RS PATHSHALA

CA INTER

FINANCIAL MANAGEMENT

THEORY

CHAPTER 1

SCOPE AND OBJECTIVE OF FINANCIAL MANAGEMENT

Financial management is concerned with **efficient acquisition (financing) and allocation** (investment in assets, working capital etc.) of funds with an objective to make profit (dividend) for owners. In other words, focus of financial management is to address three major financial decision areas namely, **investment, financing and dividend decisions**.

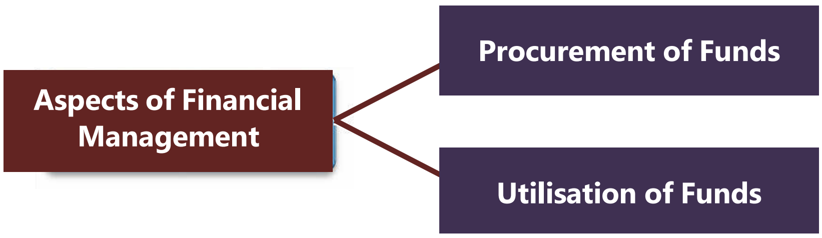
MEANING OF FINANCIAL MANAGEMENT

Financial management is that ***managerial activity which is concerned with planning and controlling of the firm's financial resources****.*

Another very elaborate definition given by Phillippatus is:

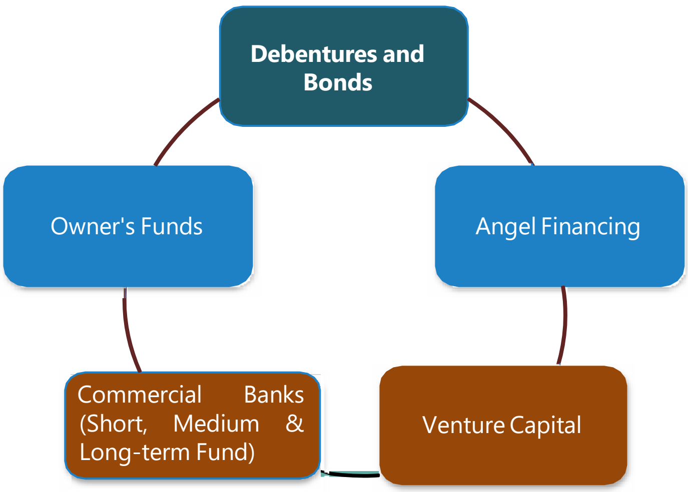
"Financial Management is concerned with the managerial decisions that result in the acquisition and financing of short-term and long-term credits for the firm."

There are two basic aspects of financial management viz., procurement of funds and an effective use of these funds to achieve business objectives.



Procurement of Funds

Since funds can be obtained from different sources therefore their procurement is always considered as a complex problem by business concerns. Some of the **sources for funds** for a business enterprise are:



Funds procured from different sources have different characteristics in terms of risk, cost and control. The cost of funds should be at the minimum level for that a proper balancing of risk and control factors must be carried out.

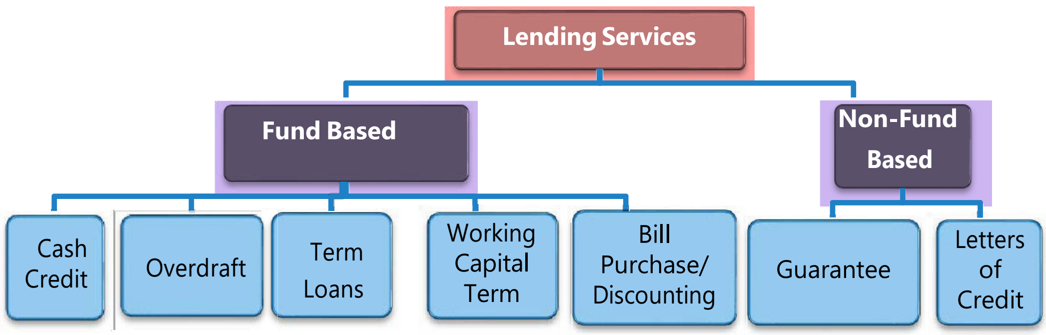
Another key consideration in choosing the source of new business finance is to ***strike a balance between equity and debt*** to ensure the funding structure suits the business.

Sources of funds (discussed in detail in later chapters):

(a) **Equity:** The funds raised by the issue of equity shares are the best from the risk point of view for the firm, since there is no question of repayment of equity capital except when the firm is under liquidation. Equity capital is usually the most expensive source of funds because of dividend (appropriation of profit i.e. no tax benefit available.

(b) **Debentures:** Debentures as a source of funds are comparatively cheaper than the shares because of their tax advantage. However, debentures entail a high degree of risk since they have to be repaid as per the terms of agreement. Also, the interest payment has to be made whether or not the company makes profits.

(c) **Funding from Banks:** Commercial Banks play an important role in funding of the business enterprises. Apart from supporting businesses in their routine activities (deposits, payments etc.) they play an important role in meeting the long term and short term needs of a business enterprise. Different lending services provided by Commercial Banks are depicted as follows:



(d) **International Funding:** Funding today is not limited to domestic market. With liberalization and globalization a business enterprise has options to raise capital from International markets also. Foreign Direct Investment (FDI) and Foreign Institutional Investors (FII) are two major routes for raising funds from foreign sources besides ADR's (American depository receipts) and GDR's (Global depository receipts).

(e) **Angel Financing:** Angel Financing is a form of an equity-financing where an angel investor is a wealthy individual who provides capital for start-up or expansion, in exchange for an ownership/equity in the company.

Effective Utilisation of Funds

Some of the aspects of funds utilization are:

(a) **Utilization for Fixed Assets:** The funds are to be invested in the manner so that the company can produce at its optimum level without endangering its financial solvency. For this, the finance manager would be required to possess sound knowledge of techniques of capital budgeting.

Capital budgeting *(or investment appraisal) is the planning process used to determine whether a firm's long-term investments such as new machinery, replacement machinery, new plants, new products, and research development projects would provide the desired return (profit).*

(b) **Utilization for Working Capital:** The finance manager must also keep in view the need for adequate working capital and ensure that while the firms enjoy an optimum level of working capital, they do not keep too much funds blocked in inventories, book debts, cash etc.

FINANCE FUNCTIONS/ FINANCE DECISION

Value of a firm will depend on various finance functions/decisions. It can be expressed as:

$$\boxed{V = f(I,F,D).}$$

The finance functions are divided into long-term and short-term functions/decisions

Long term Finance Function Decisions

(a) **Investment decisions (I)**: These decisions relate to the **selection of assets in which funds will be invested by a firm.** Funds procured from different sources have to be invested in various kinds of assets. Long term funds are used in a project for various fixed assets and also for current assets.

(b) **Financing decisions (F):** These decisions relate to **acquiring the optimum finance** to meet financial objectives and seeing that fixed and working capital are effectively managed.

(c) **Dividend decisions (D):** These decisions relate to the **determination as to how much and how frequently cash can be paid out of the profits** of an organisation as income for its owners/shareholders.

Short-term Finance Decisions/Function

Working Capital Management (WCM): Generally short- t e r m decision are reduced to management of current asset and current liability (i.e., working capital Management)

IMPORTANCE OF FINANCIAL MANAGEMENT

Following are importance of good financial management is to describe some of the tasks that it involves:

- **Taking care** not to over-invest in fixed assets
- **Balancing** cash-outflow with cash-inflows
- **Ensuring** that there is a sufficient level of short-term working capital
- **Setting** sales revenue targets that will deliver growth
- **Increasing** gross profit by setting the correct pricing for products or services
- **Controlling** the level of general and administrative expenses by finding more cost-efficient ways of running the day-to-day business operations, and
- **Tax planning** that will minimize the taxes a business has to pay.

SCOPE OF FINANCIAL MANAGEMENT

Based on financial management guru Ezra Solomon's concept of financial management, following aspects are taken up in detail under the study of financial management:

(a) **Determination** of size of the enterprise and determination of rate ofgrowth.

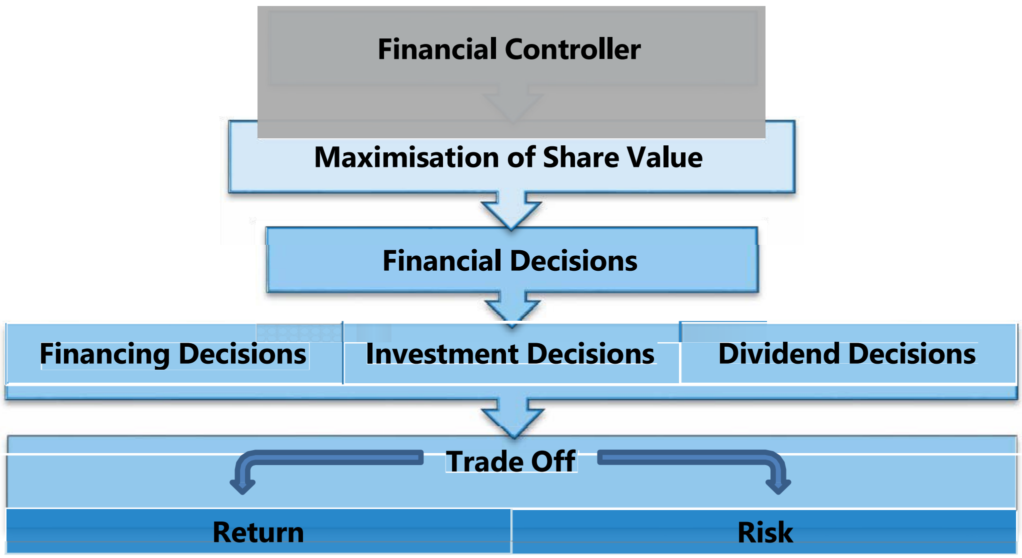
(b) **Determining** the composition of assets of the enterprise.

(c) **Determining** the mix of enterprise's financing i.e. consideration of level of debt to equity, etc.

(d) **Analysis, planning and control** of financial affairs of the enterprise.

Role of Financial Controller:

The given figure depicts the overview of the role and functions of financial controller. It also gives the interrelation between the market value, financial decisions and risk return trade off. The financial controller, in a bid to maximize shareholders' wealth, should strive to maximize returns in relation to the given risk; he should seek courses of actions that avoid unnecessary risks. To ensure maximum return, funds flowing in and out of the firm should be constantly monitored to assure that they are safeguarded and properly utilized.

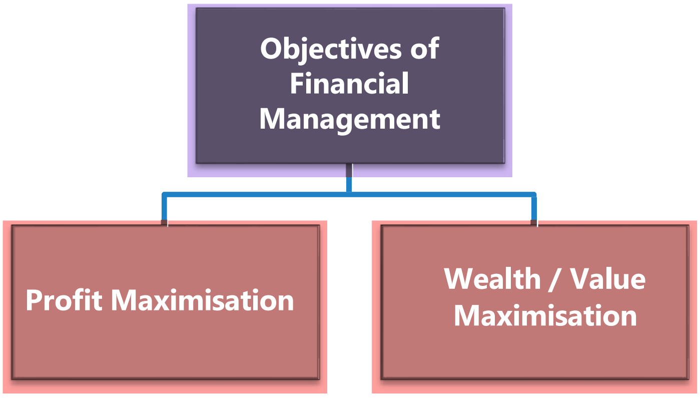


An Overview of Financial Controller

OBJECTIVES OF FINANCIAL MANAGEMENT

Although various objectives are possible but we assume two objectives of financial management for elaborate discussion.

These are:



Profit Maximisation

It has traditionally been argued that the primary objective of a company is to earn profit; hence the objective of financial management is also profit maximisation. This implies that the finance manager has to make his decisions in a manner so that the profits of the concern are maximised. Each alternative, therefore, is to be seen as to whether or not it gives maximum profit.

If profit is given undue importance, a number of problems can arise. Some of these have been discussed below:

(i) **The term profit is vague. It does not clarify what exactly it means.** It conveys a different meaning to different people. For example, profit may be in short term or long-term period; it may be total profit or rate of profit etc.

(ii) **Profit maximisation has to be attempted with a realisation of risks involved.** There is a direct relationship between risk and profit. Many risky propositions yield high profit. Higher the risk, higher is the possibility of profits. If profit maximisation is the only goal, then risk factor is altogether ignored. This implies that finance manager will accept highly risky proposals also, if they give high profits. In practice, however, risk is very important consideration and has to be balanced with the profit objective.

(iii) **Profit maximisation as an objective does not take into account the time pattern of returns.** Proposal A may give a higher amount of profits as compared to proposal B, yet if the returns of proposal A begin to flow say 10 years later, proposal B may be preferred which may have lower overall profit but the returns flow is earlier and quicker.

(iv) **Profit maximisation as an objective is too narrow.** Profit maximizationat the cost of social and moral obligations is a short-sighted policy.

Wealth Maximisation/Value Creation

Wealth = Present value of benefits – Present Value of Costs

The shareholder value maximization model holds that the primary goal of the firm is to maximize its market value and implies that business decisions should seek to increase the net present value of the economic profits of the firm.

So, for measuring and maximising shareholders wealth finance manager should follow:

- Cash Flow approach not Accounting Profit
- Cost benefit analysis
- Application of time value of money.

Stockholders hire managers to run their firms for them......

↓ Because stockholders have absolute power to hire and fire managers.

Managers set aside their interest and maximise stock prices...

↓ Because markets are efficient.

Stockholders wealth is maximised....

↓ Because lenders are fully protected from shareholders actions.

Firm value is maximised....

↓ Because there are no costs created for society.

Societal wealth is maximised...

Value of a firm (V) = Number of Shares (N) × Market price of shares (MP)

Or

V = Value of equity (V_e) + Value of debt (V_d)

Why Wealth Maximization Works? Before we answer this question, it is important to first understand and know what other goals a business enterprise may have.

Other objectives of financial management:

Some of the other goals a business enterprise may follow are:-

- Achieving a higher growth rate
- Attaining a larger market share
- Gaining leadership in the market in terms of products and technology
- Promoting employee welfare
- Increasing customer satisfaction
- Improving community life, supporting education & research, solving societal problems, etc.

CONFLICTS IN PROFIT VERSUS VALUE MAXIMISATION PRINCIPLE

Goal	Objective	Advantages	Disadvantages
Profit Maximization	Large amount of profits	1. Easy to calculate profits 2. Easy to determine the link between financial decisions and profits.	1. Emphasizes the short-term gains 2. Ignores risk or uncertainty 3. Ignores the timing of returns 4. Requires immediate resources.
Shareholders Wealth Maximisation	Highest market value of shares.	1. Emphasizes the long-term gains 2. Recognises risk or uncertainty 3. Recognises the timing of returns 4. Considers shareholders' return.	1. Offers no clear relationship between financial decisions and share price. 2. Can lead to management anxiety and frustration.

ROLE OF FINANCE EXECUTIVE

Changing Role of the Finance Executive
"Today's CFO team is expected to add value well beyond the traditional roles of cost management, controls and acting as the conscience of the organisation. These roles are challenging enough, but today's CFO is expected to work in collaboration, by serving as the integration hub for key business processes, as a catalyst for change including business transformation, and as a consultant or trusted business advisor in helping to create sustainable growth." ***Jeff Thomson, IMA President and CEO***

To sum it up, the finance executive of an organisation plays an important role in the company's goals, policies, and financial success.

His responsibilities include:

(a) **Financial analysis and planning:** Determining the proper amount of funds to employ in the firm, i.e. designating the size of the firm and its rate of growth.

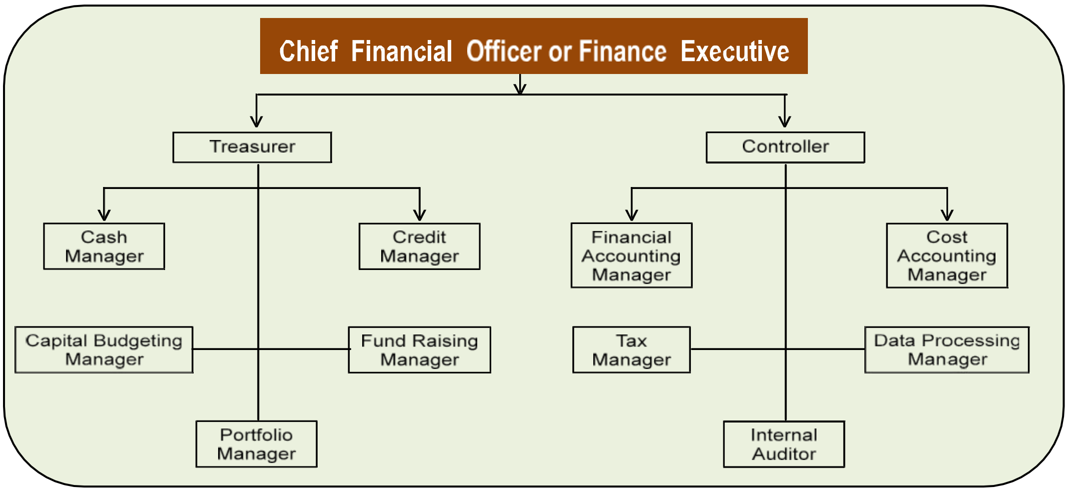
(b) **Investment decisions:** The efficient allocation of funds to specific assets.

(c) **Financing and capital structure decisions:** Raising funds on favourable terms as possible i.e. determining the composition of liabilities.

(d) **Management of financial resources** (such as working capital).

(e) **Risk management:** Protecting assets.

The figure below shows how the finance function in a large organization may be organized.



Organisation of Finance Function

Role of Finance Executive in today's World vis-a-vis in the past

Today, the role of chief financial officer, or CFO, is no longer confined to accounting, financial reporting and risk management. It's about being a strategic business partner of the chief executive officer, or CEO.

Some of the key differences that highlight the changing role of a CFO are as follows:

What a CFO used to do?	What a CFO now does?
Budgeting	Budgeting
Forecasting	Forecasting
Accounting	Managing M&As
Treasury (cash management)	Profitability analysis (for example, by customer or product)
Preparing internal financial reports for management	Pricing analysis
Preparing quarterly, annual filings for investors	Decisions about outsourcing
Tax filing	Overseeing the IT function
Tracking accounts payable and accounts receivable	Overseeing the HR function
Travel and entertainment expense management	Strategic planning (sometimes overseeing this function) Regulatory compliance Risk management

AGENCY PROBLEM AND AGENCY COST

Agency Problem

In a nutshell, Agency Problem is the chances that managers may place personal goals ahead of the goal of owners. Agency Problem leads to Agency Cost. Agency cost is the additional cost borne by the shareholders to monitor the manager and control their behaviour so as to maximise shareholders wealth.

Generally, Agency Costs are of four types:

(i) monitoring (ii) bonding (iii) opportunity (iv) structuring.

Addressing the agency problem

However, following efforts have been made to address these issues:

1. Managerial compensation is linked to profit of the company to some extent and also with the long-term objectives of the company.
2. Employee is also designed to address the issue with the underlying assumption that maximisation of the stock price is the objective of the investors.
3. Effecting monitoring can be done.

Multiple Choice Questions (MCQs)

1. Focus of financial management is mainly concerned with the decision related to:
   (a) Financing (b) Investing
   (c) Dividend (d) All of above.
2. The main objective of financial management is to:
   (a) Secure profitability (b) Maximise shareholder wealth
   (c) Enhancing the cost of debt (d) None of above.
3. The shareholder value maximisation model holds that the primary goal of the firm is to maximise its:
   (a) Accounting profit (b) Liquidity
   (c) Market value (d) Working capital.
4. Wealth maximisation approach is based on the concept of:
   (a) Cost benefit analysis (b) Cash flow approach
   (c) Time value of money (d) All of the above.
5. Management of all matters related to an organisation's finances is called:
   (a) Cash inflows and outflows (b) Allocation of resources
   (c) Financial management (d) Finance.
6. Which of the following is the disadvantage of having shareholders wealth maximisation goals?
   (a) Emphasizes the short-term gains.
   (b) Ignores the timing of returns.
   (c) Requires immediate resources.
   (d) Offers no clear relationship between financial decisions and share price.
7. The most important goal of financial management is:
   (a) Profit maximisation (b) Matching income and expenditure
   (c) Using business assets effectively (d) Wealth maximisation.
8. To achieve wealth maximization, the finance manager has to take careful decision in respect of:
   (a) Investment (b) Financing
   (c) Dividend (d) All the above.
9. Early in the history of finance, an important issue was:
   (a) Liquidity (b) Technology
   (c) Capital structure (d) Financing options.
10. Which of the following are microeconomic variables that help define and explain the discipline of finance?
    (a) Risk and return
    (b) Capital structure
    (c) Inflation
    (d) All of the above.

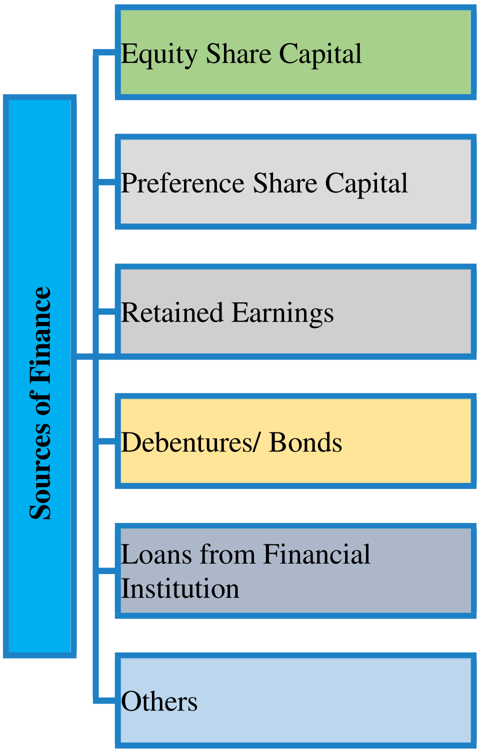
11. Financial Management is mainly concerned with the-
    (a) Acquiring and developing assets to forfeit its overall benefit.
    (b) Acquiring, financing and managing assets to accomplish the overall goal of a business enterprise.
    (c) Efficient management of the business.
    (d) Sole objective of profit maximisation.

12. Which of the following need not be followed by the finance manager for measuring and maximising shareholders' wealth?
    (a) Accounting profit analysis.
    (b) Cash Flow approach.
    (c) Cost benefit analysis.
    (d) Application of time value of money.

Answers to the MCQs

1.	(d)	**2.**	(b)	**3.**	(c)	**4.**	(d)	**5.**	(c)	**6.**	(d)
7.	(d)	**8.**	(d)	**9.**	(a)	**10.**	(d)	**11.**	(b)	**12.**	(a)

TYPES OF FINANCING



1. FINANCIAL NEEDS AND SOURCES OF FINANCE OF A BUSINESS

Financial Needs of a Business:

Financial needs types:

(i) *Long-term financial needs:* Such needs generally refer to those requirements of funds which are for a period exceeding 5-10 years.

(ii) *Medium-term financial needs:* Such requirements refer to those funds which are required for a period exceeding one year but not exceeding 5 years. This might be needed for stores and spares, critical spares, tools, dies, moulds.

(iii) *Short-term financial needs:* Such type of financial needs arise to finance working capital requirements of the concern.

Basic Principle for Funding Various Needs

Stage	*Nature of Business*	*Sources of Fund*
Early stage	High Uncertainty	Equity; mainly Angel fund
	High to moderate Uncertainty	Equity; Venture capital; Debt
Growth Stage	Moderate to Low Uncertainty	Debt; Venture Capital; Private Equity
Stable stage	Low Uncertainty	Debt

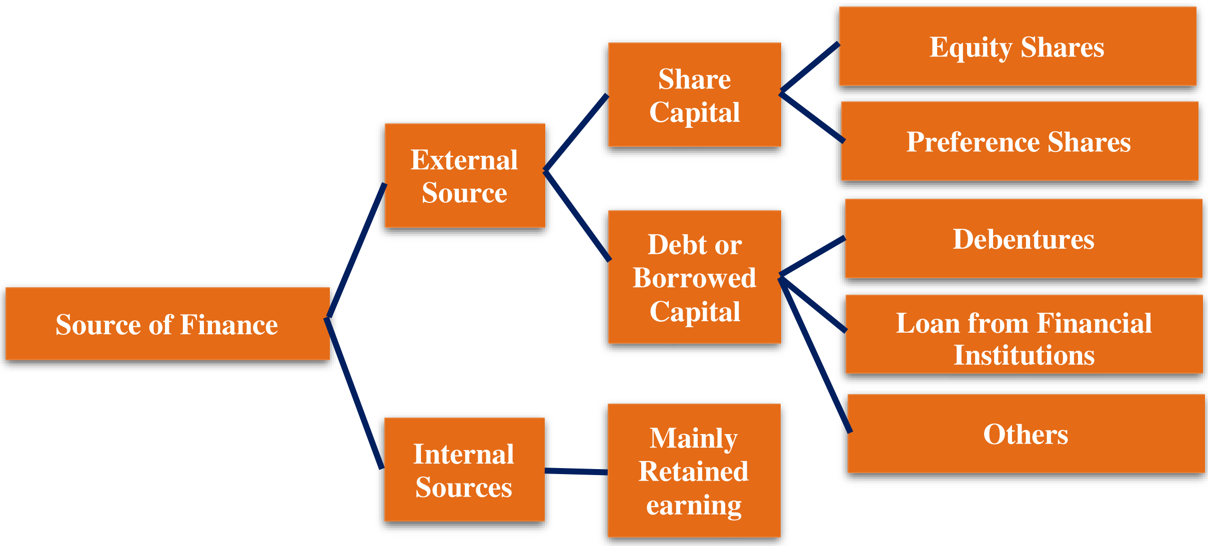
2. CLASSIFICATION OF FINANCIAL SOURCES

There are mainly two ways of classifying various financial sources

(a) Based on basic Sources,

(b) Based on Maturity of repayment period.

1. Sources of Finance based on Basic Sources:



2. Sources of Finance based on Maturity of Payment

Sources of finance based on maturity of payment can be classified as below:

Source of Finance		
Long-term	*Medium-term*	*Short-term*
1. Share capital or Equity shares 2. Preference shares 3. Retained earning 4. Debentures/Bonds of different types 5. Loan from financial institutions 6. Loans from State Financial Corporations 7. Loan from commercial banks 8. Venture capital funding 9. Asset security section 10. International financing like Euro-issues, foreign currency loans	1. Preference shares 2. Debentures/Bonds 3. Public deposits/fixed deposits for duration of three years 4. Medium term loans from Commercial banks, Financial Institutions, State Financial Corporations 5. Lease financing/Hire-purchase financing 6. External commercial borrowings 7. Euro-issues 8. Foreign Currency bonds	1. Trader credit 2. Accrued expenses and deferred income 3. Short term loans like Working Capital Loans from Commercial banks 4. Advance received from customers 5. Various short-term provisions

3. OWNERS CAPITAL OR EQUITY CAPITAL

Funds rose from promoters or from the investing public by way of owner's capital or equity capital by issuing ordinary equity shares.

Characteristics of Owners/ Equity Share Capital are:

- It is a source of permanent capital.
- Equity shareholders are practically owners of the company as they undertake the highest risk.
- The dividend payable to equity share is an appropriation of profits and not a charge against profits.
- In the event of winding up, ordinary shareholders can exercise their claim on assets after the claims of the other suppliers of capital have been met.
- Highest cost of capital due to shareholders expect a higher rate of return (as their risk is the highest) on their investment as compared to other suppliers of long-term funds.
- Ordinary share capital also provides a security to other suppliers of funds.

Advantages of raising funds by issue of equity shares are:

(i) Permanent source of finance.
(ii) Equity capital increases the company's financial base and thus helps to further the borrowing powers of the company.
(iii) A company is not obliged legally to pay dividends. Hence in times of uncertainties or when the company is not performing well, dividendpayments can be reduced or even suspended.
(iv) A company can make further increase its share capital by initiating a right issue.

Disadvantages of raising funds by issue of equity shares are:

(i) Ordinary shares risky because of uncertain dividend payment and capital gain.
(ii) The issue of new equity shares reduces the earning per share of the existingshareholders.
(iii) The issue of new equity shares can also reduce the ownership and control of the existing shareholders.

4. PREFERENCE SHARE CAPITAL

Preference shares enjoy two preferential rights over equity shares are:

- Payment of a fixed amount of dividend and
- Repayment of capital on winding up of the company.

Characteristics of Preference Share Capital:

- Long-term funds from preference shares can be raised through a public issue of shares.
- Such shares are normally cumulative, *i.e.*, the dividend payable in a year of loss gets carried over to the next year till there are adequate profits to pay the cumulative dividends.
- Rate of preference share dividend is higher than rate of interest.
- Redeemable in nature.
- It is similar to equity shares because dividend is not a tax-deductible payment. It resembles debt

capital because rate of preference dividend is fixed.

- Cumulative Convertible Preference Shares (CCPs) 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.
- Preference share capital may be redeemed at a pre decided future date orat an earlier stage inter alia out of the profits of the company.

Types of Preference Shares:

S. No.	Types of Preference Shares	Salient Features
1.	Cumulative	Arrear Dividend will accumulate.
2.	Non-cumulative	No right to arrear dividend.
3.	Redeemable	Redemption should be done.
4.	Participating	Can participate in the surplus which remains after payment to equity shareholders.
5.	Non-Participating	Cannot participate in the surplus after payment of fixed rate of Dividend.
6.	Convertible	Option of converting into equity Shares.

Advantages of raising funds by issue of preference shares are:

(i) No dilution in EPS.

(ii) Advantage of leverage as it bears a fixed charge.

(iii) Non-payment of preference dividends does not force a company into liquidity.

(iv) There is no risk of takeover as the preference shareholders do not have voting rights except where dividend payment is in arrears.

(v) Preference shareholders cannot participate in surplus profits as the ordinary shareholders can except in case of participating preference shareholders.

(vi) Preference capital can be redeemed after a specified period.

Disadvantages of raising funds by issue of preference shares are:

(i) Preference shares are costlier to the company than Debt because No tax shield on preference shares dividend. e.g. debenture.

(ii) Preference dividends are cumulative in nature.

Difference between Equity Shares and Preference Shares are as follows:

S. No.	Basis of Distinction	Equity Share	Preference Share
1.	Dividend payment	Equity Dividend is paid after preference dividend.	Payment of preference dividend is preferred over equity dividend.
2.	Rate of dividend	Fluctuating	Fixed
3.	Convertibility	Non-convertible	Convertible
4.	Voting rights	Equity shareholders enjoy full voting rights.	They have very limited voting rights.

5. RETAINED EARNINGS

Long-term funds may also be provided by accumulating the profits of the company and by ploughing them back into business. Such funds belong to the ordinary shareholders and increase the net worth of the company.

The decision to plough back depends on the rate of return generated by company vs expected cost of equity. This is further discussed in dividend decision chapter

6. DEBENTURES/ BOND

Loans can be raised from public by issuing debentures or bonds by public limited companies.

Characteristics of debentures are:

- Debentures are normally issued in different denominations ranging from ` 100 to ` 1,000 and carry different rates of interest.
- The period of maturity normally varies from 3 to 10 years and may alsoincrease for projects having high gestation period.
- Debentures are either secured or unsecured.
- They may or may not be listed on the stock exchange.
- Low cost of capital since tax shield available on debenture.
- From the investors' point of view, debentures offer a more attractive prospect than the preference shares since interest on debentures is payable whether or not the company makes profits.

Types of debentures:

(i) *Non-convertible debentures* – These types of debentures do not have any feature of conversion and are repayable on maturity.

(ii) *Fully convertible debentures* – Such debentures are converted into equity shares as per the terms of issue in relation to price and the time of conversion. Interest rates on such debentures are generally less than the non-convertible debentures because they carry an attractive feature of getting themselves converted into shares at a later time.

(iii) *Partly convertible debentures* – These debentures carry features of both convertible and non-convertible debentures. The investor has the advantage of having both the features in one debenture

Other types of Debentures with their features are as follows:

S. No.	Type of Debenture	Salient Feature
1.	Bearer	Transferable like negotiable instruments
2.	Registered	Interest payable to registered person
3.	Mortgage	Secured by a charge on Assets (s)
4.	Naked or simple	Unsecured
5.	Redeemable	Repaid after a certain period
6.	Non-Redeemable	Not repayable

Advantages of raising finance by issue of debentures are:

(i) Low cost of capital than cost of preference shares and equity shares.

(ii) investors consider debenture investment safer than equity or preferred investment and, hence, may require a lower return on debenture investment.

(iii) No dilution of control.

(iv) In a period of rising prices, debenture issue is advantageous.

Disadvantages of debenture financing are:

(i) Debenture interest and the repayment of its principal amount is an obligatory payment.

(ii) Debenture financing enhances the financial risk associated with the firmbecause of the reasons given in point (i).

(iii) Since debentures need to be paid at the time of maturity, a large amount of cash outflow is needed at that time.

BOND

Bond is fixed income security created to raise fund. Bonds can be raised through Public Issue and through Private Placement.

Types of Bonds

Based on call, Bonds can be categorized as:

(i) *Callable bonds:* A callable bond has a call option which gives the issuer the right to redeem the bond before maturity at a predetermined price knownas the call price (Generally at a premium).

(ii) *Puttable bonds:* Puttable bonds give the investor a put option (i.e. the right to sale the bond) back to the company before maturity

Various Bonds with their salient features are as follows

(i) Foreign Bonds

S. No.	*Name of Bond*	*Salient Features*
1.	Foreign Currency Convertible Bond (FCCB)	• This bond comes at a very low rate of interest. • The advantage to the issuer is that the issuer can get foreign currency at a very low cost. • The risk is that in case the bond has to be redeemed on the date of maturity, the issuer has to make the payment and at that time the issuer may not have the money.
2.	Plain VanillaBond	• The issuer would pay the principal amount along with the interest rate. • This type of bond would not have anyoptions. • Form of bond: Discounted bond or coupon bearing bond.
3.	Convertible Floating RateNotes (FRN)	• A convertible FRN is issued by giving its holder an option to convert it into a longer-term debt security with a specified coupon. • It protects an investor against falling interest rate.

		• It is long option structure • The long- term debt security can be sold in the market and the investor can earn profit. • Capital gain is not applicable to FRN.
4.	Drop LockBond	• It is a Floating Rate Note with a normal floating rate • The floating rate bond would be automatically converted into fixed rate bond if interest rate falls below a predetermined level • The new fixed rate stays till the drop lock bond reaches its maturity. • It is short option structure.
5.	Variable RateDemand Obligations	• A normal floating rate note with a nominal maturity. • The holder of the floating rate note can sell the obligation back to the trustee at par plus accrued interest • It gives the investor an option to exit, so it is more liquid than the normal FRN.
6.	Yield CurveNote (YCN)	• It is a structured debt security • Yield increases when prevailing interest rate declines • Yield decreases when prevailing interest rate increases • This is used to hedge the interest rate • This works like inverse floater.
7.	Euro Bond	• Euro bonds are issued or traded in a country using a currency other than the one in which the bond is denominated. This means that the bond uses a certain currency, but operates outside the jurisdiction of the Central Bank that issues that currency. • Eurobonds are issued by multinational corporations, for example, a British company may issue a Eurobond in Germany, denominating it in U.S. dollars • It is important to note that the term has nothing to do with the euro, and the prefix "euro-" is used more generally to refer to deposit outside the jurisdiction of the domestic central bank.

(ii) Indian Bonds

S. No.	Name of Bond	Salient Feature
1.	Masala (means spice) Bond	• These bonds are issued outside India but denominated in Indian Rupees. • NTPC raised ` 2,000 crore via masala bondsfor its capital expenditure in the year 2016.
2.	Municipal Bonds	• Municipal bonds are used to finance urban infrastructure are increasingly evident in India. • Ahmedabad Municipal Corporation issued a first historical Municipal Bond in Asia to raise • ` 100 crore from the capital market for partfinancing a water supply project.
3.	Government or Treasury Bonds	Government or Treasury bonds are bonds issued by Government of India, Reserve Bank of India,any state Government or any other Government department.

7. LOANS FROM FINANCIAL INSTITUTIONS

(i) Financial Institution: National

S. No.	Name of the Financial Institution	Year of Establishment	Remarks
1.	Industrial Finance Corporation of India (IFCI)	1918	Converted into a public company
2.	State Financial Corporations (SFCs)	1951	-
3	Industrial Development Bank of India (IDBI)	1954	Converted into Bank
4.	National Industrial Development Corporation (NIDC)	1954	-
5.	Industrial Credit and Investment Corporation of India (ICICI)	1955	Converted into Bank and Privatized
6.	Life Insurance Corporation of India (LIC)	1956	-
7.	Unit Trust of India (UTI)	1964	-
8.	Industrial Reconstruction Bank of India (IRBI)	1971	-

(ii) Financial Institution: International Institutions

S. No.	Name of the Financial Institution	Year of Establishment
1.	The World Bank/ International Bank for Reconstruction and Development (IBRD)	1944
2.	The International Finance Corporation (IFC)	1956
3.	Asian Development Bank (ADB)	1966

8. LOANS FROM COMMERCIAL BANKS

The primary role of the commercial banks is to cater to the short-termrequirements of industry. Of late, however, banks have started taking an interest in long term financing (e.g. expansion, setting up new unit or long-term working capital requirements) of industries in several ways.

Bridge Finance: Bridge finance refers to loans taken by a company normally from commercial banks for a short period because of pending disbursement of loans sanctioned by financial institutions. Bridge loans are normally secured by hypothecating movable assets, personal guarantees and demand promissory notes. Generally, the rate of interest on bridge finance is higher as compared with that on term loans.

9. VENTURE CAPITAL FINANCING

Meaning of Venture Capital Financing

- The venture capital financing refers to financing of new high risky venture promoted by qualified entrepreneurs who lack experience and funds to give shape to their ideas.
- In broad sense, under venture capital financing, venture capitalist make investment to purchase equity or debt securities from inexperienced entrepreneurs who undertake highly risky ventures with potential to succeed in future.

Characteristics of Venture Capital Financing

- It is basically an equity finance in new companies.
- It can be viewed as a long-term investment in growth-oriented small/medium firms.
- Apart from providing funds, the investor also provides support in form of sales strategy, business networking and management expertise, enabling the growth of the entrepreneur.

Methods of Venture Capital Financing

Some common methods of venture capital financing are as follows:

(i) *Equity financing:* The equity contribution of venture capital firm does not exceed 49% of the total equity capital of venture capital undertakings so that the effective control and ownership remains with the entrepreneur

(ii) *Conditional loan:* A conditional loan is repayable in the form of a royalty (ranging between 2 and 15%) after the venture is able to generate sales. Some Venture capital financiers give a choice 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 sound.

(iii) *Income notes:* 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. IDBI's VCF provides funding equal to 80 – 87.50% of the projects cost for commercial application of indigenous technology.

(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 up to a particular level of operation, after that, a high rate of interest is required to be paid.

10. DEBT SECURITIZATION

Meaning of Debt Securitization

Securitization is a process in which illiquid assets are pooled into marketable securities that can be sold to investors. The process leads to the creation of financial instruments that represent ownership interest in, or are secured by a segregated income producing asset or pool of assets. These assets are generally secured by personal or real property such as automobiles, real estate, or equipment loans but in some cases are unsecured.

11. LEASE FINANCING

Leasing is a general contract between the owner and 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.

Types of Lease Contracts

Comparison between Financial Lease and Operating Lease

Basis	*Financial Lease*	*Operating Lease*
Risk and Reward of ownership	Passed on to the lessee. The lessor only remains the legal owner of the asset.	Risk incident to ownership belong wholly to the lessor. The lessee is only provided the use of the asset for a certain time.
Risk of obsolescence	On Lessee	on lessor
Nature of contract	The lease is non-cancellable by either party.	The lease is kept cancelable by the lessor.
Cost of running and maintenance	Bear by lessee	Usually, the lessor bears cost ofrepairs, maintenance oroperations.
Cost of asset	Recovered from one lease contract.	The lease is usually non-payout, since the lessor expects to lease the same asset over and over again to several users.

Other Types of Leases

(a) *Sales and Lease Back:* Under this type of lease, the owner of an asset sellsthe asset to a party (the buyer), who in turn leases back the same asset to the owner in consideration of a lease rentals. Under this arrangement, the asset is not physically exchanged but it all happen in records only. The main advantage of this method is that the lessee can satisfy himself completely regarding the quality of an asset and after possession of the asset convert the sale into a lease agreement

(b) *Leveraged Lease:* Under this lease, a third party is involved besides lessorand the lessee. The lessor borrows a part of the purchase cost (say 80%) of the asset from the third party i.e., [redacted] lease rentals directly by the lessee and the surplus after meeting the claims of the lender goes to the lessor. The lessor is entitled to claim depreciation allowance.

(c) *Sales-aid Lease:* Under this lease contract, the lessor enters into a tie upwith a manufacturer for marketing the latter's product through his own leasing operations, it is called a sales-aid lease. In consideration of the aid in sales, the manufacturer may grant either credit or a commission to the lessor. Thus, the lessor earns from both sources i.e. from lessee as well asthe manufacturer.

(d) *Close-ended and Open-ended Leases:*

- In the close-ended lease, the assets get transferred to the lessor at the end of lease, the risk of obsolescence, residual value etc., remain with the lessor being the legal owner of the asset.
- In the open-ended lease, the lessee has the option of purchasing the assetat the end of the lease period.

12. SHORT-TERM SOURCES OF FINANCE

The different sources of short-term sources of finance are discussed below:

(i) *Trade Credit:* It represents credit granted by suppliers of goods, etc., as an incident of sale. The usual duration of such credit is 15 to 90 days

(ii) *Accrued Expenses and Deferred (Unearned) Income:*

- Accrued expenses represent liabilities which a company has to pay for the services which it has already received like wages, taxes, interest and dividends.
- Deferred income represents amount of funds received by company in lieu of goods and services to be provided in the future.

Since these receipts increase a company's liquidity, they are also considered to be an important source of spontaneous finance.

(iii) *Advances from Customers:* Manufacturers and contractors engaged in producing 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. This is a cost-free source of finance and really useful.

(iv) *Commercial Paper:* A Commercial Paper is an unsecured money market instrument issued in the form of a promissory note. The Reserve Bank of India introduced the commercial paper scheme in the year 1989 with a view to enabling highly rated corporate borrowers to diversify their sources of short-term borrowings and to provide an additional instrument to investors.

Subsequently, in addition to the Corporate, Primary Dealers and All India Financial Institutions have also been allowed to issue Commercial Papers. Commercial papers are issued in denominations of ` 5 lakhs or multiples thereof and the interest rate is generally linked to the yield on the one-year government bond.

All eligible issuers are required to get the credit rating from Credit Rating Information Services of India Ltd, (CRISIL), or the Investment Information and Credit Rating Agency of India Ltd (ICRA) or the Credit Analysis and Research Ltd (CARE) or the FITCH Ratings India Pvt. Ltd or any such other credit rating agency as is specified by the Reserve Bank of India.

(v) *Treasury Bills:* Treasury bills are a class of Central Government Securities. Treasury bills, commonly referred to as T-Bills are issued by Government of India to meet short-term borrowing requirements with maturities ranging between 14 to 364 days.

(vi) *Certificates of Deposit (CD):* A certificate of deposit (CD) is basically a savings certificate with a fixed maturity date of not less than 15 days up to a maximum of one year.

(vii) *Bank Advances:* A bank's lending policy is not merely profit motivated but has to also keep in mind the socio-economic development of the country.

Some of the facilities provided by banks are:

(a) *Short Term Loans:* It is a single advance and given against securities like shares, government securities, life insurance policies and fixed deposit receipts, etc. Except by way of interest and other charges, no further adjustments are made in this account. Repayment under the loan account is made either by way of repaying the full amount or by wayof schedule of repayments agreed upon as in case of term loans.

(b) *Overdraft:* Under this facility, customers are allowed to withdraw inexcess of credit balance standing in their Current Account. Overdrafts are repayable on demand; they generally continue for long periods by annual renewals of the limits.
Since these accounts are operated in the same way as cash credit and current accounts, cheque books are provided.

(c) *Clean Overdrafts:* Request for clean advances is entertained only from parties which are financially sound and having reputation for their integrity. As a safeguard, banks take guarantees from other persons who are credit worthy before granting this facility. A clean advance is generally granted for a short period and must not be continued for long.

(d) *Cash Credits:* Cash Credit is an arrangement under which a customeris allowed an advance up to certain limit against credit granted by bank.
Generally, cash credit limits are sanctioned against the security of tradable goods by way of pledge or hypothecation. Though these accounts are repayable on demand, banks usually do not recall such advances, unless they are compelled to do so by adverse factors.

(e) *Advances against goods:* Goods provide a reliable source of repayment. Advances against them are safe and liquid. Also, there is a quick turnover in goods, as they are in constant demand. So, a banker generally accepts them as security. Furthermore, goods are charged to the bank either by way of pledge or by way of hypothecation. Theterm 'goods' includes all forms of movables which are offered to the bank as security. They may be agricultural commodities or industrialraw materials or partly finished goods.

(f) *Bills Purchased/ Discounted:* Under this head, banks give advances against the security of bills which may be clean or documentary. Bills are sometimes purchased from approved customers in whose favour limits are sanctioned. Before granting a limit, the banker satisfies himself as to the credit worthiness of the drawer (the one who prepared the bill of exchange, i.e. the creditor or the beneficiary or the payee). Although the term 'bills purchased' gives the impression that the bank becomes the owner or purchaser of such bills, in actual practice the [redacted] against the parties liable on the bills,can also exercise a pledge's rights over the goods covered by the documents.

(viii) *Financing of Export Trade by Banks:*

The advances by commercial banks for export financing are in the form of:

(i) *Pre-Shipment Finance:* This generally takes the form of packing credit facility; packing credit is an advance extended by banks to an exporter for the purpose of buying, manufacturing, processing, packing, shipping goods to overseas buyers.

Packing credit is essentially a short-term advance.

An advance so taken by an exporter is required to be liquidated within 180 days from the date of its commencement by negotiation of export bills or receipt of export proceeds in an approved manner.

Types of Packing Credit

(a) *Clean packing credit:* This is an advance made available to an exporter only on production of a firm export order or a letter of credit without exercising any charge or control over raw materialor finished goods. It is a clean type of export advance. Each proposal is weighed according to particular requirements of the trade and credit worthiness of the exporter. A suitable marginhas to be maintained. Also, Export Credit Guarantee Corporation (ECGC) cover should be obtained by the bank.

(b) *Packing credit against hypothecation of goods:* The goods are hypothecated to the bank as security with stipulated margin. Atthe time of utilizing the advance, the exporter is required to submit, along with the firm export order or letter of credit relative stock statements and thereafter continue submitting them every fortnight and/or whenever there is any movement in stocks.

(c) *Packing credit against pledge of goods:* The exportable finished goods are pledged to the banks with approved clearing agents who will ship the same from time to time as required by the exporter. The possession of the goods so pledged lies with the bank and is kept under its lock and key.

(d) *E.C.G.C. guarantee:* Any loan given to an exporter for the manufacture, processing, purchasing, or packing of goods meant for export against a firm order qualifies for the packing credit guarantee issued by Export Credit Guarantee Corporation.

(e) *Forward exchange contract:* Another requirement of packing credit facility is that if the export bill is to be drawn in a foreign currency, the exporter should enter into a forward exchange contact with the bank, thereby avoiding risk involved in a possible change in the rate of exchange.

(ii) *Post-shipment Finance:* It takes the following forms:

(a) *Purchase/discounting of documentary export bills:* Finance is provided to exporters by purchasing export bills drawn payable at sight or by discounting usance export bills covering confirmed sales and backed by documents including documents of the title of goods such as bill of lading, post parcel receipts, or air consignment notes.

(b) *E.C.G.C. Guarantee:* Post-shipment finance, given to an exporter by a bank through purchase, negotiation or discount of an export bill against an order, qualifies for post-shipment exportcredit guarantee. It is necessary, however, that exporters should obtain a shipment or contracts risk policy of E.C.G.C. Banks insiston the exporters to take a contracts shipments (comprehensive risks) policy covering both political and commercial risks.

(c) *Advance against export bills sent for collection.*

(d) *Advance against duty draw backs, cash subsidy, etc.* 'An advance so availed of by an exporter is requiredto be liquidated within 180 days from the date of shipmentofrelativegoods

(ix) *Inter Corporate Deposits:* The companies can borrow funds for a short period, say 6 months, from other companies which have surplus liquidity.

(x) *Certificate of Deposit (CD):* The certificate of deposit is a document of title similar to a time deposit receipt issued by a bank except that there is no prescribed interest rate on such funds. The main advantage of CD is that banker is not required to encash the deposit before maturity period and the investor is assured of liquidity because he can sell the CD in secondary market.

(xi) *Public Deposits:* Public deposits are very important source of short-term and medium-term finances particularly due to credit squeeze by the Reserve Bank of India. A company can accept public deposits subject to the stipulations of Reserve Bank of India from time-to-time upto a maximum amount of 35 per cent of its paid- u p capital and reserves. These depositsmay be accepted for a period of six months to three years. Public depositsare unsecured loans; they should not be used for acquiring fixed assets. These are mainly used to finance working capital requirements

13. OTHER SOURCES OF FINANCING

(i) *Seed Capital Assistance:* The Seed Capital Assistance scheme is designedby IDBI for professionally or technically qualified entrepreneurs and/or persons possessing relevant experience, skills and entrepreneurial traits but lack adequate financial resources. All the projects eligible for financial assistance from IDBI, directly or indirectly through refinance are eligible under the scheme.

The Seed Capital Assistance is interest free but carries a service charge ofone per cent per annum for the first five years and at increasing rate thereafter. However, IDBI will have the option to charge interest at such rate as may be determined by IDBI on the loan if the financial position and profitability of the company so permits during the currency of the loan. The repayment schedule is fixed depending upon the repaying capacity of theunit with an initial moratorium up-to five years.

(ii) *Internal Cash Accruals:* Existing profit-making companies which undertake an expansion/ diversification Programme may be permitted to invest a partof their accumulated reserves or cash profits for creation of capital assets. In other words, the surplus generated from operations, after meeting all the contractual, statutory and working requirement of funds, is available for further capital expenditure.

(iii) *Unsecured Loans:* Unsecured loans are typically provided by promoters to meet the promoters' contribution norm. These loans are subordinate to institutional loans. The rate of interest chargeable on these loans should be less than or equal to the rate of interest on institutional loans and interest can be paid only after payment of institutional dues. These loans cannot be repaid without the prior approval of financial institutions. Unsecured loansare considered as part of the equity for the purpose of calculating debt equity ratio.

(iv) *Deferred Payment Guarantee:* The entire cost of the machinery is financed by supplier and the company is not required to contribute any amount initially towards acquisition of the machinery. Normally, the supplier of machinery insists that bank guarantee should be furnished by the buyer. Such a facility does not have a moratorium period for repayment. Hence, itis advisable only for an existing profit-making company.

(v) *Capital Incentives:* The backward area development incentives available often determine the location of a new industrial unit. These incentives usually consist of a lump sum subsidy and exemption from or deferment of sales tax and octroi duty. The quantum of incentives is determined by the degree of backwardness of the location.

Special capital incentives are sanctioned and released to the units only after they have complied with the requirements of the relevant scheme. The requirements may be classified into initial effective steps and final effective steps.

(vi) *Deep Discount Bonds:* Deep Discount Bonds is a form of zero-interest bonds. These bonds are sold at a discounted value and on maturity, face value is paid to the investors. In such bonds, there is no interest payoutduring lock in period.

(vii) *Secured Premium Notes:* Secured Premium Notes is issued along with a detachable warrant and is redeemable after a notified period of say 4 to 7years. The conversion of detachable warrant into equity shares will have tobe done within time period notified by the company.

(viii) *Zero Interest Fully Convertible Debentures:* These are fully convertible debentures which do not carry any interest. The debentures are compulsorily and automatically converted after a specified period of time and holders thereof are entitled to new equity shares of the company at predetermined price. From the point of view of company, this kind of instrument is beneficial in the sense that no interest is to be paid on it. If the share price of the company in the market is very high then the investors tend to get equity shares of the company at the lower rate.

(ix) *Zero Coupon Bonds:* A Zero-Coupon Bond does not carry any interest but it is sold by the issuing company at a discount. The difference between the discounted value and maturing or face value represents the interest to be earned by the investor on such bonds.

(x) *Option Bonds:* These are cumulative and non-cumulative bonds where interest is payable on maturity or periodically. Redemption premium is also offered to attract investors.

(xi) *Inflation Bonds:* Inflation Bonds are the bonds in which interest rate is adjusted for inflation. Thus, the investor gets interest which is free from the effects of inflation. For example, if the interest rate is 11 per cent and the inflation is 5 per cent, the investor will earn 16 per cent meaning thereby that the investor is protected against inflation.

(xii) *Floating Rate Bonds:* This as the name suggests is bond where the interest rate is not fixed and is allowed to float depending upon the market conditions. This is an ideal instrument which can be resorted to by the issuerto hedge themselves against the volatility in the interest rates. This has become more popular as a money market instrument and has been successfully issued by financial institutions like IDBI, ICICI etc.

The sources of external financing include:

(i) *Commercial Banks:* Like domestic loans, commercial banks all over the world extend Foreign Currency (FC) loans also for international operations.

(ii) *Development Banks:* Development banks offer long & medium-term loans including FC loans to foreign companies to invest within their country and to finance exports from their countries e.g. EXIM Bank of USA.

(iii) *Discounting of Trade Bills:* This is used as a short-term financing method. It is used widely in Europe and Asian countries to finance both domestic and international business.

(iv) *International Agencies:* The more notable among them include The International Finance Corporation (IFC), The International Bank for Reconstruction and Development (IBRD), The Asian Development Bank (ADB), The International Monetary Fund (IMF), etc.

(v) *International Capital Markets:* In international capital market, the availability of FC is available under the four main systems viz:

- *Euro-currency market*
- *Export credit facilities*
- *Bonds issues*
- *Financial Institutions*

(vi) *Financial Instruments:* Some of the various financial instruments dealt with in the international market are briefly described below:

(a) *External Commercial Borrowings (ECB):* ECBs refer to commercial loans (in the form of bank loans, buyers' credit, suppliers' credit, securitized instruments (e.g. floating rate notes and fixed rate bonds) availed from non-resident lenders with minimum average maturity of 3 years. Borrowers can raise ECBs through internationally recognized sources like (i) international banks, (ii) international capital markets, (iii) multilateral financial institutions such as the IFC, ADB etc., (iv) export credit agencies, (v) suppliers of equipment, (vi) foreign collaborators and (vii) foreign equity holders.

External Commercial Borrowings can be accessed under two routes viz (i) Automatic route and (ii) Approval route. Under the Automatic route, there is no need to take the RBI/Government approval whereas such approval is necessary under the Approval route.

(b) *Euro Bonds:* Euro bonds are debt instruments which are not denominated in the currency of the country in which they are issued

e.g. a Yen note floated in Germany. Such bonds are generally issued ina bearer form rather than as registered bonds and in such cases, they do not contain the investor's names or the country of their origin. These bonds are an attractive proposition to investors seeking privacy.

(c) *Foreign Bonds:* These are debt instruments issued by foreign corporations or foreign governments. These bonds are denominated in the currency of the country where they are issued, however, in case these bonds are issued in a currency other than the investors home currency, they are exposed to exchange rate risks. An example of a foreign bond 'A British firm placing Dollar denominated bonds in USA'.

(d) *Fully Hedged Bonds:* Fully hedged bonds eliminate the risk by selling in forward markets the entire stream of principal and interest payments.

(e) *Medium Term Notes (MTN):* Under this Programme, several lots of bonds can be issued, all having different features e.g. different coupon rates, different currencies etc. The timing of each lot can be decided keeping in mind the future market opportunities. The entire documentation and various regulatory approvals can be takenat one point of time.

(f) *Floating Rate Notes (FRN):* These are issued up to seven years maturity. Interest rates are adjusted to reflect the prevailing exchange rates. They provide cheaper money than foreign loans.

(g) *Euro Commercial Papers (ECP):* ECPs are short term money market instruments. They have maturity period of less than one year. They are usually designated in US Dollars.

(h) *Foreign Currency Option (FC):* A FC Option is the right (and not the obligation) to buy or sell, foreign currency at a certain specified priceon or before a specified date. It provides a hedge against financial and economic risks.

(i) *Foreign Currency Futures:* FC Futures are obligations (and not the right) to buy or sell a specified foreign currency in the present for settlement at a future date.

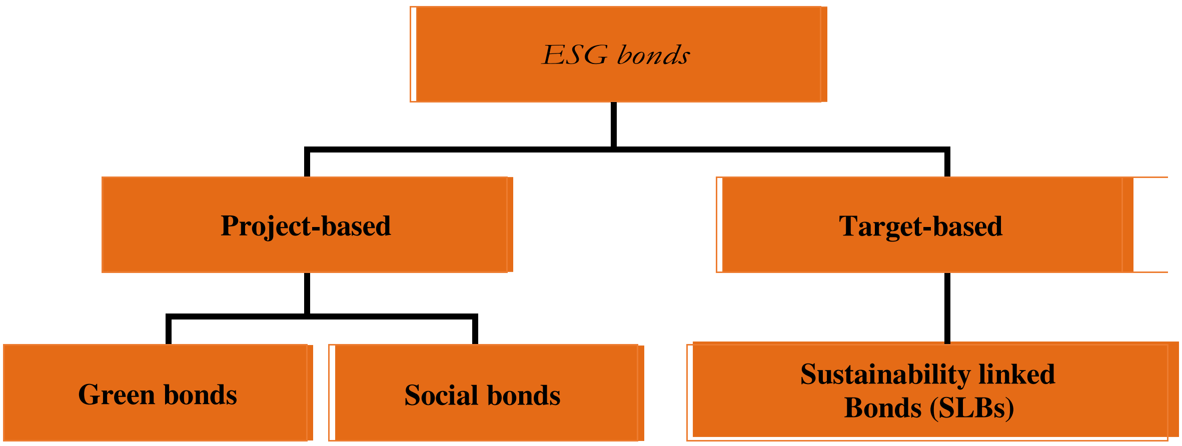
(j) *Foreign Euro Bonds:* In domestic capital markets of various countries, the Bonds issues referred to above are known by different names such as Yankee Bonds in the US, Swiss Frances in Switzerland, Samurai Bonds in Tokyo and Bulldogs in UK.

(k) *Euro Convertible Bonds:* A convertible bond is a debt instrument which gives the holders of the bond an option to convert the bonds into a pre-determined number of equity shares of the company.

(l) *Euro Convertible Zero Bonds:* No interest is payable on the bonds. But conversionof bonds takes place on maturity at a pre- determined price. Usuallythere is a five years maturity period and they are treated as a deferred equity issue.

(m) *Euro Bonds with Equity Warrants:* These bonds carry a coupon rate determined by market rates. The warrants are detachable. Pure bonds are traded at a discount. Fixed Income Funds Management may like to invest for the purposes of regular income in this case.

(n) *Environmental, Social and Governance-linked bonds (ESG* Investing in ESG bonds is considered as socially responsible investing. ESG bonds can be project-based - green bonds and social bonds; and target-based - sustainability-linked bonds (SLBs).



- *Green bonds:* These are the most popular ESG bonds that are issued by a financial, non-financial or public institution, where the bond proceeds are used to finance "green projects". For example: Ghaziabad Municipal Corporation (GMC) becomes the first Municipal Corporation to raise ` 150 crore from Green Bond in the Year 2021.
- *Social bonds:* These bonds finance the socially impactful projects. The projects here

are related to the social concerns such as Human rights, Equality, animal welfare etc. For example, "Vaccine bonds".

➢ *Sustainability-linked bonds (SLBs):* These bonds are combination of green bonds and social bonds. Proceeds of SLBs are not meant for a specific project but for general corporate purpose to achieve Key Performance Indicator (KPIs). For example: UltraTech Cement raises US$ 400 million through India's first sustainability-linked bonds in year 2021. The company aims to reduce carbon emissions through the life of bond of 10 years

(vii) *Euro Issues by Indian Companies:* Indian companies are permitted to raise foreign currency resources through issue of ordinary equity shares through Global Depository Receipts (GDRs)/ American Depository Receipts (ADRs) and / or issue of Foreign Currency Convertible Bonds (FCCB) to foreign investors. Such investment is treated as Foreign Direct Investment (FDI).

(a) *American Depository Receipts (ADRs):* These are securities offered by non-US companies who want to list on any of the US exchange. Each ADR represents a certain number of a company's regular shares. ADRs allow US investors to buy shares of these companies without the costs of investing directly in a foreign stock exchange.

(b) *Global Depository Receipts (GDRs):* These are negotiable certificates held in the bank of one country representing a specific number of shares of a stock traded on the exchange of another country. These financial instruments are used by companies to raise capital in either dollars or Euros. These are mainly traded in European countriesand particularly in London.

(c) *Indian Depository Receipts (IDRs):* The concept of the depository receipt mechanism which is used to raise funds in foreign currency has been applied in the Indian Capital Market through the issue of Indian Depository Receipts (IDRs).
The IDRs are listed and traded in India in the same way as other Indian securitiesare traded.

15. CONTEMPORARY SOURCES OF FUNDING

(i) *Crowd funding:* Raising money for an individual or organisation from a group of people to fund a project, typically via internet (social media and crowd funding websites).
In the crowd funding process, three parties are involved i.e. fund raiser, mediator and fund investor. The platforms (mediator) may also charge certain fees in the form of processing fee, transaction fee, etc. either as a fixed amount or a percentage or in combination of both.

(ii) *Equity funding: Investor invests money* in an organisation and receive securities of that organisation in return. Every investor would be entitled to a stake in the organisation depending on their investment. The digital nature of crowd funding targets large number of investors with small contributions. This type of funding is mostly adopted by startups. Some of the platforms offering equity crowd funding are Start Engine, Equity Net, Seed Invest, etc.

(iii) *Peer-to-Peer (P2P) lending:* It is that category of crowd funding where lenders match with the borrowers in order to provide unsecured loans through online platform. The fund raised are paid back by the borrowers with interest, though this kind of lending involves certain risk of defaults (just as the banks bear in the case of conventional method of lending). Some of the platforms offering P2P lending are i2i Funding, Lendbox, Faircent, Rupee Circle, etc.

(i) *Start-up funding:* A start-up company can raise money from large group of people. The crowd funding may be in the form of equity funding,P2P lending or both.

(ii) *Donation-based Crowd funding:* It is a source of finance where large groupof people donate money as a charity for some cause with no expectation of any ownership or debt. Some of the platforms that are used for donation- based crowd funding is GoFundMe (used for donations against medical needs, education, etc.), Ketto (used for donation against medical needs), Fuel A Dream (used for donation against charity projects, new ideas), etc.

FINANCING OF WORKING CAPITAL

Types of Working Capital:

1. Permanent Working Capital: The permanent working capital is always needed irrespective of sales fluctuation; hence it should be financed by the **long-term sources such as debt and equity**.
2. Temporary Working Capital: Temporary working capital may be financed by the **short-term sources of finance**.

Types of Finance of working capital:

The working capital finance may be classified between the two categories:

1. Spontaneous Sources: They **arise naturally** in the course of business operation. Example: Trade credit, credit from employees, credit from suppliers of services, etc.
2. Negotiated Sources: They have to be **specifically negotiated** with lenders say, commercial banks, financial institutions, general public etc.

Parameters for section of source of working capital finance:

(i) Cost factor

(ii) Impact on credit rating

(iii) Feasibility

(iv) Reliability

(v) Restrictions

(vi) Hedging approach or matching approach i.e., Financing of assets with thesame maturity as of assets.

SOURCES OF FINANCE

➢ Inter-corporate Loans and Deposits

Sometimes, organizations having **surplus funds** invest for **short-term period with other organizations.** This source of finance **reduces dependence on bank financing**.

➢ Commercial Papers

Commercial Paper (CP) is an **unsecured promissory note** issued by a firm to raise funds for a **short period**. The maturity period ranges from **minimum 7 days to less than 1 year** from the date of issue. CP can be issued in denomination of **` 5 lakhs or multiples thereof.**

Advantages of CP:

From the point of the issuing company, CP provides the following benefits:

(a) CP is sold on an **unsecured basis** and does not contain any restrictiveconditions.

(b) Maturing CP can be **repaid by selling new CP** and thus can provide acontinuous source of funds.

(c) Maturity of CP can be **tailored to suit the requirement** of the issuing firm.

(d) CP can be issued as a **source of fund** even when **money market is tight**.

(e) Generally, the **cost of CP** to the issuing firm is **lower than the cost of commercial bank loans.**

Limitation of CP:

(i) Only **highly credit rating firms** can use it. Now and moderately rated firm generally are not in a position to issue CP.

(ii) CP can **neither be redeemed before maturity nor can be extended** beyondmaturity.

BILL REDISCOUNTING SCHEME

The Bill rediscounting Scheme was **introduced by Reserve Bank of India** with effect from **1st November, 1970**. Under the bills rediscounting scheme, all licensed scheduled banks are eligible to offer bills of exchange **to the Reserve Bank for rediscount.**

FACTORING

Factoringis a **continuous arrangement** between a financial institution, (namely the factor) anda firm (namely the client) which sells goods and services to trade customers on credit.

A factor is an agent who **collects the dues** of his client for a certain fee

Difference between Factoring and Bills discounting:

Basis	Factoring	Bills discounting
Definition	Factoring is called as **'Invoice factoring'**	Bills discounting is known as **'Invoice discounting'**
Parties	Client, factor and debtor	Drawer, Drawee and Payee.
Nature	Factoring is a sort management of book debts	Bills discounting is a sort of borrowing from commercial banks.
Applicability of Act	No specific Act;	Negotiable Instrument Act, 1881

WORKING CAPITAL FINANCE FROM BANKS

Recently, some term lending financial institutions have also announced schemes for working capital financing. The two committees viz., **Tandon Committee and Chore Committee** have evolved definite guidelines and parameters in working capital financing, which have laid the foundations for development and innovation in the area.

FORMS OF BANK CREDIT

The bank credit will generally be in the following forms:

- Cash Credit: This facility will be given by the banker to the customers by giving **certain amount of credit facility** on continuous basis. The borrower will not be allowed to exceed the limits sanctioned by the bank.
- Bank Overdraft: It is a **short-term borrowing facility** made available to the companies in case of **urgent need** of funds. The banks will **impose limits** on the amount they can lend. When the borrowed funds are no longer required, they can **quickly and easily be repaid**. The banks issue

overdrafts with a right to call them in at short notice.

- Bills Discounting: The Company which sells goods on credit will normally **draw a bill on the buyer** who will accept it and sends it to the seller of goods. The seller, in turn discounts the **bill with his banker.** The banker will generally earmark the discounting bill limit.
- Bills Acceptance: To obtain finance under this type of arrangement a company **draws a bill of exchange on bank**. The bank accepts the bill thereby promising to pay out the amount of the bill at some specified future date.
- Line of Credit: Line of Credit is a **commitment by a bank** to lend a certain amount of **funds on demand** specifying the maximum amount.
- Letter of Credit: It is an arrangement by which the issuing bank on the instructions of a customer or on its own behalf undertakes **to pay or accept or negotiate or authorizes another bank to do** so against stipulated documents subject to compliance with specified terms and conditions.
- Bank Guarantees: Bank guarantee is one of the facilities that the commercial banks extend on behalf of their **clients in favour of third parties** who will be the beneficiaries of the guarantees.