information will in efficient management of cash.

6. **Implementing Financial Controls.** An efficient system of financial management necessitates the use of various control devices. Financial control devices generally used are: (a) Return on investment, (b) Budgetary Control, (c) Break Even Analysis., (d) Cost Control, (e) Ratio Analysis (f) Cost and Internal Audit. Return on investment is the best control device to evaluate the performance of various financial policies. The higher this percentage, better may be the financial performance. The use of various control techniques by the Finance

Manager will help him in evaluating the performance in various areas and take corrective measures whenever needed.

7. **Proper Use of Surpluses**. The utilisation of profits or surpluses is also an important factor in financial management. A judicious use of surpluses is essential for expansion and diversification plans and also in protecting the interests of shareholders. The ploughing back of profits is the best policy of further financing but it clashes with the interests of shareholders. A balance should be struck in using funds for paying dividend and retaining earnings for financing expensive plans, etc. A Finance Manager should consider the influence of various factors, such as : (a) trend of earning of the enterprise, (b) expected earnings in future, (c) market value of shares, (d) need for funds for financing expansion, etc. A judicious policy for distributing surpluses will be essential for maintaining proper growth of the unit.

Sources of Finance – Introduction

Finance is the life blood of a firm. The firm cannot have smooth sailing unless it has sufficient finance/ funds to meet its working capital and fixed capital requirements. Funds that are required for a period of one year or less than one year to meet working capital needs are known as short term funds, Funds which are needed for a period of more than one year to meet fixed capital requirements are known as long term funds. They are, sometimes, classified as (i) Medium term funds and (ii) Long term funds. The various sources of finance/funds that are available to the firm.

Short term Finance - After establishment of the firm, funds are required to meet its day-to-day expenses. For example, raw materials must be purchased at regular intervals, workers must be paid wages regularly, water and power charges have to be paid regularly. Thus there is a continuous necessity of liquid cash to be available for meeting these expenses. For financing such requirements, short term funds are needed. The availability of short term funds is essential. Inadequacy of short term funds may even lead to closure of firm. Purpose of Short term Finance Short term Finance serves following purposes: (a) It facilitates the smooth running of business operations by meeting day to day financial requirements, (b) It enables firms to hold stock of raw materials and finished product (c) 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.(d) Short term finance becomes More essential when it is necessary to increase the volume of production at a short period of time)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 realization of sales.

Sources of Short term Finance Following are the major sources of short term finance available to the firm: 1. Trade Credit 2.Bank Credit 3.Customers' Advances 4.Instalment Credit 5.Commercial Paper 6.Depreciation Fund 7.Provision for Taxation 8.Outstanding Expenses

1. **Trade Credit -** Trade credit represents credit extended by the suppliers of goods in the normal course of business. The usual duration of credit is 15 to 90 days. It is granted to the firm on 'Open accounts' without any security except that of the goodwill and financial standing of purchaser. No interest is expressly charged for this. Only the price is a little higher than the cash price.

Advantages

(a)It is more advantageous to purchase goods on an open book account in comparison with the payment of cash at the time of making purchases viz. at the time of taking delivery. (b)It is a 'Spontaneous' source of financing compared to other sources of financing because in other cases, there is a lead time to arrange the funds and hence it is a more flexible means of financing.

(c) It is advantageous to small firms that have difficulty in getting credit elsewhere or cannot get at all.

(d)There is no need of creating any sort of charge against firm's assets for getting the trade credit.

Disadvantages

(a)The cost of trade credit may be necessarily very high when all factors are considered. While determining the selling price of product to be sold, the seller takes into account the interest, the risk and the inconvenience attached with supplying goods on credit. As a matter of fact, many firms like to go in for other sources of short term finance in order to enable them to avail the benefit of cash discount.

(b)The trade credit facility may induce a firm to overtrading which may later prove to be disastrous for the firm.

2.**Bank Credit -** Commercial banks grant short term finance to business firms which is known as bank credit. When bank credit is granted, the borrower gets a right to draw the amount of credit at one time or in instalments as and when needed. Bank credit may be granted by way of loans, cash credit, overdraft and discounting of bills. (i) Loans: When a certain amount is advanced by a bank repayable after a specified period, it is known as bank loan. Such advance is credited to a separate loan account and the borrower has to pay interest on the whole amount of loan irrespective of the amount of loan actually drawn. Usually loans are granted against security of assets.

(ii) **Cash credit:** This is an advance given to customer on the security of inventory. It is an arrangement whereby banks allow the borrower to withdraw money upto a specified limit subject to margin prescribed by R.B.I. This limit is known as cash credit limit. Initially this limit is granted for one year. This limit can be extended after review for another year. However, if the firm still desires to continue the limit, it must be renewed after three years. Rate of interest varies depending upon the amount of limit.

(iii) **Overdraft:** When a bank allows its depositor or account holder to withdraw money in excess of the balance in his account upto a specified limit, it is known as overdraft facility. This limit is granted purely on the basis of credit worthiness of the borrower. Interest is charged only on the overdrawn money. Rate of interest in case of overdraft is less than the rate charged under cash credit.

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

3. **Customers' Advance**- Firms engaged in manufacturing or constructing costly goods involving considerable length of manufacturing or construction time usually demand advance money from their customers at the time of accepting their orders for executing their contracts or supplying the goods. The customers' advance is a cost free source of short term finance. **Advantages** (a**) Interest free:** Amount offered as advance is interest free. Hence funds are available without involving financial burden. (b) **No tangible security:** The seller is not required to deposit any tangible security while seeking advance from the customer. Thus assets remain free of charge. (c) **No repayment obligation**: Money received as advance is not to be refunded. Hence there are no repayment obligations.

Disadvantages (a) **Limited amount:** The amount advanced by the customers is subject to the value of the order. Borrowers' need may be more than the amount of advance . (b) **Limited period**: The period of customers' advance is only up to the delivery of goods. It cannot be reviewed or renewed.(c) **Penalty in case of non-delivery of goods**: Generally advances are subject to the condition that in case goods are not delivered on time, the order would be cancelled and the advance would have to been refunded along with interest. 4**. Instalment Credit** Instalment credit is a system under which a small payment is made at the time of taking possession of the goods and the remaining amount is paid in instalment. Instalment amount is inclusive of interest. The instalment credit is a popular source of finance for consumer goods like T.V. refrigerators as well as for industrial goods.

Advantages (a) Immediate possession of assets: Delivery of assets is assured immediately on payment of initial instalment (down payment). (b) Convenient payment for assets and equipments: Costly assets and equipments which cannot be purchased due to inadequacy of long term funds can be conveniently purchased on payment by instalments.(c) Saving of one time investment: If the value of asset or equipments very high, funds of the business are likely to be blocked if lump sum payment is made. Instalment credit leads to saving of one time investment.

(d) Facilitates expansion and modernization of business and office: Business firms can afford to buy necessary equipments and machines when the facility of payment in instalments is available. Thus, expansion and modernization of business and office are facilitated by instalment credit.

Disadvantages (a) **Committed expenditure:** Payment of instalment is a commitment tg pay irrespective of profit or loss in the business.

(b) **Obligation to pay interest**: Under instalment credit system, payment of interest is obligatory. Generally, sellers charge a high rate of interest.

(c**) Additional burden in case of default**: Seller sometimes imposes stringent conditions in the form of penalty or additional interest, if the buyer fails to pay the instalment amount.

(d) **Cash does not flow:** Like trade credit, instalment credit facilitates the purchase of asset or equipment. It does not make cash available which can be utilized for all needful purposes.

5. **Commercial Paper**- Commercial paper (CP) is a “Usance Promissory note” issued by a firm, approved by RBI, negotiable by endorsement and delivery, issued at such discount on the face value as may be determined by the issuing firm. Each CP will bear a certificate from the banker verifying signature of the executants. These are issued by a firm to raise funds for a short period, generally varying from a few days to few months. The CP may be issued in multiples of Rs. 5 lakh. CP may be issued to any person including individuals, banks and othe, corporate bodies registered/ incorporated in India and unincorporated bodies it cannot, however, be issued to NRIs. A firm issuing CP may request the banker to provide standby facility for an amount not exceeding the amount of issue for meeting the liability of CP op

maturity. The financing banker shall correspondingly reduce the working cap, limits of every firm issuing the CP.

Advantages - The advantages of commercial papers lies in its simplicity involving hard. Any documentation between the issuer and the investor and its flexibility with regard to short - term maturity. A well rated firm can diversify its sources of finance from banks to the short term money markets at a somewhat cheaper cost, especially in a situation of easy money market. The CP provides investors with higher returns than they could obtain from the banking system. They have to pay off their debts semi annually i.e., for instance, eight instalments over a period of years.

6. **Depreciation Fund** - The depreciation funds created out of firm's profit provide a reliable source of short term finance so long as they are not invested in assets or distributed as dividends.
7. **Provision for Taxation** - There remains a time lag between creating provision for taxes and the actual payment. Thus the funds appropriated for taxation can be used for short term working capital requirements of the firm during the intermittent period
8. **Outstanding Expenses** - Sometimes, the firm postpones the payment of certain expenses due on the date of finalization of accounts. Outstanding expenses like unpaid wages, salaries., rent, etc also constitute an important source of short term finance.

Long Term Finance

Funds which are required in the firm for a period of more than one year and used for purchase of fixed assets such as land, building, machinery, furniture etc, are termed as fixed capital. A part of working capital is also of a permanent nature. Funds required for this part of the working capital and for fixed capital is known as long term finance.

Purpose of Long term Finance Long term finance is required for the following purposes:
(i) **To finance fixed assets**: Firm requires fixed assets like land, building, furniture etc. Finance required to buy these assets is for a long period because such assets can be used for a long period and are not for resale.

(ii) **To finance the permanent part of working capital**: Business is a continuing activity. It must have a certain amount of working capital which would be needed again and again. This part of working capital is of a fixed or permanent nature. This requirement is also met from long term funds.

(iii) **To finance growth and expansion of business**: Expansion of business requires investment of a huge amount of capital permanently or for a long period.

Factors Determining Long term Financial Requirements

The following factors are to be considered for determining long term financial requirements of the firm:

(i) **Nature of business**: The nature and character of a business determines the amount of fixed capital. A manufacturing firm requires land, building, machines etc., So it has to invest a large amount of capital for a long period. But a trading concern dealing in, say washing machine wil| require a smaller amount of long term fund because it does not have to buy building or machines.

(ii**) Nature of goods purchased**: If a firm is engaged in manutacturin small and simple articles, it will require a smaller amount of tixed capity as compared to one manufacturing heavy machines or heavy consumer items like cars, refrigerators etc. which will require more fixed capital

(iii) **Technology used**: In heavy industries like steel, the fined capital requirement is larger than in the case of a firm producing plastic jars using simple technology or producing goods using labour intensive technique.

Sources of Long term Finance

The main sources of long and medium term finance are as follows:

1. Shares 2. Retained earnings 3. Debentures 4. Public Deposits 5. Loan from Financial institutions 6. Lease Financing 7, Venture capital Financing 8. Hire purchase Financing 9. Debt securitisation 10. International Financing

1. **Shares** Issue of shares is the main source of long term finance. Shares are issued by firms to the public. A firm divides its share capital into units of a definite face value, say of Rs.10 each or Rs.100 each. Each unit is called a share. A person holding shares is known as a shareholder.

   Features of shares - The main features of shares of the firm are as follows.

   (i) It is a unit of capital of the firm.

   (ii) Each share is of a definite face value.

(iii) A share certificate is issued to a shareholder indicating the number of shares and the amount.

(iv) Each share has a distinct number.

(v) The face value of a share indicates the interest of a person in the firm and the extent of his liability.

A firm may issue two types of shares. These are:

A. **Preference shares B. Equity shares**

Preference shares are a special kind of shares, the holders of such shares enjoy priority, both as regards to the payment of a fixed amount of dividend and repayment of capital on winding up of the firm.Preference share capital is a hybrid form of financing which partakes some characteristics of equity capital and some attributes of debt capital. It is similar to equity because preference dividend, like equity dividend is not a tax deductible . It resembles debt capital because the rate of preference dividend is same. Cumulative convertible preference shares may also be offered, under which the shares would carry a cumulative dividend of specified limit for a period of say three years after which the shares are converted into equity shares. These shares are attractive for projects with a long gestation period. For normal preference shares, the maximum permissible rate of dividend is 14%.Preference share capital can be redeemed at a predicted future date as at an earlier stage inter alia out of profits of firm. it may be mentioned that irredeemable preference shares cannot be issued by any firm.

Advantages (a) No dilution in Earnings Per Share (EPS) on enlarged capital base. If equity is issued, it reduces EPS, thus affecting the market perception about the company. (b) There is leveraging advantage as it bears a fixed charge. (c) There is no risk of takeover (d) There is no dilution of managerial control (e) Preference capital can be redeemed after a specified period.

Disadvantages (i) Preference shares dilute the claim of the equity shareholders over the assets of the firm. (ii) Preference shares may pave the way for the insolvency of the firm in cases where the directors continue to pay dividends on them ,of lower profits to maintain their attractiveness. (iii) Arrear of fixed cumulative dividend may create a burden on the firm, when equity dividend is declared.

(B) **Equity shares** A firm can also raise long term funds from promoters or from the investing public by way of owners capital or equity capital by issue of ordinary shares, Ordinary shareholders are owners of the firm. Since equity shares can be paid off only in the event of liquidation, this source has the least risk involved. This is more so due to the fact that equity shareholders can be paid dividends only when there are distributable profits. However, the cost of ordinary shares is usually the highest. This is due to the fact that such shareholders expect a higher rate of return on their investments as compared to other suppliers of long term funds. Further, the dividend payable on shares is an appropriation of profits and not a charge against profits. This means that it has to be paid only out of profits after tax.

Advantages (i) It is a permanent source of finance (ii) The issue of new equity shares increases flexibility of the firm. (iii) The firm can make further issue of share capital by making a rights issue. (iv)There is no mandatory payment to shareholders of equity shares

Disadvantages (i) Equity shares are more risky due to uncertainty of dividends and capital.(ii) Firm cannot take advantage of financial leverage or trading on equity if it issues equity shares only.(iii) In case the profits of a firm do not increase after the issue of additional shares, the EPS declines. (iv) If the existing shareholders are not able to subscribe to the new shares, their ownership gets diluted.

2. **Retained Earnings** The portion of the profits which is not distributed among the shareholders put is retained and is used in business is called retained earnings or ploughing pack of profits. As per Indian Companies Act, firms are required to transfer a part of their profits to reserves. The amount so kept in reserve may be used to meet long term financial requirements of the firm.

Advantages - (i) **Cheap source of capital**: No expenses are incurred when capital is available from this source. There is no obligation on the part of the firm either to pay interest or pay back the money. It can safely be used for expansion and modernization of business.

(ii) **Financial stability**: A firm which has enough reserves can face ups and downs in business. Such firm can continue with its business even in depression, thus building up its goodwill.

(iii) **Benefits to the shareholders**: Shareholders may get dividend out of reserves even if the firm does not earn enough profit. Due to reserves, there is capital appreciation i.e., the value of shares goes up in the share market.

Disadvantages - (i) **Huge profit**: This method of financing is possible only when there are huge profits and that too for many years.

(ii) **Dissatisfaction among shareholders**: When funds accumulate in reserves, bonus shares are issued to the shareholders to capitalize such funds. Hence, the firm has to pay more dividends. By retained earnings, the real capital does not increase while the liability increases. In case bonus shares are not issued, it may create a situation of under capitalization because the rate of dividend will be much higher as compared to other firms.

(iii) Fear of monopoly: Through ploughing back of profits, firms increase their financial strength. Firms may throw out their competitors from, the market and monopolize their position.

(iv) Mis-management of funds: Capital accumulated through retained earnings encourages management to spend carelessly.

3. **Debentures –** Long term funds can be raised from public by issuing debentures by the firm. Debenture is a written acknowledgment of money borrowed. It is issueg under the common seal of the company. It specifies the terms and conditions. such as rate of interest, time of repayment, security offered etc. It is generally issued in different denominations ranging from Rs.100 and Rs.1,000. ft is normally secured against the assets of the firm.

   Features (a) Debentures constitute the loan capital of the firm. (b)Debenture- holders are creditors of the firm.(c) Interest on debentures is paid at a fixed rate on a periodical basis such as six monthly, yearly etc.(d) Debentures carry no voting rights except under special circumstances. (e) Debenture holders can take legal action against the firm, for any default in the matter of payment of interest or repayment of capital.(f) Debenture holders can even apply for winding up of the firm if it is in their interest to do so. **Types** - (i) **Redeemable Debentures**: These debentures are to be repaid by the firm at the end of the specified period or within the specified period at the option of the firm by giving notice to debenture holders of the intention to redeem debentures or by instalment under the terms of issue.

   (ii) **Irredeemable Debentures:** These are also called perpetual debentures. A firm is not bound to repay the amount during its life time. If the issuing firm fails to pay the interest, it has to redeem such debentures.

   (iii**) Convertible Debentures:** Holders of these debentures are given an option to convert their holdings into shares under certain conditions mentioned in the debenture certificate regarding period and option to choose .

(iv) **Convertible Debentures:** These debentures cannot be converted into shares. (i) **Simple Debentures**: These debentures are also known as unsecured or naked debentures. These debentures carry no specific charge on the assets of the firm. But being creditors of the firm, they have general charge on the assets of the firm.(ii) **Secured Debentures:** These debentures are issued with a charge (fixed or floating) on the assets of the firm. In case of default in payment, the debenture holders can sell the assets and recover their dues.

(vii) **Bearer Debentures**: These debentures are payable to the bearer and are transferable by delivery only. These are negotiable instruments and the firm keeps no record for them. Interest is paid to the coupon-holder.

(viii) **Registered Debentures**: These debentures are registered in the firm with names, addresses and particulars of holdings recorded in a Debenture holder's Register kept by the firm. A regular transfer deed giving full particulars of transferor and transferee is required at the time of transfer of such debentures.

Advantages (a) The cost of debentures is much lower than the cost of preference or equity capital as the interest is tax-deductible. Also, investors consider debenture investment safer than equity or preferred investment and hence, may require a lower return on debenture investment.(b) Debenture financing does not result in dilution of control.(c) Ina period of rising prices, debenture issue is advantageous. The fixed monetary outgo decreases if real terms as the price level increases. **Disadvantages** (a) Debenture interest and capital repayment are obligatory Payments. (b) The protective covenants associated with a debenture issue may be restrictive.(c) Debenture financing enhances the financial risk associated with the firm.

4. **Public deposits** are simple to raise. A firm intending to invite deposits simply has to advertise in the newspapers. Any member of the public can fill up the prescribed form and deposit the money with the firm. The firm in turn issues a deposit receipt which is an acknowledgment of debt by the firm. The terms and conditions of the deposit are printed on the back of the receipt. Earlier interest rates were subject to a ceiling, Public Deposits are a very old source of finance in India. When modern banks were there, people used to deposit their savings with business concerns of good repute. Even today it is a very popular and convenient method of raising medium term finance. The period for which firms accept public deposits ranges between 6 months to 3 years. Public deposits are simple to raise. A firm intending to invite deposits simply has to advertise in the newspapers. Any member of the public can fill up the prescribed form and deposit the money with the firm. The firm in turn issues deposit receipt which is an acknowledgment of debt by the firm. The terms and conditions of the deposit are printed

on the back of the receipt.Earlier interest rates were subject to a ceiling, But now, is in tune with the market trends, but generally public deposits pay out a higher rate than the interest rate on bank deposits. The rate of interest on public deposits depends on the period of deposit and reputation of the firm.Since these deposits are unsecured, a firm which has public deposits is required to set aside, as deposit or investment, in the current year, an amount equal to 10% of the deposits maturing by end of the year. The amount so set aside can be used only for repaying such deposits. Public deposits cannot exceed 25% of share capital and free reserves.

Advantages (a) The procedure for getting public deposits is much simpler than equity and debenture issues. Thus, there are fewer administrative costs for deposits. (b) Public deposits are unsecured. Thus, the assets are free to be used as mortgage in future, if need arises.(c) Interest paid on public deposits is tax deductible. Hence, it helps i in bringing down the tax liability.(d) Public deposits introduce flexibility in the financial structure of the firm. This is because the deposits can be repaid when they are not required.(e) There is no dilution of shareholders' control because the depositors have no voting rights.

Disadvantages (a) The amount of funds that can be raised by way of public deposits is limited, because of legal restrictions.(b) Public deposits are an uncertain and unreliable source of finance. The depositors may not respond when conditions in the economy are uncertain. Also, deposits may be withdrawn whenever the depositors feel shaky about the financial health of the firm.

5. **Loans from Financial institutions -** In India specialized institutions provide long firm financial assistance to industry. Thus the Industrial Finance Corporation of India, the State Financial Corporations, The LIC of India, the National Small Industries Corporation Ltd, the Industrial Credit and Investment Corporation of India, the Industrial Development Bank of India and the Industrial Reconstruction Corporation of India provide term loans to firms. Before a term loan is sanctioned, a firm has to satisfy the concerned financial institution regarding the technical, commercial, economic, financial and managerial viability of the project for which the loan is required. Such loans are available at different rates of interest under different schemes of financial institutions and are to be repaid according to a stipulated repayment schedule. The loans in many cases stipulate a number of conditions regarding the management and certain other financial policies of the firm.

Term loans represent secured borrowings and at present it is the most important source of finance for new projects. They generally carry a rate of interest inclusive of interest tax, depending on the credit rating of the borrower the perceived risk of lending and the cost of funds. These loans are generally repayable over a period of 6 to 10 years in annual, semi-annual or quarterly instalments.

Term loans are also provided by banks, state financial development institutions and All India term lending financial institutions. Banks and State Financial corporations normally provide term loans to projects in the small scale sector while for the medium and large industries, term loans are provided by State Developmental Institutions aione or in consortium with banks and State Financial corporations. For large scale projects, All India financial institutions provide tie bulk of term finance either singly or in consortium with other al] India financial institutions, state level institutions, and or banks. After independence, the institutional set up in India for the provision of medium and long term credit for industry has been broadened. The assistance sanctioned and disbursed by these specialized institutions has increased impressively over the years.

6. **Lease Financing** Lease financing denotes procurement of assets through lease. Leasing is a general contract between the owner and the user of the asset over a specified period of time. The asset is purchased initially by the lessor (leasing company) and thereafter leased to the user (lessee company) which pays a specified rent at periodical intervals. Thus leasing is an alternative to the purchase of an asset out of own or borrowed funds. Moreover lease finance can be arranged much faster as compared to term loans from financial institutions.

   Types of Leases (i) Financial Lease: Long term, non-cancellable lease contracts are known as financial lease. The essential point of financial lease agreement is that it contains a condition whereby the lessor agrees to transfer the title for the asset at the end of the lease period at a nominal cost. Under this lease, an option is given to the lessee to purchase the asset he has used at the expiry of the lease. The lessor recovers 90% of the fair value of the asset as lease rentals and the lease period is 75% of the economic life of the asset. The lease agreement is irrevocable. Practically all the risks incidental to the asset ownership and all the benefits arising therefrom are transferred to the lessee who bears the cost of maintenance, insurance and repairs. Only title deeds remain with the lessor. Financial lease is also known as ‘capital lease’. In India, financial leases are very popular with high-cost and high technology equipment.

Operating Lease: This lease agreement gives to the lessee only a limited right to use the asset. The lessor is responsible for the upkeep and maintenance of the asset. The lessee is not given any option to purchase the asset at the end of the lease period. Normally, the lease is for a short period and even otherwise is revocable at a short notice. Mines, Computer hardware, Trucks and Automobiles are found suitable for operating lease because the rate of obsolescence in very high in the kind of assets.

Sale and lease Back: It is a sub-part of finance lease. Under this lease, the owner of an asset sells the asset to a party (buyer) who in turn leases back the same asset to the owner in consideration of lease rentals. However, under this arrangement, the assets are not physically exchanged but it all happens in records only. This is nothing but a paper transaction. Sale and lease back transaction is suitable for those assets which are not subjected to depreciation but appreciation, say land. The advantages of this method is that the lessee can satisfy himself completely regarding the quality of the asset and after possession of the asset convert the sale into a lease agreement.

Leveraged Leasing: Under leveraged leasing agreement, a third party is involved beside lessor and lessee. The lessor borrows a part of the purchase cost (say 80%) of the asset from the third party i.e. lender and the asset so purchased is held as security against the loan. The lender is paid off from the lease rentals directly by the lessee and the surplus after meeting the claims of the lender goes to the lessor. The lessor, the owner of the asset, is entitled to depreciation allowance associated with the asset.

Direct Leasing: Under this method, the firm acquires the right to use an asset from the manufacturer directly. The ownership of the asset leased out remains with the manufacturer himself. The major types of direct lessor include manufacturers, finance companies, independent lease companies, special purpose leasing companies, etc.

Advantages of Leasing:

(a) **Saving of capital**: Leasing covers the full cost of the equipment used in the business by providing 100% finance. The lessee is not to provide or pay any margin money as there is no down payment. In this way the saving in capital or financial resources can be used for other productive purposes ¢.g. purchase of inventories.

(b) **Flexibility and Convenience**: The lease agreements can be tailor mad in respect of lease period and lease rentals according to the convenience and requirements of all lessees.

(c) **Planning cash flows**: Leasing enables the lessee to plan its cash flow, properly. The rentals can be paid out of the cash coming into the business from the use of the same assets.

(d) **Improvement in liquidity**: Leasing enables the lessee to improve their liquidity position by adopting the sale and lease back technique.

7. **Venture capital Financing** - Venture capital financing refers to financing of high risk ventures promoted by new, qualified entrepreneurs who require funds to give shape to their ideas. Here, financier (called venture capitalist) invests in the equity or debt of an Entrepreneur (promoter/venture capital undertaking) who has a potentially successful business idea, but does not have the desired track record or financial backing. Generally, venture capital funding is associated with (a) heavy initial investment businesses eg. energy conservation, quality upgradation or (b)sunrise sectors like information technology.

Methods of venture capital Financing

(i) **Equity Financing**: The venture capital undertakings generally require funds for a longer period but may not be able to provide returns to the investors during the initial stages. Therefore, the venture capital finance is generally provided by way of equity share capital.

(ij) **Conditional Loan**: A conditional loan is repayable in the form of 3 royalty after the venture is able to generate sales. No interest is paid on such loans, In India venture capital financiers charge royalty ranging between 2 and 15 percent, actual rate depends on other factors of the venture such as gestation period, cash flow patterns, riskiness and other factors of the enterprise. Some venture financiers give a chance to the enterprise of paying a high rate of interest (which could be well above 20 per cent) instead of royalty on sales once it becomes commercially viable.

(iii) **Income Note**: It is a hybrid security which combines the features of both conventional loan and conditional loan. The entrepreneur has to pay both interest and royalty on sales but at substantially low rates.

(iv) **Participating Debenture**: Such security carries charges in three phases in the start up phase, no interest is charged, next stage a low rate of interest is charged upto a particular level of operation, after that, a high rate of interest is required to be paid. (8), **Hire purchase Financing** - Small scale firms can acquire industrial machinery, office equipments, vehicles etc. without making full payment through hire purchase. With the help of assets acquired through hire purchase, they can produce and sell. From the earnings, payments can easily be made in instalments. Ultimately the ownership of assets can be acquired. Now, several agencies like National Small Industries Corporation

(NSIC) provide machinery and equipments to small scale units on hire purchase basis.

9. **Debt Securitisation-** Debt securitisation is a method of recycling of funds. It is especially beneficial to financial intermediaries to support the lending volumes. Assets generating steady cash flows are packaged together and against this asset pool, market securities can be issued.

The basic debt securitisation process can be classified in the following three functions:

(i) **The origination function**: A borrower seeks a loan from a finance company, bank housing company or a lease from a leasing company. The credit worthiness of the borrower is evaluated and a contract is entered into with repayment schedule structured over the life of the loan.

(ii) **The pooling function**: Similar loans or receivables are clubbed together to create an underlying pool of assets. This pool is transferred in favour of a SPV (Special purpose vehicle) which acts as a trustee for the investor, once the assets are transferred, they are held in the originator's portfolios.

(iii) **The securitisation function**: It is the SVP's job now to structure and issue the securities on the basis of the asset pool. The securities carry a coupon and an expected maturity which can be asset based or mortgage based. These are generally sold to investors through merchant bankers. The investors interested in this type of securities are generally institutional investors like mutual funds, insurance companies, etc.

10. **International Financing** Indian firms can also tap international sources of finance for both debt and equity. The main instruments used by Indian firms to tap international sources of equity are: Global Depository Receipts (GDRs) and American Depository Receipts (ADRs). (1) Global Depository Receipts (GDRs): GDRs are issued to tap the global equity markets by way of global equity offerings. However, these are indirect equity offerings and the shares issued by the firm are held by an international bank referred to as a depository.

Foreign Direct Investment (FDI)

International finance also comes in the form of FDI. This is the direct contribution to the equity capital of the company by multinational companies. A large number of companies have expanded their operations beyond their national boundaries, These companies are known as Multinational Corporations (MNCs). Investment in the overseas operation of the MNCs is represented by FDI.