BUSINESS FINANCE

"We may forgo material benefits of civilization, but we cannot forgo right and opportunity to reap the benefits of the highest education to the fullest extent..."

-Dr . B.R. Ambedkar

Dr. B.R. AMBEDKAR OPEN UNIVERSITY

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COURSE TEAM

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(Corporation and Industrial Finance - 1986)

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PREFACE

The course deals with topics in 'Business Finance' included in the syllabus for the Third year of the B.Com., programme offered by Dr. B.R. Ambedkar Open University. These topics generally cover the 'core' area of the subject to be studied in the "Third year" of three year Degree Course in Commerce (B.Com.,). The syllabus, for the sake of convenience, is divided into Blocks, each of which comprises a number of units. The units are prepared by specialists in accordance with a format so designed as to enable the student to study and comprehend the subject matter without much difficulty. Each unit begins with aims and objectives followed by contents. At the end of each unit, model examination questions are given with an intention to test the students' comprehension of its subject matter. Technical terms with which the student may not be familiar are given at the end of each unit under the 'Glossary' besides summary of the unit.

The behavior and performance of business enterprises are the key to understanding the modern economic society. As such the professional viewpoint is that there is an immense need to study Business Finance. The University, therefore, offers the subject of **Business Finance** as one of the important courses to the students of Commerce-future corporate financial executives-in its B.Com., Third year programme.

This course is divided into five Blocks and 20 Units. The first Block deals with the Introductory aspects of Business Finance. The second Block discusses Financial Instruments and Markets. Block III deals with Financial Institutions while Block four explains different aspect relating to Working Capital Financing. Finally, Block five discusses Internal Financing.

The University hopes that this material will help the student to get acquainted with the principal issues in Business Finance which make for its distinctiveness and significance.

CONTENTS

BLOCK – I

INTRODUCTION TO BUSINESS FINANCE

UNIT - I : BUSINESS FINANCE : AN INTRODUCTION

Contents

1.0 AIMS AND OBJECTIVES

The aim of this unit is to acquaint you with the meaning and the significance of Business Finance.

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

- define the term finance;
- identify the sources of business finance;
- explain the scope of business finance; and
- discuss the regulations relating to the business finance.

1.1 INTRODUCTION

Finance is one of the significant factors for starting an enterprise. It determines the nature and size of an enterprise. Identification of the various sources to finance the assets of an enterprise is crucial, as it safeguards the enterprise from financial hardships. While raising the finance, the management has to comply with the legal legislations which are in existence. It is also important to understand the environment of finance, covering the developments in the money and capital markets, fiscal and monetary policies. In this context, an attempt has been made in this unit to present an overview of the business finance.

1.2 DEFINITION OF FINANCE

The term finance may be defined as the 'Science of Money'. George Christy and Peter Roden state that "to finance means to arrange payment for it". They further observe that finance maybe generally defined as the study of money, its nature, creation, behaviour, regulation and problems. Finance is a study of money management and deals with the ways in which businessmen, investors, governments, financial institutions and families handle their money. An understanding of what money is and does is the foundation of financial knowledge.

Some more definitions of the financial experts have been given under to enable the student to better comprehend the true nature of finance.

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

-- *Guthman and Dougall*

"The finance function is the process of acquiring and utilising funds by a business".

-- *R.C.Osborn*

"The issuance of, distribution of and purchase of liability and equity claims issued for the purpose of generating revenue producing assets".

-- *Ray G. Jones and Dean Dudley*

"Finance is the management of monetary affairs of a company." -- *Paul G. Hastings*

It is evident from the above that the term 'finance' is understood in many ways. Whatever may be the definition, the fact is that it focuses on the mobilisation and utilisation of funds by a corporate enterprise.

Types of Finance

There are three broad categories of finance.

1. Personal Finance;
2. Public Finance, and
3. Business Finance;

The classification of finance can be seen from the following Chart-I.

Chart-I

Finance

- Personal Finance
- Public Finance
- Business Finance
  - Proprietary Finance
  - Partnership Finance
  - Company Finance
  - Industrial Finance

It is essential that we distinguish between each of these terms in order to correctly understand the meaning and importance of business finance.

i) *Personal finance:* This subject deals with the financial affairs of individuals. Aspects relating to their savings and investments are covered.

ii) *Public Finance:* This subject deals with the mobilisation and administration of public funds. It covers all aspects relating to the securing of funds by the government from the public through various methods like the imposition of taxes and borrowing from the public in domestic and foreign markets.

iii) *Business Finance:* This relates to the study of all principles pertaining to the mobilisation of funds by various business enterprises. Business finance is too broad a concept. It relates to all the financial activities of a "business" and it includes both "Commerce" and "Industry". Stated simply, business finance is a term which applies to all the financial activities of trade, and auxiliaries of trade such as banking, insurance, transport, mercantile agencies, service organisations, and the manufacturing enterprises. Following are the forms of business organisations:

1. Sole Trading Form
2. Partnership Form
3. Company Form
4. Co-operative Form

In the case of a sole trading business, the individual will take care of the business with the help of his family members. For the requirements of his business, the sole trader will bring in his own funds. Besides, he will also get funds from his friends, relatives and other sources. In the case of partnership firm, partners will bring in capital and they will also get money from outside sources. In sole trading and partnership business, the members' liability is unlimited and they are always aware of this fact.

With the growth of industrialisation, many business establishments have preferred to set up businesses in company form of organisation. In respect of joint stock companies, the sources of finance are fairly broad based. They can secure funds through shares, debentures, banks, financial institutions, suppliers, etc. Another form of organisation is co-operative form. The co-operatives secure funds, like companies, mainly from members, financial institutions, Government, etc. **Thus business finance may be categorised into the following types:**

a) Proprietary Finance;
b) Partnership Finance;
c) Company Finance; and
d) Industrial Finance.

(a) *Proprietary Finance* : This refers to the securing and management of funds by the individuals, organising themselves as sole traders.

(b) *Partnership Finance* : This relates to the mobilisation and control of funds by the partnership firms.

(c) *Company Finance or Corporation Finance* : This refers to the mobilisation and administration of funds by the companies incorporated under Companies Act, 1956. Corporation finance deals with the financial problems of a corporate enterprise. It also includes the financial aspects of the promotion of new enterprises and their administration during their early period, the accounting problems, the administrative problems arising out of growth and expansion, and finally the financial adjustments which are necessary to bolster up on and rehabilitate a corporation which has run into financial difficulties. This also includes the financial dealings of public corporations.

(d) *Industrial Finance*: This is a term mainly used to refer to the finance supplied by the term lending organisations like IFCI, IDBI, ICICI etc., to the various private and public sector units. It also includes the provision of funds by other institutional agencies like LIC, GIC, UTI and Commercial Banks.

Though an attempt has been made so far to distinguish among the different terms used, there is a high degree of interchange in the use of these terms in practice. Corporation finance is used to include all kinds of finance extended to business units. Above all, modern finance theory is preferring the term 'financial management' in place of 'corporation finance', so as to emphasize on the managerial aspects of finance.

1.3 EVOLUTION OF FINANCE

Finance, as a subject, is hardly, a century old. It was a branch of Economics in its early stages of development. Many topics relating to the promotion and securing of funds were discussed as constituents of Economics discipline. As a separate discipline, finance is only half a century old. The development of the subject matter started in 1920s, when technological innovations started taking place and new industries were coming up, and there arose the need for funds in larger quantities. A land-mark in this period is the book written work by Arthur S. Dewing titled 'The Financial Policy of Corporations'. The later period of the thirties witnessed large scale corporate failures, and, therefore, attention was focussed on the financial aspects of liquidation, mergers and amalgamations. Finance, during the forties and the fifties, was dominated by issues like capital budgeting, capital structure and cost of capital. The sixties saw the development of portfolio theory in finance. The period of the seventies and the eighties brought forth discussion on various administrative aspects like working capital management, problems of small enterprises and public enterprises. The development in this discipline is continuing still, and there are many areas yet to be resolved, with rational explanations.

1.4 IMPORTANCE OF FINANCE

The importance of the business finance can be understood from the following two aspects:

i) Its usefulness to the undertakings and industry; and
ii) Its utility to the society.

i. Utility to the Undertakings

In all the four factors of production, viz., land, labour, capital and organisation, finance assumes a pivotal place. One cannot think of doing a business or setting up an establishment without the needed resources. Finance gives shape to the ideas of the entrepreneurs. For a business enterprise, finance is the life blood; as blood imparts life and strength to an individual, so is the function of finance in an enterprise. In all the corporate activities, mobilisation of funds and their administration pose a great challenge.

The rate of return on investment is dependent on the efficient utilisation of the funds. A financially well managed company can satisfy the various interest groups viz., employees, managers, government, shareholders and society. Further, all the decisions of the enterprise relating to production, marketing and personnel have financial consequences. Every act of the business has financial implications. For instance, all actions like purchase of materials, recruitment of personnel and selling of assets bring about a change in the financial position of the enterprise. A financially sound company can purchase and store materials at economic prices, recruit qualified and efficient staff, produce goods with the lowest possible cost and can acquire qualitative fixed assets.

More specifically, the efficiency or otherwise of the financial decisions will determine the survival or decline of the undertaking. Corporation finance assumes further importance because of the dichotomy between the ownership and management of the undertaking, a feature of the company form of organisation. In such circumstances, this subject concerns itself with providing an understanding to the shareholders and other interested groups as to what is happening to the undertakings and to their interests.

ii. Usefulness to the Society

All sections of the society will be benefitted by the understanding of the principles of corporation finance. With efficient management of the enterprises on the basis of sound principles of corporate finance, the consumers can get the products at lower prices, workers can get higher wages and shareholders can obtain higher dividends. For the government also, the healthy growth of corporate sector leads to higher tax revenues. To conclude, the efficient and sound practice of corporation finance is vital to the success of the enterprises in particular and to the society in general.

1.5 SOURCES OF BUSINESS FINANCE

Business enterprises mobilise funds from various sources. The sources from which finance can be obtained can be grouped on the following bases:

A. On the Basis of the Time Period: On this basis, one can categorise the different sources of finance into:

a) Short-term Sources; and
b) Long-term Sources.

Short-term Sources: Short-term sources are those that are required to be repaid within a year. These sources include bank borrowings, public deposits, trade credit, provisions and other current liabilities.

Long-term Sources: Those sources are required to be repaid over a long period, exceeding one year, and include debentures, loans from financial institutions, foreign capital, etc. Further this includes equity capital, preference capital, which are permanent in nature.

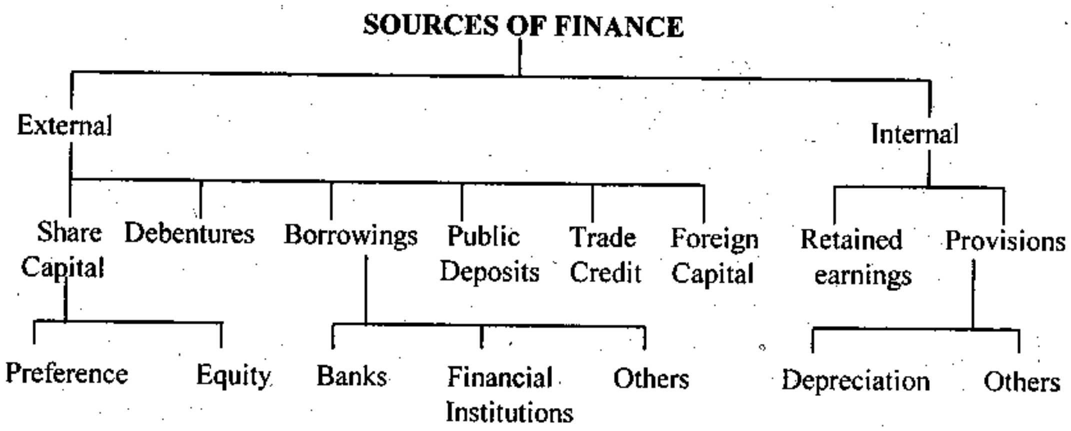
B. On the Basis of Origin: The sources of finance can be categorised into:

i) Internal; and
ii) External

(i) *Internal sources*: These are the sources of finance that are mobilised from within the company through its operations. These include depreciation, retained earnings and other reserves and surplus. The quantum of the internal resources will depend upon the profits, corporate taxes and dividend policies of the undertakings.

(ii) *External Sources*: These are funds drawn from outside sources and include funds from the issue of shares, debentures, public deposits, loans from banks, financial institutions, inter-company loans, foreign capital etc. Chart-II depicts the sources from which a company can raise finance.

Chart –II



Thus, we can identify the following sources from which funds can be mobilised by a company:

a) Share Capital
b) Debentures
c) Public Deposits
d) Borrowings from Banks
e) Borrowings from Financial Institutions
f) Retained Earnings
g) Trade Credit
h) Provisions
i) Foreign Capital

(a) ***Share Capital***: One of the primary sources of capital is the issue of shares to the public. A company is allowed to issue two types of shares viz., Preference shares and Equity shares.

Preference Shares: Preference Shares carry preferential rights to their shareholders in the matters of payment of dividend and return of capital. In the event of liquidation of the company, they have priority over the equity shareholders, in respect of return of capital.

Equity Shares: Equity shareholders are the owners of the company. They are the risk-takers. They get dividend whenever the company earns profits. They have the right to subscribe the subsequent issues of the shares of the company., In the event of winding up of the company, they get back their capital only after all the other claims are met.

(b) ***Debentures***: This is another major source of finance for companies. As against share capital, debentures mostly have an assurance of the payment of fixed rate of interest and return of principal. The investors who do not want to take risk by investing in shares, prefer investment in debentures. In debentures, there are various kinds, viz.

i. On the basis of Security

a) Secured; and
b) Unsecured.

ii. On the basis of Redeemability

a) Redeemable; and
b) Irredeemable

iii. On the basis of Convertibility

a. Convertible; and
b. Non-convertible

i) *Secured and Unsecured Debentures:* Secured debentures are those that are provided with security of assets by the company. That is to say, the debenture holders would have a charge on the assets of the company. In the event of liquidation, they would be paid after the preferential creditors. On the other hand, unsecured debentures are those that do not carry any security with them. These unsecured debenture holders would rank equal with other unsecured creditors.

ii) *Irredeemable and Redeemable Debentures:* On the basis of the redemption, debentures are classified as such. If the debentures are payable within the life time of the company or within a certain time period they are called redeemable debentures. If they are not to be paid back within the life time of the company, they are called irredeemable debentures.

iii) *Convertible and Non-convertible Debentures:* Convertible debentures are those that are convertible into specified number of equity shares at an agreed price after some time. Therefore, the holder of this debenture would have an option to get part of his investment converted into equity shares of the company as per the terms of the issue. On the contrary, non-convertible debentures do not enjoy this facility.

c) **Public Deposits:** Public deposits are the traditional source of finance for many companies. Under this, companies advertise for the acceptance of deposits from shareholders, employees and the public for duration of one to three years. This source has been used extensively by the companies for various reasons like the lower interest rate, non-provision of security and non-availability of bank credit.

d) **Borrowings from Banks:** Banks have been one of the significant traditional suppliers of funds. Companies depend largely on the banks for meeting their working capital requirements. Sometimes, they also grant medium and long term loans to the companies, Banks provide the assistance in several forms such as cash credits, overdrafts and discounting of bills. However, in the recent years, the role of Bank credit in financing industry is declining due to shift in the priorities of lending.

e) **Borrowing from Financial Institutions:** The special financial institutions and development banks provide long-term finance to the companies. They grant loans, stand as guarantors, underwrite the issues and also participate in equity capital of the companies.

At present in India, there are many financial institutions that are providing long-term finance to the industry. They include Industrial Development Bank of India, Industrial Credit and Investment Corporation of India and various State Financial Corporations.

f) **Retained Earnings**: These are the funds that are retained out of the profits of the company. Generally, companies do not declare all of their earnings in the form of dividends. They earmark a certain portion for the future use in the company for meeting the expansion and modernisation requirements. The company would always be free to utilise this source. The retained profits enable a company to withstand seasonal reactions and business fluctuations. The large accumulated savings facilitate a stable dividend policy and enhance the credit standing of the company. However, the quantum of retained earnings depends on the volume of profits earned by the company.

g) **Trade Credit**: It is common in business that enterprises sell and buy on credit basis. Normally, every company gets its raw materials and other supplies on credit basis. This is what is known as trade credit. This acts as an important source of financing. This form of financing is preferred by many enterprises because of convenience and low cost.

h) **Provisions:** Companies, in order to meet the legal and other obligations, create some funds for future use. These are known as provisions. They include provision for depreciation, taxation, dividends and for various other current and non-current liabilities. The amounts set apart in these forms would be required to be paid only on certain dates. Till then the company can use them for its own purpose. For instance, taxes payable to the Government are used in the business until these are actually paid on due date. Therefore, though for a short-while, provisions would serve a good source of finance.

i) **Foreign Capital**: Many companies draw funds not only from domestic sources but also from foreign sources. In the most usual circumstances, the collaborators of the project participate in the equity of the company and also provide loans sometimes. Foreign Direct Investment (FDI) is the most preferred source of foreign capital now. Foreign commercial borrowings can also be availed. A company may directly approach the foreign capital markets for raising funds through the issue of Global Depository Receipts (GDRs) and American Depository Receipts (ADRs). Sometimes, the Government may arrange for the transfer of funds from a foreign source to the companies. The International Finance Corporation (IFC), and Asian Development Bank (ADB) provide funds to companies directly.

CHECK YOUR PROGRESS - 1

i) State the different sources of business Finance.

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1.6 SCOPE OF BUSINESS FINANCE

As seen earlier, there have been different forms of business organisations. The subject business finance is mainly related to the study of financing aspects of business, more particularly Joint Stock Companies.

Business finance includes in itself various issues concerning the corporate planning, promotion, growth, capitalisation, issuing of corporate securities, underwriting, stock exchanges, capital market, management of working capital and financial analysis.

In fact, there has been a shift in the emphasis of the subject in the recent years. Earlier business finance concentrated much on the issues like company promotion, liquidation, mergers and amalgamation and various other infrequent episodic events relating to the business enterprises. But now more attention is being devoted to the day-to-day running of the enterprises. This is why, corporation finance is defined as the activity concerned with the raising and administration of funds used in the business enterprises. The most preferred title for this subject today is the 'Financial Management'.

1.7 ENVIRONMENT OF FINANCE

The practice of various principles of corporation finance in India is subjected to numerous regulations. The companies would be required to comply with the stipulations incorporated in various Acts. Some of the important legislations that influence the practice of corporation finance include the following:

- The Companies Act, 1956
- The Securities Contracts (Regulation) Act, 1956
- The Income Tax Act, 1969
- The Reserve Bank of India Act, 1934
- The Banking Regulation Act, 1949
- SEBI Act, 1992
- Foreign Exchange Regulation Act, 1974
- Foreign Exchange Management Act, (FEMA) 2000

Besides these Acts, the practice of business finance is also influenced by the fiscal and industrial policies of the country, situation in the capital market and strength of the banking sector and financial institutions. Let us now briefly discuss the provisions of some of these regulations to understand the environment of the business finance in India.

The Companies Act, 1956: This is a comprehensive legislation passed by the Government to regulate the functioning of joint stock companies in India. There have been stipulations in the Act right from the appointment of directors to that of the undertakings. The Act is designed to ensure the following objectives.

i) To ensure minimum standard of business integrity and conduct in the promotion and management of companies;

ii) To elicit full and fair disclosure of all responsible information relating to the affairs of the company;

iii) Promote effective participation and control by shareholders and protect their legitimate interests; and

iv) Empower the Government to intervene and investigate the affairs of companies when they are managed in a manner prejudicial to the shareholders or public interest.

Specifically, the following are some of the important provisions which effect the financial management of the companies.

1. A company can issue only two kinds of shares viz., equity and preference;

2. In the case of subsequent issue of shares, they have to be first offered to the existing shareholders;

3. For getting share capital from public, a prospectus should be issued or a statement in lieu of prospectus must be submitted to the Registrar of Companies giving full particulars about the issue of shares, the operation of the company, etc.;

4. To prevent oppression and mismanagement, the Central Government can appoint the required number of directors or order the transfer of shares from a particular individual or group; and

5. Before declaration of dividends a certain percentage of profits is to be transferred to the reserves depending on the percentage of dividends declared.

Securities Contracts (Regulation) Act, 1956: Along with the Companies Act, the government has also passed another Act to regulate the activities taking place at the stock exchanges. As a matter of fact, it has also passed capital Issues Control Act, 1947, to regulate the issue of capital by companies in India. But the same has been repealed now. The Securities Contracts (Regulation) Act is intended to promote genuine trading in securities, against speculative trading. The Act mainly focuses on the following three aspects.

a) Recognition of Stock Exchanges
b) Listing of Securities
c) Regulation of Brokers' activities

SEBI Act, 1992: In order to regulate the activities taking place in the capital market in a more orderly and effective manner, the Government has set up Securities and Exchange Board of India (SEBI) in 1988. When it started failing in discharging its duties effectively due to lack of statutory powers, the Government passed an act with the name as such. As per this legislation, SEBI has the following objectives, functions and powers.

Objectives

According to the preamble of the SEBI Act, 1992 the primary objective of the SEBI is to promote healthy and orderly growth of the securities market and secure investor protection. For this purpose, the SEBI monitors the activities of not only stock exchanges but also other intermediaries participating in the capital market. The objectives of SEBI are as follows:

1. To protect the interest of investors so that there is a steady flow of savings into the capital market.

2. To regulate the securities market and ensure fair practices by the issues of securities so that they can raise resources at minimum cost.

3. To promote efficient services by brokers, merchant bankers and other intermediaries so that they become competitive and professional.

Functions

Section 11 of the SEBI Act specifies the functions as follows:

1. Regulatory Functions

a) Regulation of stock exchanges and self regulatory organisations.

b) Registration and regulation of stock brokers, sub-brokers, registrars to an issue, merchant bankers, underwriters, portfolio managers and such other intermediaries who are associated with securities market.

c) Registration and regulation of the working of collective investment schemes including mutual funds.

d) Prohibition of fraudulent and unfair trade practices relating to securities market.

e) Prohibit insider trading in securities markets.

f) Regulating substantial acquisitions of shares and take over of companies.

2. Developmental Functions

a) Promote investor's education.

b) Training of intermediaries.

c) Conducting research and publication of information useful to all market participants.

d) Promotion of fair practices, code of conduct for self regulatory organisations.

e) Promoting self regulatory organisations.

Powers

SEBI has been vested with the following powers:

1. Power to call periodical returns from recognised stock exchanges.
2. Power to call any information or explanation from recognised stock exchanges or their members.
3. Power to direct enquiries to be made in relation to affairs of stock exchanges or their members.
4. Power to grant approval to bye-laws of recognised stock exchanges.
5. Power to make or amend bye-laws of recognised stock exchanges.
6. Power to compel listing of securities by public limited companies.
7. Power to control and regulate stock exchanges.
8. Power to grant registration to market intermediaries.
9. Power to levy fees or other charges for carrying out the purpose of regulation.
10. Power to declare applicability of Section 17 of the Securities Contract (Regulation) Act to any state or area for granting licences to dealers in securities.

SEBI has issued elaborate guidelines covering the following areas, as a matter of ensuring fair deal to the investors.

a) Investor protection

b) Pricing of issues

c) Regulation of Brokers

d) Regulation of Merchant Bankers

e) Guidelines for issue of IPOs

f) Guidelines on the activities of Mutual Funds

g) Buy back of shares

h) Bonus Shares, etc.

Fiscal Policies: Besides the above Acts, the fiscal policies of the Government also influence the financing pattern of the companies. The important instrument under this is taxation. Through the imposition of taxes, the government takes away a part of the business income. Therefore, the tax rates influence the quantum of retained earnings available with the companies. More so, taxes also influence the magnitude of investment at any time made by the individuals and businesses. Certain incentives encourage investment in companies, while other policies restrict the scope. Therefore, the level of investment is influenced by the policies of the Government.

Industrial Policy: The industrial policy of the country outlines the environment for industrial growth in the country. It identifies various areas for participation by the public and private sectors and also earmarks certain areas of production for selected sectors. In a nutshell, the policy provides a direction to the industrial development in the country. Industries Development (Regulation) Act, 1951 is the important legislation in this area. This Act regulates the setting up and development of industrial units in India. Under this Act, a licence is necessary for establishing a new industrial undertaking. Similarly, it also reserves the production of certain items by the small scale sector. Further, the Act tries to use industrial development as a means to achieve various goals of the country like balanced regional development, mitigation of unemployment, etc. However, this Act was abolished due to launching of New Economic Policy (NEP), New Industrial Policy (NIP) with regard to Liberalisation, privatisation and globalisation programmes since July, 1991.

CHECK YOUR PROGRESS – 2

Discuss briefly the environment of Finance

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1.8 SUMMING UP

Finance is the study of money and it deals with the ways in which businessmen, investors, governments, financial institutions, and families handle their money. There are various types of finance viz., public finance, business finance, proprietory finance, partnership finance, company finance and industrial finance.

Finance was a branch of economics in its early stages of development. But after 1920 it has been identified itself as a separate discipline. The efficiency with which the finance utilised would reflect in the prosperity of an organisation. By observing the principles of finance, the management would ensure benefits to various sections. There are various sources of finance. They are: share capital, debentures, public deposits, borrowing from banks, borrowing from financial institutions, retained earnings, trade credit, Provisions and foreign capital. The subject of business finance is influenced by many regulations such as the Companies Act, 1956, Securities Contracts and Regulation Act, 1956, Income Tax Act, 1969, SEBI Act, 1992, etc. Provisions incorporated in these legislations change the practice of business finance.

1.9 CHECK YOUR PROGRESS : MODEL ANSWERS

1. The following sources of finances are available to start a company:

   Share Capital
   Debentures
   Public deposits
   Borrowing from banks
   Borrowing from financial institutions
   Foreign Capital

2. The following are the Acts and Policies that constitute the environment of business finance:

   Companies Act, 1956.
   Securities Contracts (Regulation) Act, 1956
   Income Tax Act, 1961
   SEBI Act, 1992

Besides, the above Acts, the fiscal policy the industrial policy and the conditions in capital market would also influence the company finance.

1.10 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in about 30 lines each.

1. Define and explain the scope of finance in the context of business finance.
2. Discuss the following categories of business finance

   (a) Partnership finance; and (b) Company finance
3. Indicate the sources from which a company can mobilise funds.
4. Discuss the role of debentures as an important source of industrial finance.

II. Answer the following questions in about 15 lines each.

1. What are the aspects of the study of money that are relevant in the study of finance?
2. How is an understanding of finance relevant to the society?

organisation for finance function depends on the form of organisation, its size, etc. The finance manager is responsible for the discharge of finance function so as to achieve the objective of finance function. The job of finance manager has grown more challenging these days, in view of innovations taking place in the field of finance. Creation and maximisation of wealth have become the chief functions of a modern finance manager. Let us discuss the finance function in detail.

2.2 WHAT IS FINANCE FUNCTION?

Simply stated, finance function is what finance does. Every enterprise, irrespective of its nature and scale of operations, needs finance to carry out its activities and accomplish certain basic objectives. It is so indispensable that it is often described as the life-blood of all industrial and trading activity. Production and distribution of goods will, in fact, be a mere dream without flow of funds. In business circles, the importance of finance function is often acknowledged by grouping the field of management into the main operating functions of production, marketing and finance. This is one of the eight key result areas of business, listed by Peter F. Drucker.

2.2.1 TRADITIONAL CONCEPT

In the beginning of the 20th century, which was the starting point for the scholarly writings on corporation finance, the function of finance was considered to be the task of providing funds needed by the enterprise on terms that are most favourable to the operations of the enterprise. Under this concept, the finance manager has to take decisions with respect to the choice of optimum sources from which the funds would have to be secured, timing of the borrowing as also of the cost and other terms and conditions of acquiring these funds. Authors like Hunt and Donaldson have described the finance function as a task of providing funds required by an enterprise on the terms most favourable to it in the light of the objectives of the business. This concept has the merit of highlighting the core of the finance function. Ensuring that the business has funds to support programmes is the basic part of the function. This emphasis on the mere raising of funds for running a business enterprise has been criticised by many scholars, on the ground that traditional concept is limited in its interpretation.

2.2.2 MODERN CONCEPT

The financial experts now are of the view that finance is an integral part of the overall management rather than mere mobilisation of funds. The finance manager, under this concept, has to see that the company maintains sufficient funds to carry out the plans. At the same time, he has also to ensure a wise application of funds in the productive process. Thus, the present day finance manager is required to bother about all the financial activities of planning, raising, allocating and controlling of funds.

2.3 SCOPE OF FINANCE FUNCTION

In order to understand the function of finance in its broader perspective, it is necessary to survey the scope of the finance function. Finance function in a business is closely related to its other functions. Thus, purchasing, production and distribution are intimately connected with problems of financing. Moreover, success and efficiency in raising, allocating and administering funds of the business largely determine the success or failure of its management. The fact is that a large number of business decisions carry financial implications. Accounting of finance viz., public finance, business finance, proprietory finance, partnership finance, company finance and industrial finance.

Finance was a branch of economics in its early stages of development. But after 1920 it has been identified itself as a separate discipline. The efficiency with which the finance utilised would reflect in the prosperity of an organisation. By observing the principles of finance, the management would ensure benefits to various sections. There are various sources of finance. They are: share capital, debentures, public deposits, borrowing from banks, borrowing from financial institutions, retained earnings, trade credit, Provisions and foreign capital. The subject of business finance is influenced by many regulations such as the Companies Act, 1956, Securities Contracts and Regulation Act, 1956, Income Tax Act, 1969, SEBI Act, 1992, etc. Provisions incorporated in these legislations change the practice of business finance.

1.9 CHECK YOUR PROGRESS : MODEL ANSWERS

1. The following sources of finances are available to start a company:

   Share Capital
   Debentures
   Public deposits
   Borrowing from banks
   Borrowing from financial institutions
   Foreign Capital

2. The following are the Acts and Policies that constitute the environment of business finance:

   Companies Act, 1956.
   Securities Contracts (Regulation) Act, 1956
   Income Tax Act, 1961
   SEBI Act, 1992

Besides, the above Acts, the fiscal policy the industrial policy and the conditions in capital market would also influence the company finance.

1.10 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in about 30 lines each.

1. Define and explain the scope of finance in the context of business finance.
2. Discuss the following categories of business finance

   (a) Partnership finance; and (b) Company finance
3. Indicate the sources from which a company can mobilise funds.
4. Discuss the role of debentures as an important source of industrial finance.

II. Answer the following questions in about 15 lines each.

1. What are the aspects of the study of money that are relevant in the study of finance?
2. How is an understanding of finance relevant to the society?

3. What are the internal sources of finance for a company?
4. Distinguish between secured and unsecured debentures.

1.11 RECOMMENDED BOOKS

1. Kuchhal, S.C., : **Financial Management,** Chaitanya Publishing House, Allahabad.
2. Kulkarni, P.V. : **Financial Management – A Conceptual Approach**, Himalaya Publishing House, Bombay.
3. Pandey, I.M. : **Financial Management,** Vikas Publishing House Pvt. Ltd., New Delhi.
4. Rustagi, R.P. : **Financial Management,** Galgotia Publishing Co., New Delhi.
5. Viswanath, S.R. : **Financial Management,** Response Books, New Delhi.

1.12 GLOSSARY

Capital Market : Market for medium term and long term finance.

Debentures : A document acknowledging debt by the company to the holder.

Finance : The study of money, its nature, behaviour, mobilization, regulation and problems.

Industrial Finance : Securing of funds from financial institutions like IFCI, IDBI, ICICI, SECS.

Public Finance : Mobilisation and utilisation of public funds, by the Government.

Business Finance : Activity concerned with planning, raising, controlling and administering of funds used in the business.

Shares : The capital of a company is divided into small units called shares. Shares are of two types : Equity Shares and Preference Shares.

UNIT - 2 : FINANCE FUNCTION

Contents

2.0 AIMS AND OBJECTIVES

In this unit it is proposed to discuss the significance of business. The entire effort made in this unit is to explain the role of finance function in a business enterprise.

After the completion of this unit, you should be able to:

- explain finance function;
- describe executive and routine finance functions;
- know the problems of profit maximisation as the function of finance;
- discuss the implications of wealth maximisation as the function of finance; and
- understand the significance of the concept of wealth maximisation.

2.1 INTRODUCTION

The function of finance has been viewed from traditional and modern points of view. There is a debate on the function of finance between traditional writers and modern writers. The organisation for finance function depends on the form of organisation, its size, etc. The finance manager is responsible for the discharge of finance function so as to achieve the objective of finance function. The job of finance manager has grown more challenging these days, in view of innovations taking place in the field of finance. Creation and maximisation of wealth have become the chief functions of a modern finance manager. Let us discuss the finance function in detail.

2.2 WHAT IS FINANCE FUNCTION?

Simply stated, finance function is what finance does. Every enterprise, irrespective of its nature and scale of operations, needs finance to carry out its activities and accomplish certain basic objectives. It is so indispensable that it is often described as the life-blood of all industrial and trading activity. Production and distribution of goods will, in fact, be a mere dream without flow of funds. In business circles, the importance of finance function is often acknowledged by grouping the field of management into the main operating functions of production, marketing and finance. This is one of the eight key result areas of business, listed by Peter F. Drucker.

2.2.1 TRADITIONAL CONCEPT

In the beginning of the 20th century, which was the starting point for the scholarly writings on corporation finance, the function of finance was considered to be the task of providing funds needed by the enterprise on terms that are most favourable to the operations of the enterprise. Under this concept, the finance manager has to take decisions with respect to the choice of optimum sources from which the funds would have to be secured, timing of the borrowing as also of the cost and other terms and conditions of acquiring these funds. Authors like Hunt and Donaldson have described the finance function as a task of providing funds required by an enterprise on the terms most favourable to it in the light of the objectives of the business. This concept has the merit of highlighting the core of the finance function. Ensuring that the business has funds to support programmes is the basic part of the function. This emphasis on the mere raising of funds for running a business enterprise has been criticised by many scholars, on the ground that traditional concept is limited in its interpretation.

2.2.2 MODERN CONCEPT

The financial experts now are of the view that finance is an integral part of the overall management rather than mere mobilisation of funds. The finance manager, under this concept, has to see that the company maintains sufficient funds to carry out the plans. At the same time, he has also to ensure a wise application of funds in the productive process. Thus, the present day finance manager is required to bother about all the financial activities of planning, raising, allocating and controlling of funds.

2.3 SCOPE OF FINANCE FUNCTION

In order to understand the function of finance in its broader perspective, it is necessary to survey the scope of the finance function. Finance function in a business is closely related to its other functions. Thus, purchasing, production and distribution are intimately connected with problems of financing. Moreover, success and efficiency in raising, allocating and administering funds of the business largely determine the success or failure of its management. The fact is that a large number of business decisions carry financial implications. Accounting is largely concerned with the determination of financial position and income of the company. The administration of which comes within the ambit of its finance function. Even matters like corporate control, fiscal and monetary policies are of crucial importance to the business and hence, deserve closer attention of the finance executive. Thus, it covers various aspects of the business enterprise right from the stage of planning to that of control.

2.4 FUNCTIONS OF FINANCE

Traditional writers contended that the primary responsibility of the financial manager is to raise necessary funds to meet operating requirements of the business. On the other hand, the modern writers view finance as an integral part of the overall management rather than mere fund raising operations of the staff specialists. In its modern sense, the finance function is concerned with all financial activities of planning, raising, allocating and controlling and not with just any one of them. Besides this, the other functions include incorporation, liquidation, consolidation, reorganisation of the company and the like situations that occur infrequently. Thus, the finance function according to modern experts can be categorised into:

1. Executive Finance Functions; and
2. Non-executive or Routine Finance Functions.

2.4.1 EXECUTIVE FINANCE FUNCTIONS

These executive functions may be discussed under the following three broad decision areas:

I. Investment Decision;
II. Financing Decision; and
III. Dividend Decision.

I. Investment Decision: Of the three decisions, this is regarded by many as the most important one. This involves the use of funds for purchasing various assets like plant, machinery, furniture, materials, etc. Thus, the investment decision pertains to the skillful deployment of the funds in both fixed and current assets. This decision consists of the following:

(a) Management of Fixed Assets or Capital Budgeting;

and

(b) Management of Current Assets or Working Capital Management.

Assets are the resources by which the firm is able to conduct business. The assets of the company can be divided into two categories depending upon their longevity.

i) Fixed Assets; and
ii) Current Assets.

Fixed Assets include land, buildings, plant, machines, vehicles etc., whereas current assets include inventory, debtors and cash.

Management of Fixed Assets: This is also known as capital budgeting. It refers to the use of funds for acquiring fixed assets. Capital budgeting has special importance for following reasons.

1. They have long term implication for the firm.
2. They involve commitment of large amount of funds.
3. They are irreversible decisions.
4. They are among the most difficult decisions to make.

Management of Current Assets: The management of current assets or working capital is an equally challenging area. Today, in a majority of the firms, current assets are forming more than 50 per cent of the total assets. The finance manager who would be in charge of finance function, is required to bestow his attention equally in managing this vital part of the investment. The decisions relating to the management of current assets include those concerning the inventory, receivables, cash and marketable securities. It would be the task of the manager to settle the issues like; how much to invest and when to invest the funds in the case of inventory and receivables and how much to hold or retain in the form of cash.

II. Financing Decision: This decision is related to the determination of optimum financing mix. In the usual course of business, firms draw funds from various sources. The problem in securing of funds is how much to draw from each source and when. This goes into the roots of determination of the capital structure. Since every source has its own cost, finding out of cost of each source of capital is again an important decision area. More so, the cost of capital is a dynamic concept. As and when there are changes in the expectations of the investors, there occurs a change in the cost of capital. Thus, the two important areas under this head are:

a) Determination of Capital Structure: Capital structure refers to the combination of various types of securities through which the funds are raised. It involves not only the fixation of relationship between debt and equity but also the policies regarding retained earnings, bank financing and trade credit. It is essential that all these sources should be used in a proper mix.

b) Determination of Cost of Capital: The term cost of capital may be defined as the total cost of obtaining and keeping the long-term capital – debentures, long-term loans, preference shares and equity shares. While deciding about the capital structure and capital budgeting issues, the finance manager is required to estimate the cost of capital of each source viz., debt, preferred stock, equity and retained earnings.

III. Dividend Decision: This is another important decision, a finance manager is required to carry out. This decision is also related to the retention of profits. The finance manager must decide whether the firm should distribute all profits or distribute a portion and retain the balance. The dividend decision includes aspects such as the percentage of profits to be paid to the shareholders in cash, the stability of dividends and the issue of bonus shares.

CHECK YOUR PROGRESS – 1

a) List out the executive functions of finance manager.

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....

b) Distinguish between traditional and modern concept of finance function.

2.5 ORGANISATION OF FINANCE FUNCTION

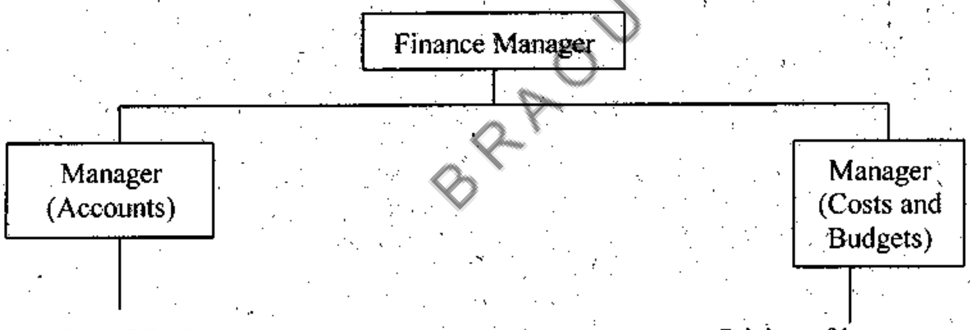
In view of the significance of finance function to an undertaking, it is essential that it should be organised properly. The organisation of finance function varies depending on the form and size of the business. In sole trading concerns and partnerships, owners will have total stake in the financial interests of the enterprises. However, in a company though the shareholders are the owners, they delegate their powers to the Board of Directors to manage corporate affairs.

Further, the size of a firm determines the number and kinds of financial executives who will be responsible for the finance function. Since the finance function is important and it affects every activity of the undertaking, it should be properly and clearly defined to avoid conflicts and overlapping of responsibilities.

2.5.1 ORGANISATION FOR FINANCE FUNCTION IN INDIA

The typical organisational structure for finance function in Indian companies would be as under:

EXHIBIT-1



... Preparation of final accounts
... Cash Management
... Credit Management
... Investment Decisions
... Banking Relations
... Internal Audit
... Reporting
... Record Keeping
... Tax Administration
... Government Relations
... Funds Mobilisation

... Pricing of issues
... Inventory Control
... Cash Budget Preparation
... Budgetary Control
... Submission of Tenders
...Placing of purchase Orders
... Profit Planning
... Financial Analysis

2.5.2 FUNCTIONS OF ACCOUNTING DEPARTMENT

Generally, the Accounting Department in Indian companies would be responsible for the following functions:

1. *Final Accounts*: The Accounting Department's primary job is the preparation of the final accounts and submission of these Financial Statements to the interested groups.

2. *Cash Management*: It would be the task of this department to control both inflows and outflows of cash and to invest idle cash balances.

3. *Credit Management*: Formulation of credit policies, granting of credit and supervision of collection system are the jobs of this department.

4. *Investment Decisions*: The Accounting Department is responsible for committing the funds of the firm in the long term ventures. This includes screening and selection of the projects.

5. *Banking Relations*: In many of the undertakings, the Accounting Department maintains relations with the bankers. It corresponds with the bankers for the fixation of credit limits from time to time and also for the gainful employment of idle funds.

6. *Internal Audit*: Almost all the medium and large organisations appoint persons to carry out the audit for internal purposes. This internal audit department, though a separate unit, would be normally under the Manager (Accounts).

7. *Reporting*: Reporting, in fact, is the job of every manager. In the day-to-day administration, managers are required to submit reports on various issues. But the accounts manager would be having much more responsibility to prepare and submit various reports on the financial performance of the company from time to time.

8. *Record Keeping*: Maintenance of all important records is again another important function of the Accounts Manager. For example, under the provisions of the Indian Companies Act, all the important records of the company are required to be kept for a period of eight years in proper order.

9. *Tax Administration*: It is also the job of the Accounts Manager to deal with the tax matters of the company. To plan for the minimisation of the tax liability is again a challenging job of the manager.

10. *Government Reporting*: According to the provisions contained in the Companies Act and various other Acts, the company is required to submit information for various purposes. All this is looked after by the Accounting Department.

11. *Funds Mobilisation*: This is another important area of action for the Accounts Manager. He has to estimate the requirements of funds of the company, comply with the procedures to float the securities in the market and determine the optimum capitalisation and cost of capital. In discharging this function, the Accounts Manager, faces a number of challenges.

2.5.3 FUNCTIONS OF THE COST ACCOUNTING DEPARTMENT

1. *Pricing of Material Issues*: It is one of the primary responsibilities of Cost Accounting Department. It has to decide about the method of pricing viz., FIFO, LIFO and Average Cost Method to be followed in pricing materials. This will have influence on the determination of actual price of the products.

2. *Inventory Control:* Controlling of the raw materials, finished products and various other stores and spares items is the function of Cost accounting Department. In that process, they try to use various control techniques like classification, codification and standardisation for better inventory management.

3. *Cash Budget Preparation:* In many of the undertakings, it is a practice to allocate this job to the costing department, since they would be dealing with the total budgetary control system.

4. *Budgetary Control:* The costing department also takes care of the preparation of different budgets and measures the actual performance of the undertaking. If necessary, it will initiate corrective measures for controlling the deviations.

5. *Submission of Tenders and Quotations:* In the usual practice, all the tenders and quotations are placed by the costing department. Here the cost structure plays the key role and the data would be available with these people only.

6. *Profit Planning:* Every undertaking has to plan for its profits. This planning is done by the costing department. It has to analyse the relationship among the costs, volume and profits.

7. *Financial Analysis:* For various internal purposes, the companies analyse their own performance. In this regard, Cost Accounting Department will carry out this exercise in the firm to a high degree.

2.6 OBJECTIVES OF FINANCIAL MANAGEMENT

We have discussed in the foregoing paragraphs that there are various finance functions that are required to be carried out by the finance manager. It is reasonable to expect that the finance manager would be wise enough in making all these decisions. In order that he should make all these decisions rationally, company should have an objective. From the financial management stand point of view, firms may have the following two objectives:

i) Profit maximization; and
ii) Wealth maximization.

2.6.1 PROFIT MAXIMISATION

According to this point of view, the objective of a firm is the maximisation of profit. According to this view accounting profit is the difference between revenues and expenses. It is the maximisation of the profit that serves as the goal. This is based on the following two important assumptions.

1. Presence of perfect competition in the market; and
2. Existence of free enterprise economy.

Arguments for the Profit maximization: The profit maximisation theory has been supported for the following reasons:

i) This is based purely on the rationality of the individuals and the firms.

ii) It promotes the use of resources to the best of their advantage to gain maximum out of them.

iii) It leads to the economic selection of the resources.

iv) It enhances the National Income of the country through efficient and increased production.

Arguments against the profit maximization: The profit maximisation concept has been criticised for the following reasons.

i) There is lack of unanimity regarding the concept of profit. There are various terms such as gross profit, net profit, earnings per share, short-term profit and long-term profit.

ii) Profits while enhancing the national income, may not contribute to the welfare of the poor, because they may lead to concentration of economic power.

iii) The assumptions on which it is based are untenable. There exists no perfect competition in the market. Similarly, all countries do not favour the idea of free enterprise economy. There exists certain controls, which will limit the profit maximising capacity of the undertakings.

iv) This concept is also criticised for ignoring the timing of returns and risk. It does not take the returns in terms of their present values.

v) More so, the term profit is often viewed with contempt. Every section of the society feels that they are fleeced by the enterprise. For example, consumers may feel that they are charged high prices.

For these reasons this traditional concept of profit maximisation has been often criticised. Thus, it has lost its relevance in the present day circumstances. Many financial experts are now advocating maximisation of wealth as the objective of the firm.

2.6.2 WEALTH MAXIMISATION

This objective stresses on the maximisation of the present value of the future benefits which the management of the company expects to receive. This concept is also known as Value Maximization or Net Present Worth Maxmization. Wealth in this case is defined as follows:

$$W = \frac{C_1}{(1+k)^1} + \frac{C_2}{(1+k)^2} + \frac{C_3}{(1+k)^3} \ldots\ldots + \frac{C_t}{(1+k)^t} - I$$

Where W = Wealth

C_1 to C_t are the cash inflows generated by the investment in a given period of time
I = original amount invested in the project
K= cost of capital rate or discount factor

Implications of Wealth Maximisation: The wealth maximisation objective is acceptable as an operationally feasible criterion to guide financial decisions only when it is in consistency with the interests of all these groups such as shareholders, creditors, employees, management and the society. The implications of this theory for various interested groups are discussed hereunder.

Shareholders: The wealth maximisation theory keeps in view the maximisation of wealth in terms of flows. The wealth maximisation theory is consistant with the objective of maximisation of the shareholders economic welfare.

Creditors: The wealth maximisation objective helps the creditors, both short-term and long-term, in getting their dues, interest, and principal, duly paid by the company. Under this objective, the company would have a long-term point of view. This would lead to the company taking care of the interests of creditors. Even in case of liquidation, the creditors will get back their amount since they would be paid out of the wealth accumulated by the company.

Employees: The employees would be paid better, when the wealth of the company is maximised. The employees will be having opportunity to share the benefits of the company and thus it leads to higher productivity, high morale and in turn the wealth of the company can be maximised.

Management: If the shareholders, creditors and employees are remunerated suitably, the task of management becomes easy and the management can also share the prosperity of the company. The success of the management depends upon the maximisation of the wealth of the company and the survival of the management will not be threatened if this objective is achieved.

Society: Increase in the wealth of the company means increase in the wealth of the society as a whole. The optimum allocation of resources among various activities will lead to optimum capital formation and growth in the economy; as a result, the maximum economic welfare to the society. When the companies' wealth is maximised, all the sections of the society viz., consumers, owners, creditors, employees, etc., would get their due share. In fact, the company can discharge its social responsibilities only when the company has wealth maximisation as the objective.

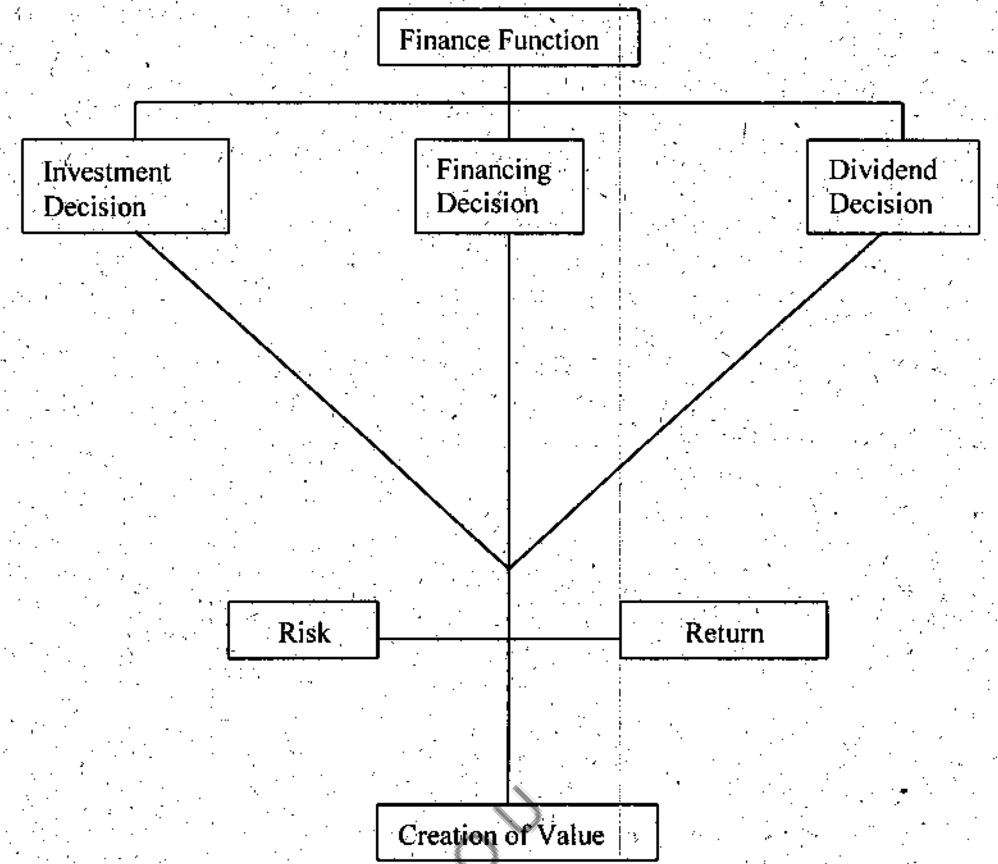
2.6.3 CREATION OF VALUE AS THE GOAL OF FINANCE

James C. Van Horne in his book titled "Financial Management and Policy" states that the objective of a company must be to create value for its shareholders. Value, here, is represented by the market price of the company's common stock, which in turn, is a function of the firm's investment, financing and dividend decisions. The idea is to acquire assets and invest in new products and services where expected return exceeds their cost, to finance with those instruments, where there is particular advantage, tax or otherwise, and to undertake a meaningful dividend policy for shareholders. Value creation is said to be a specific job, which shareholders cannot do for themselves. That is how a finance manager finds him relevant to the organisation.

It is presumed that he would be able to take advantage of imperfections in the financial markets and acquire capital on favourable terms. If the financial markets are highly efficient, as they are in many countries, we would expect the former to be a wider avenue for value creation than the latter. Further, most shareholders are unable to develop products on their own. So value creation is certainly possible.

Exhibit-II sums up the entire gamut of Finance Function.

Exhibit-II



CHECK YOUR PROGRESS – 2

(a) What are the assumptions on which the profit maximisation theory has been built up?

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(b) What do you mean by wealth maximisation and list out the parties whose objective is consistent with the wealth maximisation.

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2.7 SUMMING UP

The concept of business finance has been interpreted both from traditional and modern dimensions. The traditional concept aims at explaining the concept of finance as that of providing funds needed by the business. Whereas the modern concept views it as an integral part of overall management. The scope of finance covers the various aspects right from the stage of planning to that of control of an enterprise. While traditional writers confined the function of finance manager to that of raising necessary funds, the modern writers extends the scope from mere raising of funds. They named the functions of finance manager as executive finance functions covering the investment decision, financing decision and dividend decision.

The organisation for carrying out the finance function depends on the form of business and the size of the business. A finance manager should function keeping in view the objective of business. Some argue that the objective of business is to maximise the accounting profit. There are certain views going in favour of this theory and also against this theory. Others argue that the objective of the business must be the maximisation of wealth of the shareholders. By maximising wealth of the shareholders, the company will be able to satisfy the parties connected to the company such as creditors, employees, management, society and government. Value creation is now said to be the goal of finance.

2.8 CHECK YOUR PROGRESS : MODEL ANSWERS

1. (a) The executive functions of finance manager include:

   i) Investment decision;
   ii) Financing decision; and
   iii) Dividend decision.

(b) Traditional concept of finance function emphasizes on the mobilisation of funds; whereas the modern concept focuses on the better utilisation of funds also.

2. (a) (i) That there will be perfect competition in the market.

   (ii) That there exists a free enterprise economy.

   b) Wealth maximisation refers to the maximisation of Net Present Value (or wealth) of a firm in the course of time. This can be done by maximising the wealth and minimising the risks simultaneously, provided other things are constant.

2.9 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in about 30 lines each.

1. Discuss in detail the scope of finance function in an enterprise.
2. The executive finance functions cover three broad decision areas. What are they? Explain.
3. What are the arguments for and against the profit maximisation concept?
4. Explain wealth maximisation concept and its implications.

II. Answer the following questions in about 15 lines each.

5. How does the modern concept of finance function differ from the traditional concept?
6. Explain cost of capital and the investment decisions.
7. What is finance manager's role in management of current assets?
8. Why should particular attention be paid for the organisation of finance function?

2.10 RECOMMENDED BOOKS

1. Cohens, B. and Robbins, M. : **Financial Manager,** Harper and Row. New York.

2. Van Horne, James, C. : **Financial Management and Policy,** Prentice Hall of India Pvt.Ltd. New Delhi.

3. Kuchhal, S.C. : **Financial Management,** Chaitanya Publishing House, Allahabad

4. Pandey, I.M. : **Financial Management,** Vikas Publishing House Pvt.Ltd., New Delhi.

2.11 GLOSSARY

Current Assets : Current assets have a short span and easy and swift transformation into other asset forms viz., cash, receivables and inventories.

Finance Function : The task of securing, utilising and managing the funds needed by the enterprises on suitable terms.

Fixed Assets : Assets which are used for the purpose of production for more than one year viz., buildings, Plant and Machinery, etc.

Profit Maximisation : Maximising the rupee income of the firm.

Wealth Maximisation : Maximising the Net Present Value (or Wealth) of a firm in the course of time.

UNIT – 3 : FINANCIAL PLANNING – NATURE AND SCOPE

Contents

3.0 AIMS AND OBJECTIVES

The aim of this unit is to discuss in detail the nature and scope of Financial Planning. In that process, the unit focuses on the significance of financial planning. It is also essential that we understand the nature of financial requirements accurately to effectively carry out the job of financial planning. The tools and techniques required to plan for the financial requirements of a business are discussed at length.

On the whole, after going through the unit, you should be able to:

- understand the significance of financial planning;
- identify the steps involved in financial planning;
- describe the nature of financial requirements;
- learn the technique to carry out financial planning; and
- recognise the limitations of financial planning.

3.1 INTRODUCTION

Planning is deciding in advance as to what is to be done in future. Business units are required to plan in advance for their financial requirements. A business without planning is like a ship without a rudder. Without rudder, the ship will drift aimlessly, without any sense of purpose or direction, moving from one crisis to another. To plan effectively, the business unit should have an understanding of an internal and external factors affecting its operations. It should anticipate how these factors will change in the future and assess how they will affect the company's growth and prospects. A successful manager spends considerable time in planning and devotes the rest of the time to put these plans into action.

We will now consider opinions of some of the authors in finance to gain a comprehensive view of the nature of financial planning.

"The aim in financial planning should be to match the needs of the company with those of the investors with a sensible gearing of short term and long term fixed interest securities".

-- G.D. Bond

"The financial plan should do more than include the best available information about the economic and competitive environment in which the business operates and establish targets for the sales and profits to be achieved by certain dates".

--Gordon Donaldson

It is evident from the above that financial planning is a comprehensive task requiring business units to co-ordinate activities for pooling up of resources and putting for proper use. The success or failure of other functions such as production and distribution depend largely on the manner in which the finance planning is done.

3.2 SIGNIFICANCE OF FINANCIAL PLANNING

The success of a business enterprise depends upon the careful preparation of a prudent financial plan for the business. By estimating in detail the current and future requirements of funds for operations and capital expenditure purposes, the management gets the information and, thereby the ability, to utilise the resources to the optimal level and avoid wastage. Financial plan also helps to determine the optimal capital structure of the firm.

It is the function of the financial manager to prepare the financial plan taking into account the company policy and the forecasts of his production and marketing colleagues. It is his responsibility to coordinate the plans of each area. Once the financial forecasts are ready, the management has an opportunity to review the projected plans and modify them to match the resources of the firm. Thus the maximum utilisation of available funds can be ensured. The advantages of financial planning are:

It points out to management what funds are needed, and when, and for what duration, if the specific plans and programmes of the company are to be implemented.

It highlights to management what resources are needed, and enables management to consider suitable alterations to plans before commitments are made.

It also serves as a basis for review and control whereby deviations from the expected performance can be promptly identified and necessary corrective actions taken without delay.

E.W. Walker and W.H. Baughn have stated that the primary advantage accruing through Financial Planning is the elimination of waste resulting from complexity of operations. For example, technology changes, higher trades, increasing cost of social legislation, fluctuations in interest rates and pressures resulting from increasing competition tend to cause the management to exert wasteful effort. Financial Planning helps the management to avoid waste by providing policies and procedures that suit the present management. A clearly developed financial plan tends to relieve the top management from the burden of detailed explanation to the middle and lower level managers.

In this regard, Cohen and Robbins have succintly identified the job of financial planning. In their opinion, financial planning should aim at the following:

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

Financial planning is, thus, a framework which helps the company to prepare itself effectively for the future.

3.3 NATURE OF FINANCIAL REQUIREMENTS

The success of any business enterprise depends to a large extent on the care with which the financial requirements have been determined and provided for on a continuing basis.

What are the main purposes for which the funds have to be provided in the case of a new enterprise? And what will be the nature of financial requirements for an existing enterprise?

When a new business is set up, the promoter will have to plan for the funds for acquiring the necessary equipment and facilities, commonly known as fixed assets. He should also find the resources for meeting the promotional, legal and other preliminary expenses in connection with the setting up of the business. Once the enterprise starts production, adequate funds will have to be constantly found for purchasing and holding raw materials stocks, for meeting the costs of labour and supervision and other expenses and for supporting stocks of finished goods and credits to customers.

Looking at the nature of financial requirements for an enterprise, two distinct types of needs can be identified.

a) Funds for long-term investment in fixed assets; and
b) Funds for on-going or recurring investment in current assets

For a new enterprise, substantial funds for initial investment in fixed assets will have to be organised. Once it starts operations, the financial support for purchasing and processing of materials and for the distribution and sale of manufactured goods will have to be provided regularly and continuously. When an existing business plans to expand will become necessary and the required long term funds will have to be organised. As and when the existing equipment and facilities wear out or become obsolete, funds will also have to be found for acquiring and replacing such equipment and facilities.

We may now have a closer look at the different items and activities of a business that requires long term and short term financial resources.

1. Long Term Financial Requirements

We observed that funds are required for long term investment in fixed assets. What are fixed assets? And why long term investment?

Assets, in the form of facilities and equipment, which are used for production for long periods of time are known as fixed assets and they include the following:

a) Land and Buildings

When a new enterprise is planned, the promoter should ensure that land is acquired at an appropriate location, not only to house the factory to be constructed initially but also to meet growth and expansion requirements in future. Buildings for the production shops and services, for storage of materials, components and finished goods and for offices will have to be properly planned and constructed. The cost of land can generally be ascertained without difficulty, but the construction cost of buildings will have to be carefully determined, taking the advice of the architects. Development of sites for construction of the factory and administrative buildings and special requirements of foundation and strength for different types of manufacturing and other activities should all receive due consideration at the planning stage so that the required financial resources can be organised in advance. Lack of attention to these essential details often results in stoppages and delays in construction work for want of funds or other critical materials.

b) Plant and Machinery

In relation to the products to be manufactured and the processes selected, the required plant and machinery will have to be chosen by the technical people. Wrong selection of machinery can prove to be very costly as the funds thus spent would have already been committed for a long time, but the expected output of products may fail to come and the income will also be affected adversely. Once the proper choice of machines has been made, their prices can be ascertained from the manufacturers and the required funds provided.

c) Furniture, Fixtures, Vehicles etc.

Furniture, fixtures, office equipment and vehicles are other types of long-term assets essential for the proper functioning of the enterprise, and call for long-term investment of funds.

d) Intangible Assets

Intangible assets refer to certain expenses incurred at the time of setting up of the business. For instance, promotion expenses include all expenses incurred from the time the business idea originated till the investigations about its commercial feasibility are carried out and action is initiated to assemble the required men, materials and money. Then there are organization expenses incurred at the time of incorporation of the enterprise, such as lawyer's fee, filing fee and incorporation fee. In connection with the raising of financial resources by issuing shares or debentures, commission will have to be paid to the underwriters and brokers. These categories of expenses come to be termed assets for the reason that they are not operating and regular expenses like salaries, wages, rent etc., and are in the nature of initial heavy expenditure, as in the case of fixed assets. But these expenses do not create tangible assets like buildings, machines, furniture or vehicles and are therefore referred to as intangible assets. The initial financial requirements for these preparatory steps in establishing business will have to be properly estimated and the funds arranged, from long and medium term sources.

2. Short-Term Financial Requirements

Having decided on the funds needed for long term investment in fixed assets, the enterprise management's attention should turn to identify the requirements of funds for the smooth functioning of the regular manufacturing and related operations.

The amount of money that a company must have to finance its day to day operations is generally referred to as working capital. Another name for it is circulating capital. The important point to note is that these amounts are employed in short-term operations.

What is the nature of the requirements of day to day operations? We noted earlier that funds are required for investment in current assets. What are current assets?

Current assets are converted into cash in the short run, say, within a year, or within the normal operating cycle of the business. These include stocks of raw material and stores, work-in-progress, stocks of semi-processed components, finished goods, book debts and cash and bank balances. Let us have some details on the components of current assets.

a) Raw material

Raw material is in most cases, the major element of production cost. It is also in many instances the dominant part of current assets. It is not possible to purchase materials on a day to day basis to meet the daily requirements for production. We have necessarily to buy and stock raw materials and issue them for production as and when required. When prices are rising or price concessions can be obtained for large volume of purchases, it might be found desirable to buy in bulk and stock. The cost concesions on purchases will more than compensate the additional costs for carrying inventory, some critical items of materials may take a long time to procure and to ensure that there is no hold up in production due to their non-availability, adequate stocks of these items will have to be kept. Sudden changes in production programmes result in some materials being rendered surplus while the required materials are not readily available. The proper sources for purchases have not been established and the quality standards have not been clearly set, poor quality purchase of materials will lead to defective production adding to costs and affecting profits adversely. In taking note of all these aspects and taking necessary advance action, the aim is to reduce the locking up of funds in excessive or defective stocks. The factors that influence the levels of raw materials inventories are the expected production volumes, seasonal aspects of production, dependability of the sources of supply and the degree of efficiency of materials planning, and purchases.

A planned effort at supporting a given production programme with the right quantity of materials, of required quality, made available at the right time, ensuring at the same time that the funds tied up in stocks are minimum and for short duration, can be said to be the essence of effective materials inventory management. If materials planning is weak and wrong purchases are made, there will be accumulation of redundant, non-moving and slow moving stocks blocking funds for long periods. Such inventories cannot be termed current assets and represent wasteful and expensive long term investment of funds.

b) Work-in-progress

The stock of semi-manufactured items or work-in-progress will depend on the nature of manufacturing operations, the number of operations and the time taken to perform the required number of operations. The technical people will constantly try to speed up operations by method changes, improved designs and other methods and thereby reduce the blocking of funds in work-in-process inventories. If production flow is well organised, the financial requirements will be much less and for shorter duration.

c) Finished Goods' Inventories

Why should finished stocks be maintained? We know that it is not possible to match production to day to day demand, particularly where the products have a seasonal demand, or even though the demand exists throughout the year, the raw materials are available only during a certain part of the year. Sometimes, it is advantageous to produce in bulk to gain the economies of large scale production and, in this case, the products will have to be stocked and sold. If the customers demand is to be promptly met, we should be in a position to hold adequate stocks at the various outlets so that they can be delivered from the shelf. This requires planned effort to hold adequate but not excessive stocks at the various selling points. Moreover, these inventories are to be held only for short periods so that there is no undue and prolonged locking up of funds. Without delay, the stocks should be converted into sales and money realised to support the company's operations. If due to faulty planning or wrong assessment of demand, excessive stocks pile up and remain unsold for long spells of time, wasteful investment in non-moving stocks will be the outcome, and to this extent there will be the need to find additional external funds for financing the ongoing activities of the business. This will not only mean additional costs and reduced profits, but will also upset the financial arrangements and health of the company adversely. The aim of effective management of the finished goods inventory should be to keep adequate stocks of the products at the required outlets to meet the market needs promptly, and yet avoid build-up imbalances such as excess stocks in certain outlets and stock-outs in other areas.

d) Book Debts

Goods and services are often sold against promise of future payment. The extent and the quantum of credit will depend on a variety of factors such as the related commercial practice, the credit rating of the parties to whom the facility is being extended and the increase in sales that is expected to be achieved by providing attractive credit facilities. It must be noted that granting credit has the effect of diverting financial resources since there will be delays in realising monies due on sales and the funds required for operations will have to be obtained from banks or other sources at considerable expense. It is, therefore, necessary to ensure that the right amount of credit is provided for the right duration. While too little credit might affect sales, too much of it can lead to serious financial problems as a result of long delays in collection of monies due and on account of bad or unrecovered debts. Well administered credit can serve as an effective tool for sales promotion. It can win and keep new customers. But once credit is extended, the flow-up and collection of book debts should also be effective so that monies are promptly collected. If due attention is not given to this aspect, funds will get blocked up in outstanding debts, and avoidable financial problems will have to be faced and tackled.

e) Cash and Bank balance

The need for business to hold cash arises from the necessity to meet current cash obligations in the ordinary course of business. The operating needs have to be promptly met and any delay will effect production and profitability. The business can be viewed as a series of cash inflows and outflows. The cash inflows come from the collections from sales and the debtors, and the cash outflows relate to payments for purchase, payment of wages and other operating expenses. These inflows and outflows rarely match or synchronise and it is to be expected that there will be days when there will be surplus cash balance remaining unused while on other days there may be cash shortages causing much embarrassment. By preparing a cash budget, taking care to note the expected receipts and payments on a day to day, week to week and month to month basis, the requirements of funds to cover the excess of payments over receipts at different dates or periods can be determined and necessary resources can be mobilised in time.

Some cash reserve should also be kept to meet the unexpected needs. In the absence of proper resource planning, payment of taxes and dividends may pose serious problems. The aim of effective cash management is to ensure smooth functioning of day to day business, by careful direction of the flow of cash into and out of the business, so that the operating and contractual payments are promptly made. In the absence of cash planning, steep cash surpluses and cash deficits may occur in unexpected manner, causing serious problems for organising the necessary finances.

We have already seen that current assets are short term assets. They are also referred to as working capital or circulating capital which emphasises the circular flow nature of funds invested in current assets. Raw materials that have been purchased stay for a while as inventories and then move into the production streams. Labour and other manufacturing expenses enter the production process. The raw materials pass through the interim stage of work-in-process to finished goods. Finished goods pass through the phase of book debts, until the collection of outstandings results in the reappearance of cash at the completion of the cycle. This cyclical process involving cash to cash journey repeats itself again and again. But it will be wrong to presume that the flow is steady and smooth all the time. Left to themselves, the flow are capable of violent fluctuations and unless they are carefully watched and resulted, they can cause serious financial problems and even lead to business failure. Effective management will involve pre-determination of the minimum funds required, study of the pattern of receipts and payments, and advance planning of short-term borrowings and investments.

3. A mix of Long-term and Short-term Funds

Long-term financial arrangements have to be made for financing the fixed assets. Current assets are to be financed entirely by short term funds? Not necessarily. Every firm will have to maintain a minimum level of current assets, in terms of minimum level of raw materials work-in-progress, minimum finished goods and book debts, throughout the year. This part of current assets can be regarded as permanent working capital and long term financial arrangements will have to be made for supporting this segment of current assets. It should be understood that unlike fixed assets, the permanent working capital constantly changes its form from one component of current assets to another and its size will be influenced by the pattern of growth of the enterprise. The fluctuating requirements of the working capital are short term in nature and will have to be found from short-term sources. The management will have to decide on a right mix of long- term and short term sources of funds to finance current assets, besides organising long- term funds for the entire investment needs of the fixed assets.

3.4 STEPS IN FINANCIAL PLANNING

There is a procedure to be followed for planning any activity. It can be likened to that of a sequential order, one has to follow. The whole exercise should be completed in a phased manner within a prescribed time schedule. The following are the steps in financial planning.

i. Establishment of objectives

ii. Formulation of policies

iii. Forecasting items to be included in the financial plan

iv. Formulation of procedures, rules and regulations

i. **Establishment of objectives:** The first and foremost requirement for any planning is the establishment of objectives. Every business unit should lay down the purpose for which it is set up. Objectives follow the basic purpose of an organisation. Setting up of objectives may be related to the final performance of the business unit. It is in this context, Peter F. Drucker, the doyen of management theory, developed the concept of Management By Objectives (MBO). In the area of financial planning, a business unit may establish objectives concerning the following aspects:

(a) Achieving a desired rate of return

(b) Developing an optimum capital mix

(c) Minimising the cost of capital

(d) Formulating an optimum dividend policy

ii. **Formulation of Policies:** Policies are guidelines for action. Financial policies deal with procuring, administering and disbursing funds of the business. In this stage, objectives are translated into policies. To be effective, they need to be properly formulated and communicated among the employees of the organisation. Financial policies may relate to any of the following:

(a) Amount of capital required for the organisation.

(b) The sources from which, capital is to be raised

(c) The debt-equity proportions

(d) Credit and collection policies

(e) Cash management

(f) Inventory management

(g) Banking relations, etc.

iii. **Forecasting:** This is the next step in the financial planning exercise. Since we are dealing with time period ahead, we have to make certain estimates of items to be incorporated in the plan. Facts and figures relating to the events of the past are available. Sometimes, nothing may be available. But we may have to predict into the future. This process of projecting into the future is referred to as 'forecasting'. There are several statistical and non-statistical techniques available for this purpose.

iv. **Formulation of procedures, rules and regulations:** In order to carry out the message of the top management, policies are still require to be translated into procedures, rules and regulations. Procedures spell out the sequence in which work is to be undertaken. For example, procedure for raising capital may specify the sources from which capital needs to be raised, the method of raising like public issue or private placement, the lead managers and bankers to the issue, the underwriters, the method of allotment of shares or debentures, etc.

CHECK YOUR PROGRESS –1

List out the steps in financial planning.

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3.5 TOOLS OF FINANCIAL PLANNING

The most significant aspect of financial planning is the way it is done. The following are the methods used to carry out financial planning in businesses.

1. Cash Budget
2. Proforma Income Statement
3. Proforma Balance Sheet
4. Capital Expenditure Budget

3.5.1 CASH BUDGET AS A TOOL OF FINANCIAL PLANNING

Companies plan for their business requirements, by noting down the movements taking place in the cash resources of the organisation. All the business transactions are finally reflected in the cash. Whether we buy raw materials, sell finished goods, pay wages and incur other direct and indirect expenses, the cash position of the undertaking is affected. That is why cash planning is considered as a first step of financial planning.

Cash Budget shows the schedule of cash receipts and cash disbursements which have been committed by the firm and are expected to arise during the budget period. It is a presentation of projected cash receipts and cash payments. The Cash Budget incorporates both capital and revenue items. The capital nature cash inflows and outflows are also considered while preparing the Cash Budget through these cash flows may be a part of long term budget. So, the Cash Budget shows the cash flows arising out of operating budgets and capital budget of the firm. Since the Cash Budget deals basically with the liquidity, reflects the changes in all items affecting the liquidity of the firm.

Cash Budget is an important technique of financial planning and helps in controlling the cash flows through the firm. It helps keeping the cash balance at an optimum level. The basic purpose of the Cash Budget is to coordinate the timings of the firm's cash needs and the cash availability. The Cash Budget emphasizes the planning for surplus cash and shortages. The preparation of Cash Budget is critical since cash is the life blood of any firm. It is no denying the fact that without adequate cash as and when required, any firm could fail. The Cash Budget help in identifying the shortages of cash so that proper arrangements may be made in advance to procure the necessary funds. The temporary excess or surplus of cash position is also traceable with the help of the Cash Budget. The finance manager can plan to invest these surplus in short term securities in order to generate income for the firm.

The Cash Budget may be prepared on a quarterly or, a monthly or even on a weekly basis to cover a period of 1 year. The choice between the quarterly/monthly/ weekly interval depends upon the nature of the business and the relevance of cash for the firm. The more seasonal and uncertain are the cash flows of a firm, the shorter should be the interval. The firm in an extreme case may prepare the Cash Budget on a daily basis also revealing the importance of cash for it.

Format of the Cash Budget

The following is the general format of the Cash Budget.

CASH BUDGET FOR THE PERIOD FROM JANUARY TO MARCH 2003

		January	February	March
I	**Cash Receipts:**			
	(a) Cash sales	xxx	xxx	xxx
	(b) Receipts from customers	xx	xx	xx
	(c) Bank Loan	--	--	xxx
	(d) Issue of Shares	--	xx	--
	(e) Any other Receipt	xx	xx	xx
	TOTAL RECEIPTS	xxxx	xxxx	xxxx
II	**Cash Payments:**			
	(a) Purchases	xxx	xxx	xxx
	(b) Wages and salaries	xxx	xxx	xxx
	(c) Administrative Expenses	xx	xx	xx
	(d) Other Expenses	xx	xx	xx
	TOTAL PAYMENTS	xxx	xxx	xxx
(I-II)	Surplus/Deficit	xx	xx	xx
	Add: Opening Balance	xx	xx	xx
	Closing Balance of Cash	xx	xx	xx

In order to prepare the Cash Budget, one has to make several estimates about the receipts and payments. All the plans that the company may be intending to implement will have cash implications. Then the cash will be coming in or cash will be going out. Cash Budget reflects all these plans. Quite often, the cash balance as indicated by the Cash Budget may be more or less than the desired minimum balance at the end of the budget period. If there is excess cash balance, the firm has to find avenues for investing the same. If the firm ends up with deficit, it has to explore the possibilities of fresh sources of loan/credit.

Illustration-1

The following forecasts have been made for XYZ Ltd., for the period January to March, 2003.

	January	February	March
Sales	75,000	1,05,000	1,80,000
Raw Materials	70,000	1,00,000	80,000
Manufacturing Expenses	10,000	20,000	29,000
Loan Instalment	1,000	11,000	21,000

Additional Information

i) All sales are made on credit basis. 2/3 of debtors are collected in the same month and balance in the next month. There is no expected bad debt. The debtors on January 1, 2003 were Rs.30,000.

ii) The minimum cash balance, the firm must have is estimated to be Rs.5,000, however, the cash balance on January 1 was Rs.6,500.

iii) Borrowing if any, can be made in multiple of Rs.100 only.

Prepare the cash budget for the period of 3 months (ignoring interest on borrowings)

Solution

A) **Cash Budget for the period from January-March 2003**

	January	February	March
Opening Cash	6,500	5,500	5,000
Inflows:			
Debtors (Previous month)	30,000	25,000	35,000
Debtors (Current month)	50,000	70,000	1,20,000
Total Cash Inflows	**86,500**	**1,00,500**	**1,60,000**

B)

	January	February	March
Outflows:			
Raw Materials	70,000	1,00,000	80,000
Manufacturing Expenses	10,000	20,000	29,000
Loan Instalment	1,000	11,000	21,000
Total Cash Outflows	**81,000**	**1,31,000**	**1,30,000**

Cash Balance (A-B)	5,500	-30,500	30,000
Borrowings (Refund)	--	35,500	(25,000)

Comment

It is evident from the cash budget that the firm will have a positive balance of Rs.5,500 at the end of January 2003. Whereas, the firm will have to borrow Rs.35,500 during February so as to meet its outflow requirements and maintain the required minimum balance of Rs.5,000. For the month of March, there will be a positive balance of Rs.30,000. The firm can repay upto Rs.25,000, keeping Rs.5,000 as minimum balance.

3.5.2 PROFORMA INCOME STATEMENT

The Proforma Income Statement (PIS) is simply forecast of the expected income and expenditure for the intended planning period. The major utility of the preparation of PIS is to find out the result of the business operations. We will be knowing whether the firm will end up with profit or loss. The following information is required for the preparation of the PIS.

a) The sales forecast or the sales budget.

b) The Income Statement of the preceding period and the identification of those items (of expenses) which varies directly with the sales. The two items which have a direct relation with the sales are the cost of goods sold and the operating expenses. These two items are expressed as a percentage of sales on the basis of the Income statement for the preceding period.

c) Identification of those items (of the Income Statement) which are independent of the sales. Such items may be fixed expenses, depreciation etc.

d) The dividend policy for the budget period.

The preparation of PIS has been explained with the help of the following Illustration.

Illustration 2

The following is the Income Statement of ABC Ltd., for the year ending December 31, 2002. Prepare the PIS for the year 2003 given that the sales have been forecasted to increase by 10% during the year 2003 and the dividends will be maintained at the same level.

INCOME STATEMENT FOR THE YEAR 2002

		Amount Rs.
Sales		3,00,000
(-) Cost of Goods sold		2,15,000
Gross Profit		85,000
(-) Depreciation	10,000	
(-) Operating expenses	40,000	50,000
Profit before Interest and Taxes (PBIT)		35,000
(-) Interest		6,000
Profit Before Tax (PBT)		29,000
(-) Taxes @ 40%		11,600
Profit after Tax		17,400
(-) Dividend Paid		4,000
Retained Earnings		13,400

Solution

PROJECTED INCOME STATEMENT FOR THE YEAR 2003

		Amount Rs.
Sales (forecast)		3,30,000
(-) Cost of Goods sold (71.67%)		2,36,510
Gross Profit		93,490
(-) Depreciation	10,000	
(-) Operating expenses (13.33%)	43,990	53,990
Profit Before Interest and Taxes (PBIT)		39,500
(-) Interest		6,000
Profit Before Tax (PBT)		33,500
(-) Taxes @ 40%		13,400
Profit After Tax (PAT)		20,100
(-) Dividend Paid		4,000
Retained Earnings		16,100

3.5.3 PFOFORMA BALANCE SHEET

A Proforma Balance Sheet (PBS) is a direct estimate of the expected ending values for all the assets, liabilities and equities. Unlike a cash budget, a proforma balance sheet gives only the cumulative funds required over a period of time rather than when (within the period) the funds will be needed. In addition, cash budget directly relate only to a few balance sheet items, such as cash, while a pro forma balance sheet forecasts all assets and claims on assets. Moreover, based on this projected statement, additional information on future financial condition and performance can be obtained by performing a ratio analysis of the pro forma statements and by constructing proforma derivative statements such as a common-size statement.

Because a cash flow forecast is normally prepared first and because most approaches to constructing a pro-forma balance sheet depend on cash flow estimates, this statement is not only a supplementary source of information but also a check on the consistency of the two forecasts. Besides cash flow estimates, the construction of a proforma balance sheet relies on the current period's ending balance sheet and the pro forma income statement.

Illustration –1

The following is the Income statement of XYZ Ltd., for the year ending December 31, 2002.

INCOME STATEMENT FOR THE YEAR 2002

		Amount Rs.
Sales		3,00,000
(-) Cost of Goods sold		2,15,000
Gross Profit		85,000
(-) Depreciation	10,000	
(-) Operating expenses	40,000	50,000
Profit before Interest and Taxes (PBIT)		35,000
(-) Interest		6,000
Profit Before Tax (PBT)		29,000
(-) Taxes @ 40%		11,600
Profit After Tax		17,400
(-) Dividend Paid		4,000
Retained Earnings		13,400

In the above same period, the Balance Sheet of XYZ Ltd., is

BALANCE SHEET AS ON DECEMBER 31, 2002

Liabilities	Amount	Assets	Amount
Share Capital	40,000	Fixed Assets	75,000
Retained Earnings	35,000	Cash	18,000
Long term debts	60,000	Stock	21,500
Creditors	7,167	Debtors	35,000
Other Current Liabilities	7,333		
Total	**1,49,500**	**Total**	**1,49,500**

The following assumptions may be made to prepare the PBS at the end of the year 2003:

1. A minimum cash balance of Rs.5,000 is desired at the end of the year.
2. Average debtors will be same as in the year 2002.
3. Closing stock will be maintained at the level of Rs.22,000.
4. During January 2003, a new plant worth Rs.50,000 will be acquired. The rate of depreciation applicable to this assets is 20% WDV.
5. The creditors may reduce to Rs.7,000 and the other current liabilities are expected to be Rs.6,000 only.

6. The firm's long term debts and equity share capital is expected to remain same at Rs.60,000 and Rs.40,000 respectively since the firm has no plan to issue or redeem these sources.
7. The retained earnings will increase by the amount of retained profits projected by the PIS.

Prepare the projected Balance Sheet as on December 31, 2003.

Solution

On the basis of the assumptions made, the PBS may be drawn as follows:

PROJECTED BALANCE SHEET AS ON DECEMBER 31, 2003
(Judgement Method)

(Figures in Rs.)

Liabilities	Amount	Assets	Amount
Share Capital	40,000	Fixed Assets	1,05,000
Retained Earnings	41,100	(75,000+50,000-10,000-1,000)	
[35,000 + (16,100-10,000)]		Cash	5,000
Long term debts	60,000	Stock	22,000
Creditors	7,000	Debtors	35,000
Other Current Liabilities	6,000		
Additional Funds (Bal. Fig.)	12,900		
Total	1,67,000	Total	1,67,000

Comment

The preparation of proforma balance sheet presupposes the availability of Income Statement and the Balance Sheet of the preceding year. In the example sited above, the proforma Balance Sheet is totalled with Rs.1,67,000. For the preparation of this some of the figures are assumed to be unchanged from the preceding year. Similarly, an amount of Rs.10,000 is provided as depreciation on the new asset.

3.5.4 CAPITAL EXPENDITURE BUDGET

A capital expenditure budget is a summary of the planned cash expenditure for different kinds of assets such as Plant & Machinery, Land and Buildings, Equipment and Furniture. This Budget deals with the activities relating to the capital expenditures during the budget period. This budget may include planning to acquire new asset, making investment in new products, new markets, raising long term and large amounts of funds, etc. The capital budget may also include planning for expansion, diversification and modernization activities of the firm. The capital budget has long term implications and therefore, includes cash inflows and outflows over a long period of time. Based on the nature of the capital budget, it may be prepared separately from the other types of budgets. Nevertheless, the capital budget has an interaction with the financial budgets and therefore, the short term implication of the capital budget are included in the financial budgets. For example, a capital expenditure decision today may require a fund outlay of Rs.5 lakhs after 3 years and another Rs.3 lakhs after 5 years. These needs must be included in the financial budgets of the 3rd year and the 5th year.

A capital budget should reveal the maximum and comprehensive information for each of the projects in terms of original outlay, cumulative expenditure made upto current year, unutilized outlay, additional appropriations required, escalation in costs due to delays, etc. The capital budget may include the Capital Expenditure Budget, Capital Fund Budget, Research and Development Expenditure Budgets, etc.

3.6 LIMITATIONS OF FINANCIAL PLANNING

As is evident from the discussion made so far, the entire exercise of financial planning is based on certain assumptions and forecasts. It is expected that whatever assumed is going to happen. If the forecasts or assumptions prove to be wrong, the financial planning will not be of any use. Further, the tools employed to prepare financial plans are based on the much used financial statements, viz., Income Statement and Balance Sheet. The preparation of financial statements itself underlies so many assumptions. If the figures incorporated in these statements are untrue, financial plans also turn out to be unrealistic. Finally, there is an element of personal judgement involved in projecting into the future. Therefore, the capacity and value judgement of the planner may be at variance.

CHECK YOUR PROGRESS – 2

What ate the limitations of financial planning?

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3.7 SUMMING UP

Financial Planning involves projects into the future. If a firm is to be run successfully, it should plan for the diverse resources and expenses. This unit focused on the tools available to prepare financial plans. Cash Budget, Proforma Income statement and Proforma Balance Sheet are some of the useful techniques in this regard.

3.8 CHECK YOUR PROGRESS : MODEL ANSWERS

1. The steps in financial planning are :
   a) Establishment of objectives;
   b) Formulation of policies;
   c) Forecasting; and
   d) Formulation of procedures, rules and regulations.

2. a) If forecasts upon which financial planning is based prove to be wrong the financial planning will not be of any use

   b) The tools employed to prepare financial plans are based on financial statement. The financial statements are based on assumptions. If the figures incorporated in these statements are untrue, the financial statements become unrealistic.

   c) There is always a danger of personal judgement, bias and prejudice entering the whole process of financial planning

3.9 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in about 30 lines each.

1. Explain the significance of financial planning.
2. Describe the nature of financial requirements.
3. Distinguish between Proforma Income Statement and Proforma Balance Sheet.

II. Answer the following questions in about 15 lines each.

4. Steps in Financial Planning.
5. Cash Budget.
6. Capital Expenditure Budget.
7. Limitations of Financial Planning.

3.10 RECOMMENDED BOOKS

1. Rustagi, R.P. : **Financial Management,** Galgotia Publishing Co., New Delhi.

2. Khan, M.Y. & Jain, P.K. : **Financial Management,** Tata McGraw Hill, New Delhi.

3. Srivastava, R.M. : **Financial Decision Making,** Sterling Publications, New Delhi.

3.11 GLOSSARY

Planning : Deciding in advance as to what is to be done.

Financial Planning : Projecting into the future financial requirements.

Cash Budget : An estimate of cash inflows and outflows.

Proforma Income : Forecast of the expected income and estimated expenditure Statement.

Proforma Balance Sheet : Forecast of the estimated values of assets and liabilities.

UNIT – 4 : CAPITALISATION – OVER CAPITALISATION AND UNDER CAPITALISATION

Contents

4.0 AIMS AND OBJECTIVES

The broad aims of this unit are to explain the concept of capitalisation, the theories of capitalisation and to discuss about the concepts of capital structure as part of capitalisation. At the end of the discussion, the student would be able to:

- understand the meaning of capitalization;
- comprehend the theoretical basis for capitalization;
- know about over capitalisation and under capitalization;
- understand the concept of capital structure;
- explain the factors influencing capital structure; and
- determine the optimum capital structure.

4.1 INTRODUCTION

A business without planning is like a ship without a rudder. It will drift aimlessly, without any sense of purpose or direction, moving from one crisis to another. The management of any company should decide as to where it wishes the company to go. It should have an understanding of an internal and external factor's affecting the company's operations, anticipate how these factors will change in the future and assess how they will affect the company's growth and prospects. The successful manager spends considerable time in planning and devotes the rest of the time to ensure that other people put his plans into action.

The term 'Capitalisation' has attracted different interpretations. It is generally stated to refer to the total capital employed in the business. But what are the components of this capital? One view is that it will include share capital, reserves and surplus and long term borrowings. Only long tem funds get reckoned in this case. Another view which has gained considerable acceptance asserts that all sources of finance that are used to raise the required amount of capital for the enterprise should be recognised as part of capitalisation process. This will include long term as well as short term sources of funds. The following are the important definitions on capitalisation.

Definitions

1. **Guthmann** and **Dougall** defined capitalisation as the "Sum of the par value of outstanding stocks and the bonds".

2. **A.S. Dewing** "Capitalisation is the valuation of the capital, which includes the capital stock and debt".

3. According to **Lincoln,** "Capitalisation is a word ordinarily used to refer to the sum of the outstanding stocks and funded obligations, which may represent wholly fictitious values".

4. **Husband** and **Dockeray** defined capitalisation as "The computation, appraisal or estimation of the present values".

5. According to **Gerstenberg,** "Capitalisation means the total accounting value of all the capital regularly employed in the business".

Thus from the above definitions, it can be understood that capitalisation means the computation, appraisal or estimation of the present value. The value of the total assets employed in the business at a point of time is the figure obtained by the valuation concept at a given rate of normal return. Thus in capitalisation, the emphasis is placed upon the "amount of capital".

4.2 THEORIES OF CAPITALISATION

There are two theories which are generally used in determining the amount of capitalisation:

i) The Historical Cost Theory; and
ii) The Earnings Theory

j) **The Historical Cost Theory**: According to this theory, capitalisation is considered to be the equivalent of the cost, actually incurred on setting up a corporation. The amount of capitalisation is based upon the original, out of pocket investment in plant, equipment, etc. The historical cost theory lays greater emphasis on current outlays than on the requirements which are necessary to accommodate the investment on a going concern basis. Husband and Dockeray observed that the cost principle may at first appear to give an assurance that capitalisation would at least the representative of the value of the enterprise. However, this correlation exists only momentarily.

ii) **The Earnings Theory**: According to this theory, the principal earnings are forecast and capitalised at a required rate of return. Earnings as a test or measurement of the amount of capitalisation have significance in their own right and also as a double check on the costs of bunching a new enterprise.

Example

It is estimated from the proforma profit and loss account of a firm, the profit is Rs.3,00,000. If the normal rate of return is estimated to be 10% per year, the required investment will be (capitalisation method).

$$\frac{3,00,000 \times 100}{10} = \text{Rs.}30,00,000$$

4.3 OVER CAPITALISATION

Over capitalisation refers to the state where the company is unable to earn reasonable return on its funds. "A corporation is over-capitalised when its earnings are not large enough to yield a fair return on the amount of stocks and bonds that have been issued." If over a period of years a company has not been able to earn a fair return on its total capital, it can be said to be over-capitalised. What should be a fair return? This should be determined with reference to the earning rate achieved by similar companies. Temporary set-back like strikes, fire accidents or equipment failure, may cause a short-run fall in the company's earnings but it cannot be taken as indicative of its being over-capitalised. But if over an extended period, organisational or operational irregularities persist it will affect the company's productivity, profitability and its resources will continue to be under-utilised resulting in yielding of inadequate rewards. If a company is in such a state the company may said to be over capitalised.

Prospective investors will look for indications of over-capitalisation of the company, if any, before wanting to invest. A company is normally said to be over-capitalised if - (1) the par value of the shares of the company is higher than their market values; (2) the book value of shares is higher than their real value.

It is necessary to have an understanding of the different attributes of share values. The par value of the share is its face value, as stated in the Memorandum of Association of the company. The market value of the shares is the price at which they are quoted for trading in Stock Exchanges. The market value of the company's share is influenced by a variety of internal and external factors and is subject to fluctuations from time to time. The book value of the shares of the company is determined by dividing the company's net worth by the number of shares outstanding. The net worth is the sum of the company's paid up capital and its accumulated reserves and surplus (or paid up capital less accumulated losses). The real value of shares is a notional value arrived at by dividing the capitalised value of the company by the number of shares outstanding. The company's average annual earnings have to be first determined by forecasting the expected annual earnings for the future years. The average earning thus determined is multiplied by the relevant capitalisation rate, which will normally be the average rate of return in a similar business. The resulting figure will represent the real value of the company's assets. This is also referred to as the firm's capitalised value. If this value is divided by the number of shares outstanding we get the real value per share for the company. It would be appropriate to relate the real value of the shares to their book value, and wherever the real value is lower than the book value, a state of over capitalisation exists.

Causes of over-capitalisation

A variety of factors can be cited. If at the time of installation and commissioning, the assets have been acquired at exhorbitant costs with a relatively poor earning capacity of the company may be said to be over-capitalised since its inception. Often the promotional expenses of a company far exceed its earning capacity, and in such a case it is afflicted with over-capitalisation from the very start. If a company which gets established with highly optimistic estimates of sales revenues and returns, finds its earnings falling substantially low, the real value of its shares will drop drastically leading to over-capitalisation. Again, if a company gets set up during a highly inflationary phase acquiring its assets and other inputs at very high prices unrelated to its earning capacity, and if subsequently prices tend to fall during its operational phase causing its earnings to fall sharply it will itself over-capitalised.

Companies failing to pay adequate attention to replacement of assets and follow up a defective depreciation policy will find their fixed assets progressively declining in their capability and their earnings going down fast, which would lead to over-capitalisation. when a company follows a very liberal dividend policy on a continuing basis, it will be denying itself the benefits of retained earnings which otherwise will be available for replacement and modernisation of equipment and facilities. As a consequence, its operating efficiency will suffer, its earnings will drop substantially and the outcome will be over-capitalisation. Very heavy doses of corporate taxes will also have the same draining effect on the company's resources, impairing its earning capacity and reducing it to a state of over-capitalisation.

Effects of over-capitalisation

Over-capitalisation can have disastrous consequences for the company. Its financial stability will be threatened, and if its dividend paying capacity falls, the investors may lose their confidence in the company, and be reluctant to respond when the company seeks their support for additional funds by inviting subscription to share capital. Lenders will also shy away from such a poor performer thereby, aggravating the company's adverse condition. If the company's condition deteriorates further resulting in its being unable to pay the interest and instalments on loans or pay its suppliers' bills the creditors may even demand the liquidation of the company. The shareholders of an over-capitalised company will have to face a spell of low and uncertain dividends. The market price of the shares will fall which can even lead to the erosion of invested capital, if losses persist. In such a case, the share holders will find it extremely difficult to borrow money against the security of their shares, and even if they are able to negotiate, the terms and conditions will be very much against them.

Over-capitalisation will have social implications too, since such companies resort to irrational methods for survival. Such methods set in motion a disastrous chain reaction. They try to raise prices and market substandard products, and in the process, get into deeper trouble. When they fail, unemployment will result and wages in the affected regions tend to fall. With fall in the purchasing power, demand declines. This may accentrate recessionary trends, and the economy will have to face the risk of decline in development activity. what are the steps which can be taken to contain the adverse effects of over-capitalisation? A variety of remedial measures can be thought of.

Correction of over captialisation

When the earnings fall pointing to the possibility of over-capitalisation setting in, one course of action is to examine the scope for reducing the debt of the company. This is a difficult one, since there will not be enough internal resources available for paying back debts, and it will therefore, be necessary to issue fresh shares and raise funds for reducing debts. For a company which is not performing well, raising funds from the capital market is bound to be a very difficult task. That is why this possibility of raising funds has to be explored with caution. In such a case, in order to reduce the interest on existing debts, the company may issue fresh bonds and at lower interest rates with an assurance of repayment or redemption at a premium. But whether such an offer will receive a favourable response or not is doubtful. Some companies resort to reorganisation of share capital by reducing the number of outstanding shares. This capital reduction process seems to be the only fair option granting that shareholders can be convinced to accept such schemes. The finance manager should therefore, be vigilant enough to identify symptoms of over-capitalisation even in the initial stages and initiate prompt remedial measures.

4.4 UNDER CAPITALISATION

Under-capitalisation is evident if the company has consistantly maintained an abnormally high earning capacity and if the market value of the company's shares continues to stay well in excess of their book value. It means that the company is utilising its funds to utmost advantage. Such companies have the benefit of efficient management and sound financial condition.

Causes of under capitialisation

There should be several reasons. When at the stage of the formation of the company the finances are organised on the basis of under estimation of its earnings the initial capitalisation will be low, and if the subsequent earnings far exceed expectations as a result of efficient exploitation of favourable environment, the company will experience under-capitalisation. In such a case, the investors will reap high rewards and the obligations to lenders will be promptly met. Low initial capitalisation might also be an outcome of the application of a low capitalisation rate adopted at the time when the finances were planned and organised in the formative stages. Companies formed during recessionary periods tend to become under-capitalised when subsequently boom and prosperous conditions emerge. Some companies follow conservative dividend policies, thus conserving resources. These resources are effectively utilised for replacement and modernisation of equipment and facilities, and as a result, the company's earnings soar up sharing in a state of under-capitalisation. Constant attention to the updating of technology and efficient upkeep of assets will also enhance the company's earning capacity enormously causing under-capitalisation. Thus under-capitalisation should not be misconstrued as shortage of capital or resources, but on the other hand, it reflects the most efficient use of available resources. It represents a situation in which the best possible results are obtained out of the scarce capital employed in the venture.

Effects of under capitialisation

Complacency on the part of management is a possible danger that may subsequently affect its performance. Another risk is that the high profitability might invite intense competition from ambitious promoters. High tax obligations and invitation to government control and intervention are other possible risks. Share prices of under-capitalised companies will show a tendency to rise and fluctuate violently and speculators will be tempted to drive undue advantage from such share price variations. Continued high profitability of the under-capitalised company will induce the employees to demand enhanced emoluments and if these are not amicably settled, industrial relations may get impaired unsettling company's performance and results. Similarly, consumers may insist on price reduction or argue for state intervention and price controls.

The share holders of under-capitalised companies stand to benefit in a variety of ways. They enjoy high dividends. They can take advantage of soaring share prices and derive immense benefits by trading in their shares. When necessary, they can also easily obtain loans on soft and easy terms against the security of their shares.

The society also benefits from under-capitalisation. The existing units grow and new units enter the field, resulting in increased overall production. Employment opportunities increase, and consumers have the advantage of lower prices and wider choices. The economy grows. But, beyond a point, when the employees and consumers start clamouring for a larger share in the boom and prosperity, the environment will turn less favourable. This possibility has to be anticipated and guarded against to the maximum extent possible.

Correction of under capitialisation

What actions are to be initiated to avert or minimise the ultimate risks of under-capitalisation mentioned above? One measure is to capitalise the reserves and surplus accumulated by the company through the issue of bonus shares. This will not change the capitalisation of the company, but will alter and reduce the earnings per share for the company. This is bound to happen, since the reserves and surplus will reduce to the extent of bonus shares issued and correspondingly the number of shares outstanding will increase abruptly. Yet, in absolute terms the investor will continue to receive the same quantum of income as before. The employees and consumers will not have the complaint of phenomenal or exploitative returns to investors.

Stock split is another option that is available for reducing the earnings per share without affecting either the capitalisation of the company or the quantum of income to the investors. Thus, the consequences of under-capitalisation can be averted to a large extent.

In sum, both over-capitalisation and under-capitalisation require managerial attention. Comparatively, over-capitalisation has greater adverse effects on the company, the investors and the society. It spells all-round decline in financial health. Under-capitalisation, on the other hand, presents a healthy state for the company, the investor and the society, and the risk arises from the resulting complacency and subsequent conflicts that prosperity brings in its wake in respect of contending claims for sharing the fortunes. The finance manager, in particular, and the corporate management in general, should steer clear off these two extreme positions of financial distress and financial buoyancy and maintain an optimal state and package of capitalisation for the company.

CHECK YOUR PROGRESS –1

a) What do you mean by over capitialisation? List out the causes for over capitilisation.

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b) Describe under capitialisaion. What would be the effects of it.

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4.5 CONCEPT OF CAPITAL STRUCTURE

The term capital structure is understood as the relation between debt and equity. It is always debated as to the proportion of these two in the financing of an enterprise. Capital structure can be defined as "the pattern of financing company's requirements through long-term sources such as debt and equity." The following are the possibilities of structuring the capital of an enterprise.

i) Finance the entire requirements of capital through ordinary share capital.

ii) Finance the requirements through ordinary share capital and preference share capital.

iii) Finance the capital requirements through ordinary share capital, preference share capital, debentures and long term loans.

What should be the preference? Before a choice is made, we have to assess the different qualities of these sources of finance.

Maturity: Share Capital is in the nature of permanent capital. Once the money is raised through issue of ordinary share capital it is available for permanent use in the business and there is no obligation to return amounts to the share holders so long as the business lasts. It is only at the time of liquidation of the company, that the share holders are eligible to receive the funds remaining after the claims of all the creditors have been met. It should, however, be noted that the share-holders have the freedom to sell the shares to others and benefit from such trading, and from their point of view, therefore, the realisability investment has quick or short-term maturity from the investor's point of view. Redeemable preference shares, debentures and long and short term loans have stipulations as to the repayment of the principal amounts involved. For the duration for which borrowed funds are utilised, interest at agreed rates are also payable. the company has the choice to decide on the amounts and duration of borrowings from different sources and select combinations of long and short maturity debts that is best suited to the requirements of the company.

Priority of claim: The lenders of funds to the company have priority over the share holders in respect of the claims on the income of the company. Interest payments due to them have to be paid before the company can think of distributing dividends to the share-holders. Even among the share-holders, the preference share-holders have priority of claim over the ordinary share-holders. The ordinary share-holders thus have only the final residual claim, on the income of the company.

Amount of claim: In the case of debentures and loans, the stipulated rates of interests are payable. These claims have certainty in terms of amounts and timing of interest payments. In the case of preference share-holders, the preference dividends fall due where the profits are adequate and not otherwise. Though the quantum of dividend is stipulated, the obligation to pay is subject to the adequacy of profits. Thus, some degree of uncertainty exists in respect of the claim on income by way of preference-dividend. On the other hand, there is no stipulated commitment to pay dividend to the ordinary share holder. If the company makes enough profits after meeting all other claims including those of preference shareholders, if any, the management may decide to declare dividend on ordinary shares. Even here, the ordinary share-holders cannot demand dividends as a matter of right and the discretion rests with the company's management. If management decides not pay dividends, the ordinary shareholder has to abide by their decision.

Claim on assets: The question of claim on the company's assets arises only at the time of liquidation of the company. If such an exigency were to arise, the secured creditors of the company will have the first claim. The debenture-holders and creditors who have provided long-term loans will have their money claims secured by way of mortgages of the company's fixed assets and, in the event of liquidation, will realise their claims in priority. Other creditors for short-term collateral security of the inventories of the company, also come under the category of secured creditors and will receive settlement on priority. Creditors, such as suppliers of goods, and those who have lent money to the company by way of deposits, are in the nature of unsecured creditors and their claims for return of money due to them will arise after the claims of the secured creditors are met. The preference shareholders have priority of claim over ordinary shareholders for the return of capital. Their claims rank next to the secured and unsecured creditors. The ordinary shareholders have the final and residual claim on return of capital. The one important factor to be noted is that while the claims of the debenture-holders, creditors and preference shareholders are limited to the amount of their lending or investment with the company, the ordinary shareholders, with the residual claim, will get whatever is left after settling all prior claims. This could be less or more than what they have invested in the company.

Right to Control: The ultimate control of the affairs of the company rests with the ordinary shareholders who have the voting rights. As owners of the company, they elect the directors who are to function on the company's Board and guide the destiny of the company. The creditors or debenture holders have no direct controlling power, though the term lending financial institutions often stipulate a condition in their contract empowering them to nominate their representative on the company's Board. Preference Shareholders have limited voting rights, in the sense that they are eligible to vote on matters of vital concern to their interests. For instance, if for two consecutive years, they have not received dividends, they are entitled to vote on resolution relating to this matter.

4.6 CRITERIA FOR SELECTION OF CAPITAL STRUCTURE

The finance manager of the company has to give considerable attention to the pattern of the capital structure that he intends to select for the company. He has to take note of a variety of factors including the general state of the economy, the specific circumstances of the industry to which his company belongs and the operating factors and prospects of his own company. For instance, it is widely believed that it is preferable to raise as much of funds as possible by way of 'debt' rather than as 'equity'. In the face of adverse economic conditions, or recessionary trends in the industry or continued substandard performance of his own company, he may not be sure of being able to meet the interest obligations on large scale borrowings and may prefer to invite subscriptions to share capital. But, in view of the prevailing circumstances or his company's poor image, he may be denied this choice of raising capital from the public. In deciding on a package of financing sources, he has to strike a balance between the company's preference and the external constraints, pertaining to the diverse sources of funds.

Cost principle: The management's primary aim should be to minimise the cost of financing. The financing mix in the capital structure should be such as would incur the minimum average cost of capital. As a source of finance, is 'equity' expensive or is 'debt' expensive? Equity is the more expensive source of finance, except in instances where the firms, as in the case of many public sector undertakings (where the Government has provided the equity capital) have no prospect or intention of giving dividends on capital. For a progressive company which is keen to maintain a good dividend on share capital, 'equity' is a costlier source of funds than 'debt' in view of the tax implications. While interest payable on 'debt' is an expense chargeable to revenue before determining taxable profits, dividend payable on shares has to come from after tax profits. In other words, dividend is not a tax deductible expense and has to be paid out of the profits remaining after providing for or paying the corporate tax. For instance, if the company was to borrow Rs.100 lakhs at 10 per cent interest, the interest amount of Rs.10 lakhs will be charged in the Profit and Loss Accounts in the same manner as in the case of salaries and wages, power, rent etc., and taxable profits will be computed after this charge is recognised. If, on the other hand, the company has raised Rs.100 lakhs by way of share capital and intends to give a 10 per cent dividend, the dividend of Rs.10 lakhs will have to be paid out of profits after tax. Assuming a tax rate of 50 per cent on profits, a tax of Rs.10 lakhs should have been provided for or paid before the dividend of Rs.10 lakhs can be declared or paid. Thus, the real cost of equity, in this case, is 20 per cent pre-tax, whereas pre-tax cost in the financing package will therefore have the effect of reducing the over-all cost of capital.

Risk principle: 'Debt' involves commitment to pay interest at agreed rate for a long period and this has a risk attached. If the company fails to meet its interest obligation during a phase of continued poor working, the creditors may press for its liquidation. Even where the interest obligations are met but the profits are low and just suffice to meet these interest commitments, the shareholders run the risk of receiving little or no dividends. Ordinary share capital, known as risk capital, does not carry any stipulated entitlement for dividend, and during the days when the company's performance is poor, and non-payment of dividend will reflect in low market prices for the company's shares and the company will find it difficult to raise additional capital through issue of shares. The main point to note is that excessive 'debt' in the capital structure of the company will expose it to heavy risks in times of decline in performance, as the servicing of these debt has to be ensured whether the company makes a profit or not.

Control Principle: Since the debenture holders and the lenders of funds to the company do not have voting rights they cannot exercise control over the management of the company. So long as their debts are serviced promptly and the interests are regularly paid, they cannot complain. So, where additional funds are required for the company, the management may prefer to obtain additional debt capital rather than additional share capital, if the intention is to retain the control with the existing shareholders. If additional funds are raised through share capital, there will be dilution of control since the new shareholders will also have a voice in the company management. The extent of willingness of existing shareholders to share control with new shareholders thus becomes a relevant factor.. Closely managed companies where the directors enjoy the patronage of the existing shareholders to share control with new shareholders thus becomes a relevant factor. The directors of such companies enjoy the patronage of the existing shareholders and are eager to retain their positions in the Board will be very cautious in the matter of raising additional funds through issuing shares to the wider public. They would rather issue debentures or raise loans. However, this preference has to emerge against the risk involved in going for excessive borrowings.

Flexibility Principle: The management should have a balanced approach in selection of sources of funds. If it borrows by mortgaging all its fixed assets, then its flexibility is lost in case of need for additional funds though the market conditions for borrowing are favourable. It will have to go for unsecured debts which may not be easily forthcoming, or it may have to invite subscription to the share capital, but the time may not be opportune of doing so. In making decisions on sources of finance, the aim should be to maintain a degree of maneuverability and bargaining strength for negotiations, by ensuring that borrowing strength is sustained with an adequate equity base and availability of uncommitted collateral securities such as fixed assets and current assets.

Timing principle: Timing is a critical factor for approaching the market for raising funds by way of debt capital. There are a variety of market factors that intervene and the finance manager has to take note of them before launching his fund raising efforts. When the market is experiencing paucity of funds, he will have to commit higher interest charges. But it might be easier for him to borrow rather than raise capital because investors may not be willing to risk investing in shares during periods of depression. When the economic conditions brighten up and companies are doing well, raising funds through issue of shares may be easier. The external market factors will determine whether it is advisable to borrow or to issue shares.

CHECK YOUR PROGRESS –2

What principles should be kept in mind while selecting the capital structure?

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4.7 FACTORS INFLUENCING THE PATTERN OF CAPITAL STRUCUTRE

In choosing a suitable pattern of capital structure, one has to resolve certain conflicts in principles or criteria. Debt as source of finance is preferable to equity from the cost angle, but if the risk involved in excessive dependence on debt, is taken into account, it may be seen that it is not easy to determine the amount of debt that can be incurred in a given situation. However, by raising additional funds required through debts and debentures, the existing shareholders can retain control over the enterprise; but when the company's growth has to be sustained through expansion it may become necessary to invite fresh subscriptions to the share of the company from the public. A number of factors influence the financing decisions, which can be broadly related to:

a) the characteristics of the economy;
b) the characteristics of the industry;
c) the characteristics of the company.

It is necessary to take a note of the expected changes in economic environment, while deciding on the pattern of capital structure. Among the important considerations that deserve attention in this connection are the anticipated trends in business activity, changes in legal provisions affecting business and industry, the state of the capital market, the prevailing taxation and financial policies and the expected changes in these policies.

When the economic environment is conducive to business growth, the company should be ready to take advantage of it and be willing to raise substantial resources through issue of shares to the public rather than restrict itself to limit growth through borrowing. With a larger equity base, its ability to borrow also increase and its overall ability to grow improves considerably.

If the expectation is that borrowing is likely to become consider on account of stricter credit control measures and rising interest rates, it may be advisable to raise additional resources required through debts as early as possible.

It has already been noted that there is a strong tendency to raise funds through debentures or other types of borrowing rather than through issue of shares, since the interest on borrowings is a tax deductible expense where as the dividend on share capital is payable only after tax profits.

The government stipulates ceilings on borrowings in relation to equity and the Securities Exchange Board of India (SEBI) administers such regulations. The pattern of capital structure has to be in accordance with the guidelines.

Where the financial institutions provide ready assistance, on relatively fair terms, the tendency will be to raise more of the required funds through borrowing from these institutions. On the other hand, if the financial institutions resort to a tight lending policy, market by under delay in processing loans, the public may be invited to the share capital.

The term lending financial institutions also lay down certain conditions, which they consider essential, governing the extent of borrowing in the total capital employed. The management will therefore, have to negotiate and obtain as easy terms as possible in order to improve the financial leverage. This may be done through a higher proportion of borrowing than is usually done in order to keep the cost of funds as possible.

Certain products are subject to the impact of cyclical changes in the economy. Products which come under the categories of regular consumable items are not subject to fluctuations in demand in response to changes in income. But items such as refrigerators and capital goods are very sensitive to changes in income and are subject to sharp changes in demand during periods of economic depression or recession. If the company's products are subject to wide fluctuations in demand during a business cycle, the emphasis in choosing the source of funds should be on maneuverability and risk aspects in order that the company may have the freedom to expand or contract the sources depending on the changing requirements from time to time. At the same time, it is essential that during the periods of depression or recession, the company is not burdened with debt on which it has to pay interest which it would cause serious strain when its profits are low. To sustain operations during such periods the company should be able to rely on its equity or risk capital, where the investors have to forego their share of dividends, in order that the company's resources may be conserved for meeting operational commitments.

The nature of industry may be such that there are several units competing constantly with each other which makes it difficult for some to make profits consistently. If such a risk factor exists, it is safer to have a larger extent of equity financing so as to avert the risk of being unable to meet the interest obligations on borrowed funds. On the contrary, in the case of the company whose products enjoy a competition free market and whose profits are expected to be steady it will be advisable to take advantage of financial leverage and have a larger component of borrowings in the capital structure.

The stage in the life cycle of the industry to which the company belongs is another factor which will influence the capital structure. The infant industry, with greater susceptibility to failure, will have to rely more on equity support and curtail debts than an older one. During the growth stage where aspects and profits keep rising, debt financing will assume increasing importance. Subsequently, when the maturity stage is reached there will be an insistent demand for capital expenditure on modernisation. If despite rationalisation and research and development the profits tend to fluctuate, the risk factor deserves to be taken into account and share capital is to be preferred as the main source of additional financing. Yet, care should be taken to see that in the declining stage reduction of funds will be possible, if found necessary. In other words, in the capital structure there should be a debt component which can be structured through repayment in periods of prolonged decline in activities. Decisions on optimal structure have to be based on the continuous assessment of the industry's characteristics and the company's own position within the industry and respond to the dynamic changes that are bound to occur from time to time.

Apart from the characteristics of the industry to which the company belongs, there can be specific characteristics peculiar to the company which influence its selection of the sources of funds. The size of the company is a relevant factor. Smaller companies find it more difficult to raise sources through borrowing from the institutions or from the public than the bigger ones. A larger part of their financing will be from the promoter's contribution to capital. When these units grow, the issue of capital to the public may face the risk of some larger company buying up controlling interest by acquiring the shares, and they may prefer to raise debts rather than resort to capital issues. Larger companies whose shares are widely held are prone to such a desire to retain control in a closed circle and will be influenced in their financing decisions by the principles of leverage, manoeuvrability and cost minimisation.

Private limited companies tend to have the ownership confined to a closed circle, whereas the larger sized public companies are inclined to acquire equity and debt capital for their growth needs. The form of business organisation has thus an impact on capital structure decisions.

Some companies have the ability to maintain stable earnings even in the face of adversity that is generally faced by the industry to which they belong. Such companies can give weightage to the leverage principle and resort to an increasing extent of debt financing, while the other less fortunate units in the industry will consider it risky to contract debt and prefer to plan and raise capital during periods of good performance.

Capital intensive companies with heavy investment in fixed assets and assured markets for their products can afford to reap the benefits of financial leverage. Companies with a substantial blocking of funds in inventories and book debts whose levels will depend upon fluctuating activity have to be more cautious. They should pay more attention to the risk factor and suitably tone down the extent of borrowing in their capital structure.

Established companies with an appreciable credit standing have the freedom to select the pattern of financing from diverse sources of capital or debt. But younger companies which are still to establish themselves will have to depend are on capital subscribed by promoters and friends willing to face the risks in investments during the early phase. Thus, a variety of factors specific to the individual company have a bearing on its choice of sources of financing.

The proportionate mix of different securities in the capitalisation is be decided by the company's finance manager. He has to assess the various aspects which are environmental or specific to the industry and the company and arrive at an appropriate composition that would minimise the risk and cost and provide the maximum advantage of leverage and manoeuvrability.

4.8 OPTIMUM CAPITAL STRUCTURE

We have seen that the use of debt has the effect of increasing the potential earnings per share to the ordinary shareholders. But with the increase in the debt composition the financial risk of the firm also increases. As the borrowings component of the total funds keeps increasing, the firm will have the benefit of financial leverage. But from the investor's standpoint, the vulnerability of the firm to market adversities increases, with the possibility of its becoming bankrupt in case adverse conditions prevail for long affecting its ability to service debt promptly and consistently. The earnings of ordinary shareholders will also suffer a severe set-back if such debt servicing obligations exist in the face of adverse business conditions with such an increase in financial risk following increase in leverage, the market prices of the company's shares will be affected. They will tend to fall or may not increase in response to the company's improved performance. Moreover, as the debt increases, forming large proportion of the company's capital structure, the lenders will also start demanding higher rates of interest to cover the risk factor and fresh borrowings will be at increasing cost. Simultaneously, the shareholders would expect a higher return on their capital, and this will have the effect of bringing down the market prices for the shares. The finance manager should recognise the indiscriminate increase in use of debt as source of finance will have the effect of raising his cost of capital and reducing the valuation of the firm. He has to weigh all its implications and evolve an optimal capital structure policy that will maximise the total valuation of the firm and minimise the overall cost of funds. He has to select an appropriate combination of debt and equity for his firm.

In this context, it will be of use if he understands the implications of over capitalisation and under capitalisation in terms of causes and consequences.

4.9 SUMMING UP

The term capitalisation has been understood in various ways. Nevertheless, there is a consensus that it refers to the amount of capital invested in a business and its mix. Two theories are used, generally, to determine the amount of capital. They are: cost theory and earnings theory. Again, there are two types of situations with which a firm is concerned. They are: over capitalisation and under capitalisation.

Over capitalisation is a situation where the company is not able to earn a fair rate of return on its total capital. The causes for over capitalisation include acquisition of assets at abnormal price at the beginning, incurring heavy promotional expenses, making highly optimistic estimates, setting up the unit during inflation, etc., owing to over capitalisation the dividend paying capacity of the company falls, investors lose confidence, lenders will not come forward to lend their money and market value per share falls. There are certain remedies to check over capitalisation.

Under capitalisation is a case where the company maintains consistently an abnormal rate of return and the market value per share continues to stay at well in excess of book value. Under estimation of earnings, adoption of low capitalisation rate at the time of formation of the company, forming the company during recession, following conservative dividend policy, constant updating of technology etc., are the causes for under capitalisation. The effects of under capitalisation are: i) development of complacency on the part of management; ii) entering new competitors in the market; iii) drawing the attention of government to impose control; iv) leading to high speculation in share prices, etc. Of course, there are remedies to this situation also.

This unit also discussed the concept of capital structure, i.e., the aspect of mix of resources. While selecting capital structure, the proportion of various sources of finance has to be examined taking into account their cost and other aspects. While deciding a particular source of finance the aspects like maturity, priority of claim, amount of claim, claim on assets and right to control have to be thoroughly examined. The selection of capital structure mix should be done on the basis of certain principles such as cost principle, risk principle, flexibility principle, control principle and timing principle.

4.10 CHECK YOUR PROGRESS : MODEL ANSWERS

1. a) A company is said to be lover capitialised when it has not been able to earn a fair rate of return on its capital. The fair rate of return is determined in accordance with the earning rate achieved by similar companies. The causes for this include:

   i) acquisition of assets at abnormal price at the time of inception;

   ii) incurring high promotional expenses;

   iii) making highly optimistic estimates; and

   iv) setting up the unit during inflation etc.

   b) It is a case where the company has consistently maintained an abnormal high earning capacity and the market value of its shares continues to appear at well in excess of their book value. The effects of under capitailisation are:

   i) develops complacency on the part of management,

   ii) new competitors may enter the market,

iii) it may draw the attention of government to control the company,

iv) speculators may get benefit out of violent share price fluctuations,

v) there will be demand for higher wages from employees etc.

2. The following principles have to be kept in mind while determining the capital structure.

i) Cost Principle,

ii) Risk Principle,

iii) Control Principle,

iv) Flexibility Principle; and

v) Timing Principle.

4.11 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in about 30 lines each.

1. Explain the concept of capitalisation.
2. What do you mean by over-capitalisation?
3. What is under capitalisation?
4. Discuss the factors influencing capital structure.
5. What are the criteria for selection of capital structure?

II. Answer the following questions in about 15 lines each.

6. Earnings Theory
7. Cost Theory
8. Concept of capital structure
9. Optimum Capital structure
10. Cost principle
11. Right to control
12. Timing principle
13. Flexibility principle
14. Control principle
15. Characteristics of Economy
16. Characteristics of Industry
17. Characteristics of Company

4.12 RECOMMENDED BOOKS

1. Rao, Ramesh, K.S. : **Financial Management**, Macmillan, New York.

2. Kuchhal, S.C. : **Financial Management**, Chaitanya Publishing House, Allahabad

3. Kulkarni, P.V. : **Financial Management**, Himalaya Publishing House, Bombay.

4. Pandey, I.M. : **Financial Management**, Vikas Publishing House Pvt.Ltd., New Delhi.

5. Van Home, James, C. : **Financial Management and Policy**, Prentice Hall of India Pvt. Ltd., New Delhi.

4.13 GLOSSARY

Capitalisation : The sum of the par value of outstanding stocks and bonds

Over capitalisation : A state where the company is unable to earn reasonable return on its investment

Under capitalisation : A situation where the company has consistently maintained an abnormally high earning capacity and the market value of the company's shares continue to stay well in excess of their book value.

Capital structure : Refers to the manner in which funds from different sources have been organised to meet the companies total money requirements.

Financing mix : The proportion in which the different sources of finance have been combined.

Debt financing : Main part of the financial requirements through borrowings

Equity : Shareholders funds

BLOCK – II

FINANCIAL INSTRUMENTS AND MARKETS

UNIT – 5 : CORPORATE SECURITIES

Contents

5.0 AIMS AND OBJECTIVES

This unit is designed to explain the various types of securities that a corporation can offer for raising funds. Further, the merits and demerits of each of the securities are discussed.

Having studied this unit, you should be able to:

- explain the meaning of corporate securities;
- distinguish between stocks and shares;
- describe preference shares and the types thereof;
- discuss the various types of debentures; and
- explain innovative capital market instruments.

5.1 INTRODUCTION

After making the financial plan, the next step is to raise funds. Finances are necessary to meet the long-term and short-term needs of the corporation. Therefore, the sources to be tapped and agencies to be employed for raising capital will be decided by the management on the basis of length of period for which funds are needed. Initial capital and funds for expansion purposes at later stages come under long-term needs of corporations. These funds are mobilized by issuing securities by the corporation at appropriate time, in an appropriate size and manner. We explain all these types of securities in this unit.

5.2 MEANING OF CORPORATE SECURITIES

Corporate securities mean the shares and debentures issued by companies for raising long-term capital. Securities represent claims on a stream of income and/or particular assets. They are the documentary evidence of commitment of companies to the holders of such securities. Corporate securities can be classified under two categories: (a) ownership securities, and (b) creditorship securities.

Ownership securities consist of shares issued and allotted to the investors with a right to participate in the profits and management of the company. The investors, by their right to participate in the prosperity and management, become owners, As such, the capital raised by issuing there securities is known as 'owned capital' or 'risk capital'.

Creditorship securities consist of various types of debentures. They are acknowledgements of corporate debt to the respective holders. They confer upon them a right to receive interest at specified rates and at pre-determined periods and the principal sum after maturity. Capital raised through these securities is known as 'borrowed capital' or 'debt capital'.

Ownership securities

The funds raised by the issue of ownership securities (i.e., shares) provide basis to the capital structure of business enterprise. Every share is ascribed with face value which has to be paid for by its purchasers.

A corporation can issue different types of shares such as equity and preference shares to tap the savings of the people with different temperaments and financial position.

5.3 EQUITY SHARES

Equity shares represent proportionate ownership of the company. This right is expressed in the form of participating in the profits of a going company and sharing the assets of a company after winding up. Equity shares are the ownership securities which do not carry any special or preferential rights as to annual dividends and as to the return of capital in the event of the winding up of the corporation. Equity shareholders benefit much in times of prosperity and incur loss when the corporation is in difficult conditions. Equity shareholders willingly assume the risk of losing their investment during the periods of depression. However, the risks are more than balanced by the opportunity to have a larger voice in the management of the company, by the chance to participate in profits and the prospects of appreciation in the value of shares.

No doubt, equity shareholders have the opportunity of participating in the prosperity of the company but the basic characteristic feature is that the equity shareholders secure claims to profits of the company only after all the other classes of debt and preference shareholders have received their specified returns. In other words, the debenture-holders and preference shareholders have a prior claim on the profits of the company. Similarly, these security holders have a first claim on the assets of the company over the equity shareholders in the event of liquidation.

When investors buy equity shares either through subscription to a public issue or through stock exchange from an existing owner, they obtain a share certificate as proof of their part as owners of the firm. A share certificate states the number of shares registered in the name of the shareowner and their paid-up value apart from certificate number and folio number. In the case of shares purchased through stock exchange, the new owner's name is entered on the rear of the certificate. After the introduction of depository system in 1996, investors have the option for dematerialization which can be used for receiving allotment of shares and transfer of securities. A depository system is paperless or scripless form of holding the shares. Shares are held in the form of electronic accounts.

Equity Share with Detachable warrant

A hybrid equity instrument introduced in 1992-93 is equity share with detachable warrants. Detachable warrants are issued along with fully paid equity shares which will entitle the warrant holder to apply for a specified number of shares at a determined price. Detachable warrants are separately registered with stock exchanges and traded separately. The terms and conditions relating to issue of equity against warrants would be determined by the company.

Voting Rights

Companies Act (Sections 87 to 89) deals with the voting rights of a shareholder. An equity shareholder has a right to vote on every resolution placed before the company. The voting rights are proportional to the shareowner's share of paid-up capital of the company. All shares carry proportionate rights. No company can issue shares which carry voting rights disproportionate to the rights attached to the holders of their issues. Voting right cannot, however, be exercised in respect of shares on which a call or any other sum due to the company has not been paid.

Advantages

The advantages of equity shares are many. Both issuing company and investors will have the benefits of equity shares.

Advantages of equity shares to issuing company

The following advantages of equity shares will accrue to the issuing company:

1. The issuing company will be able to collect huge fixed capital without any specific charge on the assets.

2. As the equity capital is permanent, the company is not bothered with the problem of refunding. The problem of returning the capital will arise only when the company goes into liquidation.

3. The company need not pay dividends compulsorily and at a fixed rate. The shareholders will get a return on their capital only when there are profits and they forego when the company incurs losses. Thus, dividend is not a fixed charge like interest on borrowing.

4. A company with an adequate equity base will be viewed with considerable favour by creditors. They regard equity capital as a cushion for granting loans.

5. As equity shares are usually of relatively lesser nominal value, they are likely to attract large number of investors belonging to all income groups.

Advantages of equity shares to investors

The investors in equity shares will have the following benefits:

1. During good periods, investors in equity shares are rewarded amply in the form of handsome dividends and bonus shares.

2. Equity shareholders have an exclusive privilege of voting rights on all the issues that come for discussion in the General Body Meetings. Thus, they play a decisive role in shaping the policies.

3. Equity shareholders can sell or transfer their holdings whenever they wish.

4. Equity shareholders have right to allotment of newly issued shares. Under the provisions of the Companies Act, the company intending to mobilize funds through the issues of new shares will have to offer to its existing equity shareholders pro-rate the shares proposed to be issued. Such shares are called right shares. This right assures them the opportunity to maintain the degree of required control and to share in the prospects of the company.

Limitations of Equity Shares

Inspite of the above mentioned advantages, the equity shares suffer from the following limitations:

1. Since the equity capital is non-refundable, in the event of excess capital due to faulty financial planning, the company may experience the evils of over-captalisation. This will create grave situation in times of decreasing profits and the earnings per share would be reduced drastically.

2. As equity shares have proportionate voting rights, management of the companies get concentrated in a few hands. It may lead to clique-formation leading to oligarchy i.e., a rule by a few.

3. The pre-emptive right of equity shareholders to new issue of securities will result in the continuation of the control by a few people and concentration of equity shares among a few shareholders.

4. Higher dividend on equity shares during the periods of prosperity pushes up their market values, often leading to awkward speculation.

5. Equity shareholders cannot claim any particular rate of dividend regularly every year as a matter of right. Moreover, there is no guarantee of dividends for all times, year after year.

6. In times of depression, dividends on equity shares may fall down. This will result in a drastic fall in their market value. Their resalable value declines in times of low earnings of the corporation. Thus, the fortunes of shareholders fluctuate according to

the business exigencies. As Wheeler points out, the equity shareholders "may experience feast or famine in dividends and they stand to lose heavily in the event of business failure".

Safeguards for Equity Shareholders

It is clear from the above limitations that the position of equity holders is not very safe. Democratic control of business operations by equity shareholders, as a matter of fact, is a myth. There is a dichotomy between ownership and management of company affairs as the control always vests in the hands of Board of Directors. Therefore, there is every justification for safeguarding the equity holders against the manipulations and misdeeds of the management. The government, through its corporate legislations, seeks to protect the equity shareholders by conferring certain rights on them. The following are a few of such rights.

i) **Right to vote:** The equity holders can exercise their franchise on all matters such as alteration of Memorandum, Articles of Association, removal of directors and managing directors, etc.

ii) **Right against ultra-virus acts of the company:** If the corporation enters into any agreement against the provisions of Memorandum and Articles of Association and exposes the investors to risks not mentioned in these documents, the shareholders may initiate legal action to prevent the company from enforcing such action.

iii) **Pre-emptive right:** The right to allotment of new issue of securities on pro-rata basis preserves the existing interests on the assets and the control of corporation.

iv) **Right to have knowledge of company affairs:** The equity shareholders have a fundamental right of being informed about the various developments in the corporation. They can inspect and refer the records, account books of company during the business hours.

v) **Right to transfer the shares:** The equity shareholders of public limited companies can sell or transfer their holding and convert them into cash. This right enables the equity holders to decrease their loss in the event of unsatisfactory business conditions.

Besides the above rights, the equity holders have many others prevelages such as participating in exceptional profits and the right to share in the residual assets after satisfying the creditors and preference shareholders at the time of winding up of company.

CHECK YOUR PROGRESS - 1

a) What are equity shares?

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b) What are the advantages of equity shares to the investors?

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5.4 STOCKS AND SHARES

After the shares or debentures have been fully paid up, they may, if so authorised by the Articles, be converted into stock by the company in the General Body Meeting as provided in section 94 (i) (c) of Companies Act. A stock is transacted in multiples of a monetary unit while a share is an individual unit. A share is transferable as an indivisible unit and as a whole. A share may be partly or fully paid up, while a stock must be fully paid up. A share possesses a distinct number, whereas a stock bears no number. The rights of shareholders remain intact after conversion, but the notice of the change must be given to the Registrar of Companies within 30 days after the change.

5.5 PREFERENCE SHARES

Corporations desirous of mobilising large savings from the public have to tap all varieties of investors including cautious and less venturesome people. Preference shares are a method of inducing cautious investors. These securities provide dividend in preference to the equity shareholders.

Preference shares are those which carry certain priority rights in regard to the payment of dividend and return of capital. At the same time they are subject to certain limitations with regard to voting rights. Preference shares are called as "Hybrid Securities" since they have features of bonds as well as equity shares. The dividend is stated at the time of issue of preference shares. The following are the basic features of preference shares:

1. Fixed rate of dividend.
2. Preferential payment of dividend prior to the equity shareholders.
3. Preferential rights in redemption of capital when the corporation is in liquidation.
4. **Limited voting rights:** The preference shareholders have little say in the management of business affairs. They may be accorded a contingent right to vote as they are allowed to participate in policies which may affect their interest. The preference shareholders may acquire right in the management when the dividend falls in arrears for a number of years.
5. **Preference as to conversion:** This is meant to encourage the preference shareholders to avail the opportunity of enjoying the results of the success of the corporation. This right to conversion will be given for a limited period only during which they must avail. Otherwise, the holding remains less attractive.

5.6 TYPES OF PREFERENCE SHARES

Companies registered under the Companies Act can issue the following types of preference shares:

1. **Cumulative Preference Shares**: On preference shares, it is already observed that fixed dividend is payable out of the annual profits. If the corporation does not earn sufficient profits in any year the dividend guaranteed may not be paid at all in that year. But in case of cumulative preference shares the unpaid dividend is carried forward as arrears and becomes the charge on profits of subsequent years. They go on accumulating till they are paid off fully out of the available profits of subsequent years. It was decided by a court decision in 1857 that the preference shares are always cumulative unless something contrary to it is mentioned.

2. **Non-Cumulative Preference Shares**: Holders of these shares are entitled to dividends only if there are adequate divisible profits in that year. In case the earnings are not sufficient to meet the dividend liability, they are not paid and these unpaid dividends are not carried forward. Thus, it does not, have a charge against the profits of subsequent years.

3. **Participating and Non-Participating Preference Shares:** Besides the fixed rate of dividends, the holders of these shares are entitled to a specified share in the excess profits of the company, after satisfying the equity shareholder at a certain rate of dividends. In other words, the excess profits are apportioned between these shareholders and equity holders in a specified ratio. The Articles of Association must allow specifically such participation by preference shareholders.

   Such preference shares which do not carry this privilege of participation along with equity shares in the surplus profits are known as non-participating preference shares. As a matter of fact, participation by preference shareholders in profits over and above their fixed dividend must be mentioned clearly and absence of such specification entails no right of participation.

4. **Redeemable and Irredeemable Preference Shares:** Preference share capital is not permanent if the shares carry a provision as to be repayment after a specified number of years. As against this, the equity capital is permanent. Preference shares which can be redeemed after a specified period or at the discretion of the corporation are called **redeemable preference shares.** A company limited by shares can, if authorised by its Articles, issues preference shares which are redeemable subject to certain conditions as under:

   i) Redemption shall not be allowed unless they are fully paid.

   ii) Repayment must be either out of net profits of the company or out of a new issue of shares made for the purpose of redemption.

   iii) If the redemption plan is to make refund of preference shares out of profits, the Capital Redemption Reserve account must be opened. Every year suitable amount should be transferred to this account from the profits made by the company.

Redeemable preference shares are paid back to the shareholders out of the profits or out of the proceeds of new issue of shares. The maximum period of redemption is 20 years with effect from 1-3-1997 under the Companies Amendment Act, 1996. It is to be clearly stated that they are redeemable. It should be noted that redeemable preference shares are not shares in the strict sense of the term. Since they are repayable, they are similar to debentures. Only fully paid preference shares are redeemed. Where redemption is made out of profits, a Capital

Redemption Reserve Account is opened to which a sum equal to the nominal amount of the shares redeemed is transferred. It is treated as paid-up share capital of the company.

Two-innovative types of preference shares were introduced into the market in 1992-93. These are fully convertible cumulative preference shares (Equipref) and preference shares with warrants attached. Let us discuss about these two innovative instruments.

Fully convertible cumulative preference share (Equipref)

Equipref has two parts of A and B. Part A, is convertible into equity shares automatically and compulsorily on the date of allotment without any further act or application by the allottee. Part B will be redeemed at par/converted into equity shares after a lock-in period at the option of the investors.

Conversion into equity shares after the lock-in period will take place at a price which would be 30 per cent lower than the average market price. The average market price shall be the average of the monthly high and low price of the shares in a stock exchange for a period of six months to the date of conversion including the month in which the conversion would take place.

The dividend on fully convertible cumulative preference shares shall be fixed and shall be given only for the portion that represents part B shares. Upon conversion of each part of the equipref shares, the face value of it will stand reduced proportionately and the equipref shares shall be deemed to have been redeemed to the extent of each part on their respective dates of conversion.

Preference with warrants attached

Under this instrument, each preference share would carry certain number of warrants entitling the holder to apply for equity shares for cash, at 'a premium' at any time, in one or more stages between the third and fifth year from the date of allotment. If the warrant holder fails to exercise this option, the unsubscribed portion will lapse. The holders of warrants would be entitled to all rights/ bonus shares that may be issued by the company. The preference shares with warrants attached cannot be transferred / sold for a period of three years from the date of allotment.

Advantages of preference shares

The issuing company and shareholders will have the following benefits of preference shares:

1. It is a means to mobilise funds from cautious investors who prefer safety with guaranteed rate of return. It combines security with a fixed rate of return.

2. A corporation whose earnings are not likely to be uniform may not be able to meet fixed charges on debentures. But if the earning are fairly on an average, it can issue preference shares at fixed rate of dividend.

3. When the assets of a corporation are not having high value as collateral security for the debenture holders it may issue preference shares.

4. When the assets of a company are already encumbered, a second lien may require the offer of a high rate of interest on the issue of debentures. In such cases, preference shares offer a better means than debentures to raise capital.

5. If debentures are to be issued, adequate security has to be offered by company. But the management may not wish to mortgage properties in order to preserve them for the future contingencies. In such an event, issue of preference shares offers good alternative.

6. As the preference holders have limited voting rights, capital can be raised without diluting the control by the existing equity holders.

7. At the time of carrying out a reorganisation scheme of a company by way of merger or reduction of long-term indebtedness, the corporate debt may be converted to preference shares. The reason is that they carry the privileges of participation, redemption and conversion.

8. Preference shares can also be given to the purchasers as a bonus while selling the debentures or ordinary shares to them. Thus, they may also be used to enhance the marketability of other securities.

Disadvantages

The disadvantages of preference share are as follows:

1. Dividend on preference shares is almost fixed charge against the annual profits. It results in a permanent burden in the event of inadequacy of profits.

2. The cost of issue of preference shares, in terms of fixed dividends, may some times be greater than the cost of debentures. The dividend paid is not tax deductible.

3. Preference shareholders carry only a limited voting rights. Hence, they cannot participate in shaping the corporate policies. Thus, they are regarded as capital contributors only.

4. Usually, the preference shareholders are to be content with fixed dividend even when bumper profits are earned by a corporation. As against this the equity holders will benefit appreciably. Of course, participating rights may, to some-extent, lessen this limitation.

5. Preference shareholders will be put to enormous loss if the company exercises its discretion to redeem them during the period of depression. It is quite possible that the Board may take advantage of a favourable money market to redeem it, replacing with shares carrying lower dividend rate.

CHECK YOUR PROGRESS - 2

1. List out the features of preference shares

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2. Discuss the types of preference shares.

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5.7 DEBENTURES

We have discussed the ownership securities in the form of equity shares and preference shares in the foregoing pages. Let us know discuss different types of creditorship securities.

Meaning and Definition of Debentures

Debentures represent the borrowed capital of a corporation. Therefore, they are known as creditorship securities. Debentureholders are creditors but not the owners as equity shareholders. As such debenture capital is known as debt capital. The debenture issue is preferred when the earnings of the company are likely to be constant and sufficient to meet interest liability. The Indian Companies Act is silent about the definition of debentures. The term debentures is derived from Latin word "debere" which means "to owe a debt". Therefore, debenture may be described as an acknowledgement of debt by a company, usually issued under the common seal. It may be unsecured or secured by a fixed or floating charge on the assets of the issuing company. The terms and conditions governing the debentures are normally found on the back of the security. Palmer defines debentures as "any instrument under seal of the company, evidencing a debt deed, the essence of it being admission of indebtedness".

In the words of Eveyn Thomas " it is a document under the company's seal which provides for the payment of a principal sum and interest thereon at regular intervals which is usually secured by a fixed or floating charge on the company's property or undertaking and which acknowledges a loan to the company".

Features of Debentures

From the above definitions it can be understood that debentures have the following basic features.

1. It is an acknowledgement of debt in writing.
2. It is a deed explaining the terms and conditions of debt between the company and the holders of debentures as to interest rate and refund of principal amount.
3. As debentureholders are creditors, they do not have voting rights. Section 17, of Indian Companies Act prohibits the issue of debentures with voting rights.
4. Debentures can be unsecured or secured by a charge on the assets.
5. Debentureholders can enforce the security by sale in case of default.

Debentures and Bonds

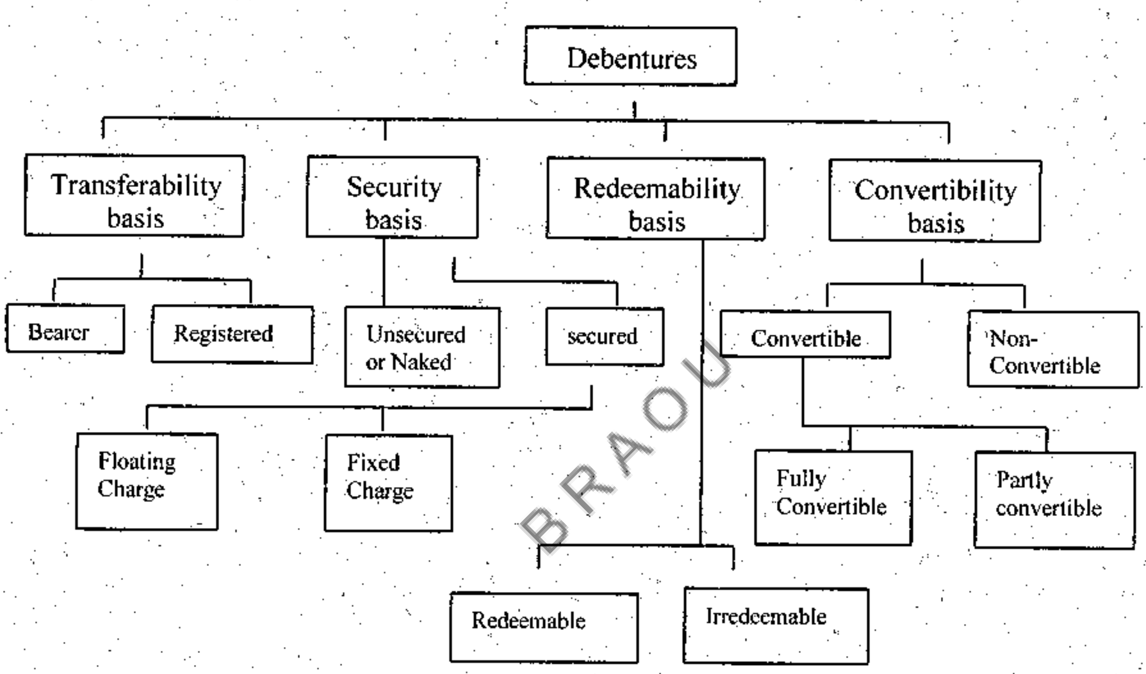
In reality there is no distinction between debentures and bonds. However, in the USA, only unsecured bonds are termed as debentures but in the UK no distinction is made between the two terms. As we have borrowed the terminology from Great Britain, we too in India do not make any distinction between them. In other words; debentures can be secured or unsecured since it is generic term. In America the generic term is "bond" which may be secured or unsecured, and a debenture is an unsecured bond.

As against this tangle of terminology, the laymen's understanding is that bonds are the acknowledgement of debt issued by Government whereas debentures is a debt acknowledgement give by a company.

5.8 TYPES OF DEBENTURES

On the basis of transferability, security offered and redeemability debentures are classified as indicated in the following Chart.

Chart –5. 2



a) On the basis of transferability: On this debentures are classified into Bearer Debentures and Registered Debentures.

i) **Bearer Debentures** are negotiable by mere delivery of the document. This type of debtntures can be freely purchased and sold without giving any intimation to the company. As such, these securities are as good as cash in hand provided there is a market value.

ii) **Registered debentures** are not freely negotiable by delivery of the security. The name of the debentureholders are recorded in a Register kept by the company. Only those debentureholders whose names appear in this Register are entitled to repayment of principal amount and periodical payment of interest as agreed upon. They are, however, transferable, as per the provisions of Articles of Association of the company.

b) On the basis of Security: Based on the security offered to the debenturholders, debentures are classified into Unsecured Debentures and Secured Debentures.

iii) Unsecured Debentures are also known as simple or naked debentures. These debentureholders are treated as ordinary creditors. They are not endowed with any charge on the assets to support these debts. In the event of default in repayment of principal amount or interest, the holders of these securities can file suit against the company. They will not have any right to charge the assets of the company because they are not secured by any property.

iv) Secured Debentures are popularly known as mortgage debentures. They are secured by a charge on the property of the company. These debenture holders have the right to recover their debt from the company out of sale proceeds of mortgaged assets. Such assets which are charged to debentureholders will not be available for other creditors. A mortgage deed is executed by the company in favour of the debenture holders setting forth the terms of repayment, rate of interest and the details of the assets mortgaged. The charge created against the assets may be fixed or floating.

Fixed charge is one which is created only on specified and definite assets. It prevents the company from dealing with those assets without the consent of holders of such charge. Thus, fixed charge is a specific mortgage on specified assets.

Floating charge is created on the assets of the company, present or future. As the business operations of company go on, its assets will constantly undergo a change. The company can deal with those assets existing in the usual course of business until mortgage takes any step. Thus the floating charge is shifting in its nature. The debentureholders can attach the assets as and when:

(i) the company stops its business;
(ii) the company goes into liquidation; and
(iii) the company commits default in repayment.

c) On the Basis of Redeemability: Based on the redeemability, the debentures are classified into Redeemable Debentures and Irredeemable Debentures.

i) Reedeemable Debentures are repayable after a specified period.

Any charge fixed or floating created by the company on its assets for the issue of debentures can be redeemed by the company on a specified date or on demand by the debentureholders as per the terms and conditions. By its own discretion also the company can redeem by giving a notice of redemption. Redeemable debentures can be issued after redemption under section 121 of Companies Act.

ii) Irredeemable debentures are not repayable during the life time of the company. Therefore, they are also described as perpetual debentures. This debenture debt becomes repayable only when the company goes into liquidation or when interest is not regularly paid as and when accrued.

d) On the Basis of Convertibility: On this basis debentures are classified into convertible and non-convertible.

Convertible debenture holders are given the choice to convert their debentures into equity shares of the company at stated rates after a specified period. Thus, these holders can become shareholders on conversion and take part in the management of company.

Let us discuss about convertible debentures which assumed importance in the Indian Capital Market in recent years.

i) Convertible debentures

Convertible debentures are instruments which, as per the terms of issues, are convertible into other security, mostly equity. Convertible Debentures have become appealing to the investors as a result of which there has been a shift in favour of debentures from traditional equity shares. Under this, unless the conversion is compulsory, the investor has the option of retaining the debenture without exercising the conversion option in the event of a fall in the equity price subsequently. The fully convertible debentures are treated at par with equity by financial institutions and the debt-equity ratio improves creating thereby reserve debt capacity for the company.

In India until mid-eighties the non-convertible debentures were largely in vogue though the debentures market was not very encouraging. Of late the convertible debentures have been carried out by many of the companies and seem to have taken deep roots in the corporate sector presumably because of the benefits tilting in favour of the companies.

For the first time in the corporate history of India, partly convertible debentures offers have emanated from Greenfield ventures like Tata Timken, Bausch and Lomb, Tata Elxsi in the early 1992. But now the PCDs also do not appear to be very attractive to the investors because of the illiquidity of the non-convertible part (khokha).

ii) Non - Convertible debentures

Non-convertible debentures are the debt instruments which cannot be converted into equity at any time and they remain as a debt until redemption. With the term deposit rates at their lowest, non-convertible debentures are becoming attractive and the gap between return on equity and yield from debentures has narrowed. Foreign Institutional Investors are currently investing in non-convertible debentures because of their high price earning ratio. Big corporate houses find such debentures safe for parking their funds.

Importance of debentures

In meeting the corporate long-term needs debentures have a significant place.

i) The company will be able to acquire huge funds for a long-period without giving any control to the debentureholders.

ii) An opportunity is provided to the corporation to trade on equity and thus increase the return for equity holders.

iii) Interest on debentures is a fixed charge payable at periodical intervals irrespective of fluctuating fortunes of the corporation.

iv) Debentures will have a great market response during depression.

v) As the debentures are usually secured by mortgage of the assets safety of funds as to their repayment is guaranteed. Therefore, debentures will have good response from the investors.

vi) A company with large number of small debts of short duration may always feel financial congestion. They can be converted into a single issue of debentures which will be less costly.

vii) Since debentures are generally issued on redeemable basis, the company can avoid over-captitalisation by refunding the debt when the financial needs are no longer felt.

viii) Interest paid on debentures is a charge on income of the company and is deductible from computable income for income tax purpose. This benefit will be more felt when we understand that the outflows of cash on account of dividends to shareholders are liable to corporate income tax. Thus, the companies can take advantage of 'trading on equity' by issuing debentures.

ix) During tight financial market conditions, small and medium companies find debentures as a low-cost source of long-term finances.

5.9 LIMITATIONS OF DEBENTURES

The debentures suffer from certain limitations. They are:

i) Debenture financing involves a greater risk as it is a fixed charge. Corporation with un-predictable and volatile earnings have to use debentures very cautiously. Due to fluctuations in its earning, the corporation may find it difficult to meet these fixed charges.

ii) Resorting to debenture financing is not practicable for certain corporations particularly dealing with consumer goods, where the proportion of fixed assets to total assets is very low.

iii) Heavy reliance on debenture financing with high servicing charges will leave the corporation with little profits. Consequently the corporation may not be able to declare dividends. As such the value of shares may decline in the stock exchange.

iv) If the corporation has already issued debentures, it will have to offer higher rate of interest on successive issues of debentures.

v) Corporations dealing in luxury products for which demand is highly elastic, cannot oscillate debentures as their earnings are highly oscillating.

vi) Debenture financing, sometimes, may paralise the business operations when the corporation is passing through adverse business conditions as its assets are mortgaged.

vii) From the point of view of debentureholders it is felt that, since they do not have any power of control over the corporation's affairs, mis-management or speculative trading by the corporation may weaken their position.

Debenture and Debenture Stock

Consolidation of borrowed money by way of debentures into one mass for the sake of convenience, is called debenture stock. Debenture stock represents the share of individual debentureholder in the total loan and is evident by a certificate. The important difference between the debenture and debenture stock is only with regard to form but not substance. For example, in place of 1000 debentures Rs.100/- each held by Mr. X, if the corporation issued only one certificate representing Rs.1,00,000 for the sake of convenience, it may be called debenture stock.

CHECK YOUR PROGRESS - 3

a) Define the 'debentures'.
b) Explain the 'fixed charge' and 'floating charge'.

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In addition to, the traditional capital market instruments let us discuss the financial innovations in the capital market in recent years after liberlisation of the Indian economy since July, 1991. The innovative financial instruments discussed in the following pages are warrants, secured premium notes, deep discount bonds, Euro convertible bonds, inflation bonds, floating rate bonds, Government guaranteed bonds. Tax saving bonds, regular income bond, zero interest bond and capital index bonds.

5.10 INNOVATIVE CAPITAL MARKET INSTRUMENTS

Having discussed debentures including convertibles, let us have an idea of some financial innovative instruments that entered the Indian capital market in recent years to suit the requirements of investors.

Warrants

A warrant is a security issued by a company, granting its holder the right to purchase a specified number of shares, at specified price, any time prior to an expirable date. Warrants, also called sweeteners and they may be issued with either debentures or equity shares. They clearly specify the number of shares entitled, the expiration date, along with the stated/exercise price. The expiration date of warrants in USA is generally 5 to 10 years from the date of issue and the exercise prices is 10 to 30 per cent above the prevailing market price. Warrants have a secondary market. The minimum value of a warrant represents the exchange value between the shares at current price and the shares to be purchased at the exercise price. They have no flotation costs and when they are exercised, the firm receives additional funds at a price lower than the current market price, yet higher than those prevailing at the time of issue. Generally, new/growing firms and venture capitalists issue warrants. They are also issued during mergers and acquisitions. Warrants have been issued by a few Indian companies since 1993. Debentures issued with warrants, say convertible debentures, carry lower coupon rates.

Bond

Bond is not defined under Companies Act, 1956, but according to Section 2(5) of the Indian Stamp Act, 1989, bond includes any instrument attested by a witness and not payable to order or bearer whereby a person obliges himself to pay money to another.

Bond can also be issued with or without warrants. Bond may be attached with a detachable warrant which entitles the holder to buy more bonds of the company with certain concessions. Some companies issue high yield bonds which have high interest rates and are issued by lower credit rated companies. Bonds may also be issued with buyback option.

Inflation Bonds

Inflation bonds are the bonds in which interest rate is adjusted for the inflation rate. Thus, the investor gets an interest rate, free from the effects of inflation. These types of bonds are more in use in countries like US. These bonds are called inflation bonds or inflation protection bonds giving a fixed rate of interest after making allowance for inflation. For example, if the interest rate is 10 per cent and the inflation is 6 per cent, the investor will earn 16 per cent meaning thereby that the investor is insulated against inflation.

Floating Rate Bonds or Notes

Floating rate bond as the name suggests is a bond where the interest is not fixed and is allowed to float depending upon the market conditions. This is an ideal instrument which can be resorted by the issuers to hedge themselves against the volatility in the interest rates.

Government Guaranteed Bonds

These are medium to long term debt instruments issued by Government agencies and Public Sector undertakings owned by Central or State Government. The repayment of principal and payment of interest is guaranteed by Government. Such bonds have been issued by various electricity boards, power Corporations, Road Transport corporations and state owned utility services.

Zero Interest Bonds

These were introduced in Indian markets in early nineties. The debentures or bonds are convertible into equity shares after a certain period but no interest is payable till such conversion. Since no interest is payable till maturity when it is converted into equity, company is able to service the equity in a better position. The investors are rewarded by way of a low premium on conversion. This instrument has been used by very few and provides a tax shield to the investor. The benefit accrues to the investor by way of lower premium paid for acquisition of shares. This instrument can also be used for managing cash flows.

Zero Interest Fully Convertible Debentures / Bonds

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 the holders thereof are entitled to equity shares of the company at a pre-determined price.

Deep Discount Bonds (DDB)

These bonds are sold at a discounted value on maturity, face value is paid to the investors. Recently, deep discount bonds were issued by IDBI with a maturity of 25 years at Rs.2,700 with a maturity value of Rs.1Lac. Subsequently, happy return bonds were issued by SIDBI for Rs.2,500 with face value of Rs.1 lac payable at maturity after 25 years. These are negotiable instruments transferable by endorsement and delivery by the transferor. Institutions like ICICI, IDBI and IFCI have issued such bonds several times (for example, family bonds, liqui bonds, flexi bonds, etc.)

Secured Premium Notes (SPN)

This instrument frees the firm from debt servicing costs in the first three years. Investors are repaid the principal in four equal instalments between the fourth and seventh years, with the option of taking their returns as either interest or redemption premium. Besides, investors are given a warrant entitling them to buy the company's share one year after the allotment of SPNs

Euro Convertible Bonds (ECB)

Euro convertible bonds are quasi-debt securities (unsecured) which can be converted into depository receipts or local shares. They are targeted at non-US investors. In the past, Reliance and Sterlite Industries have given investors an option of converting their ECBs into global depository receipts (GDR) as it is at no cost to the company (The Depository makes money on trading in GDRs). ECBs offer the investor an option to convert the bond into equity at a fixed price after a minimum lock in period. The exchange rate for the conversion price is fixed as is the conversion price. Investors are offered a put option, which allows him to get his money back before maturity. A call option allows the company to force conversion if the market price of the shares exceedS a particular percentage of the conversion price.

5.11 SUMMING UP

Funds are mobilised by issuing securities by the companies. Securities are classified into ownership securities and creditorship securities. A company can issue either equity shares or preference shares or both. Within the preference shares there are various types. They are : participating, non-participating; redeemable; irredeemable and cumulative and non-cumulative preference shares. Each of this class has merits and demerits of its own. There is distinction between stock and shares. Debenture is a document, acknowledging the debt issued under the common seal of the company. Debentures are classified on the basis of transferability, security and redeemability. On the basis of transferability they are classified into bearer debentures and registered debentures and on the basis of security, they are classified into secured and unsecured debentures. According to redeemability, they are categorised into redeemable and irredeemable debentures. All these classes of debentures have certain advantages and disadvantages of their own. There are certain limitations of issuing debentures. Debentures can be consolidated and such consolidated form is known as debenture stock. A number of innovative instruments have been issued to attract investors and to suit their needs.

5.12 CHECK YOUR PROGRESS : MODEL ANSWERS

1. a) Equity shares are the ownership securities which do not carry preferential rights neither as to dividend nor as to return of capital at the time of liquidation of company.

   b) The advantages of equity shares to the investors are:

      i) They get handsome dividend during good periods,

      ii) They have voting rights in the General Body Meeting and thereby they effect the decisions of the company,

iii) They can sell the shares and get cash as and when they need money, and

iv) They are entitled to get shares in the event of subsequent or new issue of shares.

2. a) The following are the features of preference shares:

   i) They get fixed rate of dividend.
   ii) They are paid dividend prior to equity shareholders.
   iii) They have limited voting rights.
   iv) They get, sometimes, preference as to conversion of these shares into equity shares.

   b) The following are the types of preference shares:

   i) Cumulative, non-cumulative preference shares,
   ii) Participating and non-participating preference shares, and
   iii) Redeemable and irredeemable preference shares.

3. a) Palmer defines debentures as "any instrument under seal of the company, evidencing a debt deed, the essence of it being admission of indebtedness".

   b) Fixed charge is specified charge on specified assets. The company has no right to deal with those assets without the consent of holders of such charge. Floating charge is a charge created on the assets of the present and future which are in the possession of company. The company can deal with those assets in the usual course of business until the holders of such charge do not take any step.

5.13 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in about 30 lines each.

1. What are the sources of long-term finance for corporations?
2. What are the safeguards offered by Government to protect the rights of equity holders?
3. Explain the importance of debentures in raising long-term finances by a company.
4. What is meant by debenture? What are the features of debentures?

II. Answer the following questions in about 30 lines each.

5. What are the different types of ownership securities?
6. Explain the advantages of equity shares.
7. Explain the difference between stocks and shares.
8. What are the conditions under which a company can issue redeemable preference shares?
9. Differentiate between fixed and floating charge.
10. Explain about innovative instruments in the Indian Capital Market?
11. Explain the innovative instruments in the Indian Capital Market.

5.14 RECOMMENDED BOOKS

H.R. Machiraju	: **Indian Financial System,** Vikas Publishing House Pvt. Ltd, New Delhi.
Sanjiv Agarwal	: **Guide to Indian Capital Market** Bharat Law House, New Delhi.
Prasanna Chandra	: **Financial Management, Theory and Practice** Tata McGraw Hill, New Dehli
Vasant Desai	: **Indian Financial System** Himalaya Publishing House, Bombay
M.Y. Khan	: **Indian Financial System** Tata McGraw Hill, New Dehli.

5.15 GLOSSARY

Bonus Shares	: Payment of dividend in the form of shares instead of cash to shareholders.
Corporate securities	: Shares and debentures issued by companies for long raising long term finances.
Debentures	: An acknowledgement of debt due by a company.
Depository System	: Is paperless or scripless from of holding the shares.
Equity shares	: Ownership securities carrying no special or preferential rights as to dividends and return of capital at the time of liquidation.
Fixed charge	: Mortgage created by only on specified and definite assets.
Floating charge	: Mortgage charge created on the assets of the resent and future which are in possession of a company.
Floatation	: Incorporation of a company or release of share for sale to the public.
Investor	: Owner of securities viz., shareholders and debenture holders.
Participating preference share	: A preference share carrying an additional right to participate in the surpluses after satisfying equity holders at a certain rate of dividend.

Preference share	:	A share carrying certain priority rights as to dividend and return of capital.
Premium	:	Excess amount over and above the face value.
Pre-emptive right	:	Right to purchase before an offer is made.
Redeemable preference share	:	Preference shares repayable after a specified period.
Redemption	:	Repayment
Right shares	:	Shares which must be offered first to the existing equity shareholders of the company in proportion to their holders.

UNIT – 6 : CAPITAL AND MONEY MARKETS IN INDIA

Contents

6.0 AIMS AND OBJECTIVES

The main aim of this unit is to explain the concepts of capital market, money market, primary market and secondary market; their importance, constituents, sources of supply and demand for funds, and their functions. Further, the structure and development of capital and money markets in India are presented in this unit.

After studying this unit, you should be able to:

- explain the meaning of capital and money markets;
- state the sources of supply and demand for short term and long term funds;

- describe the functions of both capital and money markets;
- identify the constituents of capital and money markets;
- explain the structure and recent developments in capital and money markets in India;
- distinguish between primary and secondary markets; and
- highlight the recent developments in primary and secondary markets.

6.1 INTRODUCTION

Capital formation is sine qua non of economic development. Economic development and the development of capital and money markets are inter-dependent. Developed money and capital markets indicate the development of economic system. For mobilising savings and for rapid capital formation, healthy growth and development of these markets are the pre-requisites. They help in the promotion of investment activities and encourage entrepreneurship development in the country. To ensure liquidity of funds, mobility (geographical, functional, temporal and sectoral) of funds, alround development of money and capital markets is essential. They, in brief, lead to sustained growth and development of an economy. A well founded and sound money and capital market activities will lead to full employment and increased purchasing power leading to further demand for goods and services. Therefore the capital market and money market constitute an important component of financial system of a country. In fact the relationships between the markets, instruments and services are integrated as well as interdependent and they are the components of capital market. The capital market consists of primary market and secondary market. The primary market deals with the issue of new instruments by the corporate sector such as equity shares, preference shares and debentures. The secondary market consists of 23 stock exchanges in India including the National Stock Exchange, Over The Counter Exchange of India (OTCEI) and Inter Connected Stock Exchange of India (ICSE) where the existing instruments are traded for providing liquidity. While the capital formation occurs in the primary market, the secondary market provides a continuous market for the securities already issued in the primary market. There is a symbiotic relationship between the primary and secondary markets. We will discuss in this unit the various concepts and the developments taking place in the Indian Capital Market so as to have a comprehensive view of the functioning of the Indian Capital Market.

6.2 CAPITAL MARKET

6.2.1 MEANING OF CAPITAL MARKET

Capital markets denotes all buyers and sellers of capital funds as well as the entire mechanism for facilitating and effecting long-term funds. It provides long term funds needed for investment purpose. Thus, the capital market is concerned with long-term finance. It refers to facilities and institutional arrangements for the borrowings and lending of long-term funds. According to W.H. Husband and J.C. Dockeray, "The Capital Market is used to designate activities in the long-term credit, which is characterized mainly by securities of investment type". Capital market is an organized market mechanism for efficient and effective transfer of financial resources from the investing class to the entrepreneur class including individuals and institutions engaged in the industry, business or service in the private and public sectors of the economy. In a broad sense it is a market for all financial instruments both short term and long term and also commercial, industrial and Government paper. In the words of Gold Smith, "Capital market of a modern economy has two basic functions: first the allocation of the savings among users and allocation of investment; second the facilitation of the transfer of existing assets; tangible and intangible among individual economic units." Grant defines Capital Market in a broader sense as a 'series of channels' through which the savings of the community are made available for industrial and commercial enterprises and for public authorities. According to international standards, loans and financial transactions which have a maturity period of one year and above come within the definition of long term funds and those having maturity period of less than one year are termed as short-terms funds. In capital market, to a large extent, funds are traded for long term purposes.

Capital market may be divided into two segments-primary market and secondary market. New issues are made in the primary market. For instance, when a company wishes to raise capital by issuing securities, it goes to primary market where borrowers exchange financial securities for long term funds. The primary markets facilitates the formation of capital. The secondary market offers facilities for trading in outstanding issues. In other words, buyers and sellers negotiate for the shares and debentures issued by companies earlier. The secondary market consists of stock exchanges recognized by the Government. In these stock exchanges outstanding securities are offered for sale and purchase. Both these segments of capital market are indispensable since they have reciprocal impact on their growth and development.

6.2.2 IMPORTANCE OF CAPIATL MARKET

An ideal capital market is one where finance is used as a handmaid to serve the needs of industry. It is available at a reasonable rate of return for any proposition, which offers a prospective yield sufficient to make borrowing worthwhile given the prevailing rates of interest. An efficient capital market is an essential pre-requisite for the economic development and the capital market in a country is dependent upon the availability of savings, and the proper organization of intermediary institutions to b.ing the investor and the business ability together for mutual interests. With the rise of the joint stock form of organization of production and distribution, the importance of capital markets as a liaison between the investor and the entrepreneur has become paramount.

In brief, capital market helps in providing the following

- The mobilization of surplus money in the community,
- Encouraging the investment behavior of funds holders,
- Improving the liquidity of funds,
- The economic development of the country, and
- The creation of employment of all types of categories.

The increase in the size of the industrial units and business corporations due to technological developments, economies of scale and other factors have created situation wherein the capital at the disposal of one or few individuals is quite insufficient to meet the investment demands. A developed capital market can solve this problem of paucity of funds because an organized capital market can mobilize and pool together even the small and scattered savings and augment the availability of investible funds. While the rapid growth of joint stock companies has been made possible to a large extent by the growth of capital market, the growth of company form of business has in its turn encouraged the development of capital market. A developed capital market provides a number of profitable investment opportunities for the small savers.

6.2.3 SOURCES OF LONG TERM FUNDS

The success of capital market depends upon its capacity to mobilize surplus funds available in the community. Under capitalistic form of economy savings or the surplus of income over expenditure of an individual constitutes the main source of capital. Therefore supply of capital funds emanate broadly from (i) the ultimate savers of the funds as direct investors, and (ii) the investment and financial intermediaries with some specific micro and macro objectives. In other words the supply of funds in the capital market originates from savings which accrue mainly from the following sources: (a)individuals, (b)business operations, (c) governments, (d) foreign countries, (e) bank credit, (f) provident funds, and other funds, (g) financial institutions etc. These sources are broadly classified into: (i) Household sector, (ii) Agriculture sector (iii) Treasury sector, and (iv) Business or Corporate sector.

Institutional investors may further be divided into two categories. Firstly, the private institutional investors which consist of two types of investors; and they can be segregated on the basis of investment of their fund: (i)private institutional investors which invest on their own account. For example, private commercial banks, life insurance companies, investment trusts and commercial and industrial concerns possessing surplus; i.e., corporate savings, and (ii) private institutional investors which invest on behalf of their clients and do not purchase corporate securities on permanent investment basis, such as under writing houses, issue houses and investment bankers or trustee companies.

Secondly, the public institutional investors which include various governmental agencies employed directly or indirectly in the financing of private enterprises such as IDBI, ICICI, IFCI and SFCs.

The following chart depicts various sources of long term funds broadly classifying under the heads of individual investors and institutional investors.

Chart – 6.1

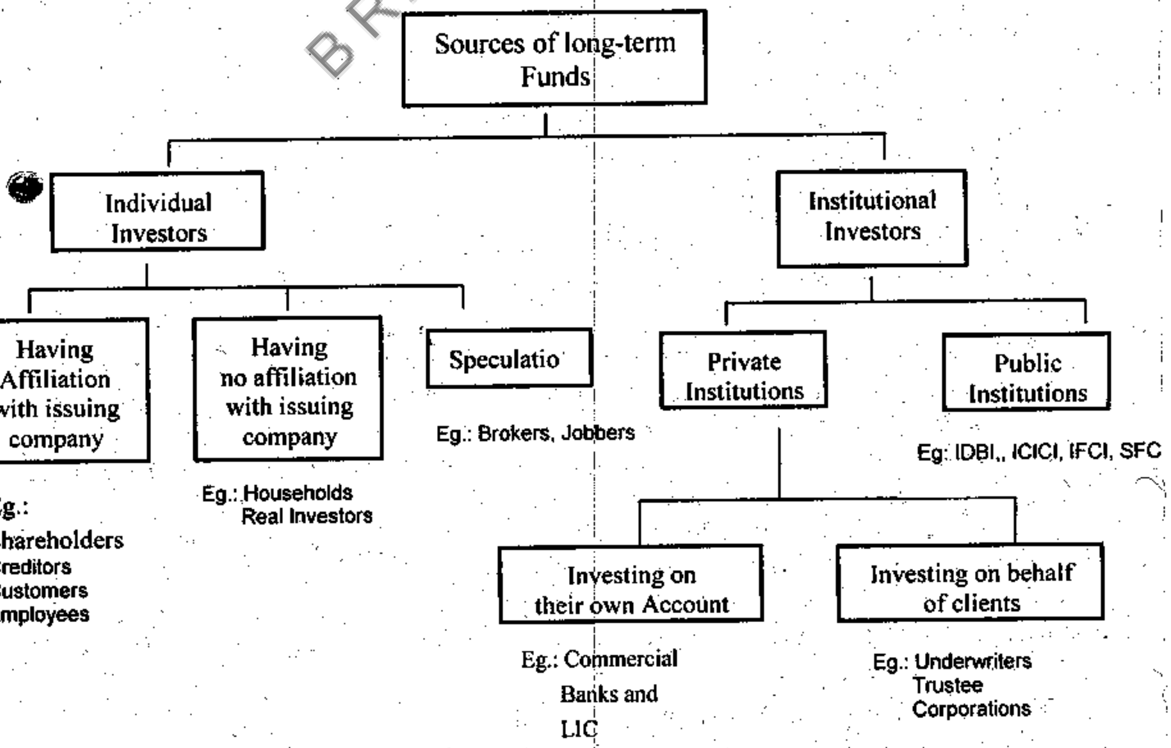


Chart 6.1 reveals that funds generated from various sources for investment purposes. But they take number of routes to reach the capital markets. Funds, can be obtained directly from the individual investors, venture capitalists and special financial institutions, and underwriters. Thus it is to be noted that long term funds reach capital market through various means.

6.2.4 DEMAND FOR LONG TERM FUNDS

The demand for capital arises from public borrowers such as the Central, State and Local Governments and from private borrowers such as the industrial, financial and real estate companies. The demand for capital by joint stock companies constitutes an important part of the whole of the demand in the private sectors. The important means of raising the company's funds are : (a) issue of shares; (b) sale of debentures; (c) borrowings from banks; and (d) borrowings from individuals. Among all these sources, the raising of funds through the issue of shares constitutes the most important one. Capital issues comprise shares issued by newly established companies and the companies at work. Thus the capital market brings those who supply capital into contact with those who demand funds. The need for long term funds arise on account of rapid industrialization. For instance, the encouragement by government for establishing industrial units creates demand for long-term funds. Modernization of existing plants by established units results in greater demand for funds. Similarly, expansion programmes and the reorganization of the existing companies may lead to the issue of shares, debentures for subscription, because companies require capital for these purposes.

Let us now consider the marketing organization of the capital market to meet the demand for funds. It consists of various intermediaries responsible for the transfer of funds from those who save to those who demand funds for investment. These intermediaries bring together the borrowers and the investors. The companies that issue capital and the persons desirous of procuring capital so issued are brought together. Further the intermediaries which perform the twin functions of the capital market (a) raising of new capital in the form of shares and debentures; and (b) trading in securities already issued by the companies are also the constituents of the capital market. The efficiency of a capital market depends largely on the specialization in attending to the different functions such as the formation of an enterprise and raising of capital. Promotion of new companies, issuing of shares and debentures, underwriting and sale of securities are attended by separate agencies. All of them are called the constituents of capital market. There are Issue Houses in the U.K. and Investment Banks in USA serving as specialized agencies to meet the demand for funds. Stockbrokers and institutional agencies such as Life Insurance Companies, investment trustees and finance corporations are also treated as constituents. Thus the important constituents of the Indian capital market for instance are: development banks, Unit Trust of India, Life Insurance Corporation, Commercial Banks, Stock Exchanges, Finance and Investment Companies, Joint Stock companies and Merchant Banking Companies.

6.2.5 FUNCTIONS OF CAPITAL MARKETS

The functions of capital market may differ from country to country depending upon the level of economic development. The traditional functions of capital market may not be suitable for the developing countries like India. In developing countries the capital market should perform two important functions to assist economic development of the economy. Firstly, it must help to promote savings and investment. Secondly, it must make an efficient allocation of funds among various fields which need investment.

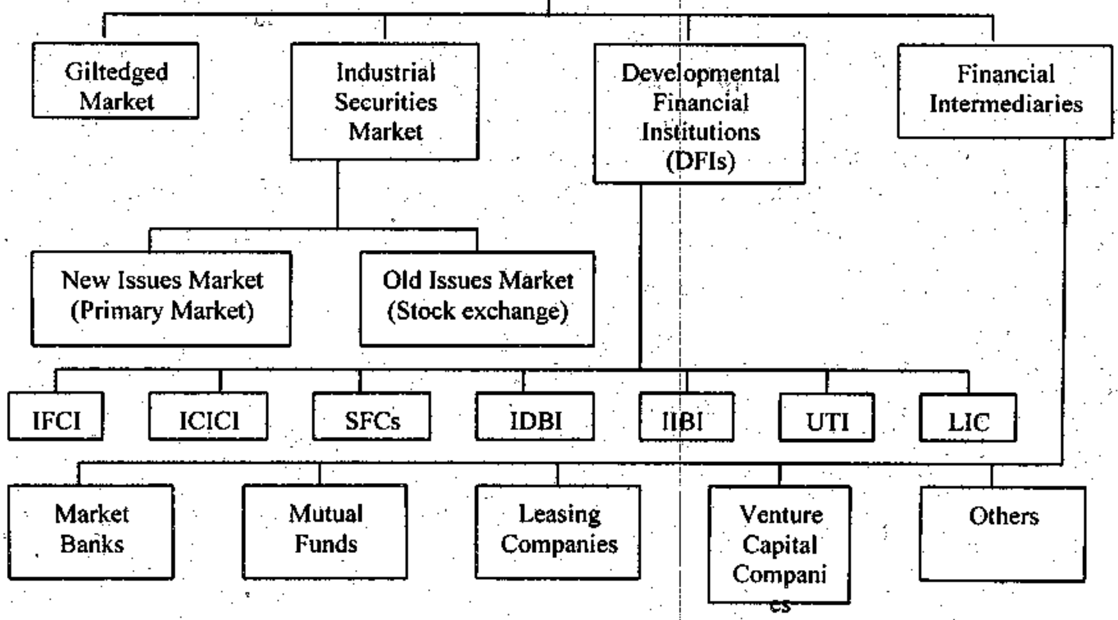
These functions are performed through the services of expert intermediaries. As stated earlier, these intermediaries are in touch with the parties in possession of disposable capital and also with the parties eager to employ it. To accelerate the real growth, therefore, productive investments should be encouraged and unproductive investments should be discouraged. But strict observance of these activities is needed so that the financial intermediaries may not extend speculative credit which may be used unproductively. If that is allowed to happen these institutions will frustrate the development policy of the authorities. Like commercial banks their activities need to be controlled and regulated. Unless a policy of effective control is applied by the Reserve Bank of India (RBI), the possibility of misallocation of resources will constitute a serious threat to economic development.

The financial institutions constituting the capital market can affect the capital stock for growth purposes in three ways. Firstly, these can encourage for efficient allocation of a given total amount of tangible wealth by bringing about changes in its ownership and composition through intermediation among various types of asset-holders. Secondly, they encourage a more productive use, by intermediation between sellers and entrepreneurial investors. Thirdly, they can induce an increase in the rate of accumulation of capital by providing increased incentives to save and invest in bunnies enterprises.

6.2.6 STRUCTURE OF INDIAN CAPITAL MARKET

The Indian Capital Market broadly consists of gilt-edged market, industrial securities market, development and financial institutions, and financial intermediaries. The gilt edged market refers to the market for Government and semi-Government securities backed by the Reserve Bank of India. The Industrial Securities market consists of both primary and secondary market (Stock Exchange). The developmental financial institutions like IFCI, ICICI and IDBI and other institutions are important players in the Indian Capital Markets. Apart from these, the financial intermediaries including merchant banks, leasing companies and venture capital companies constitute also important part of Indian Capital Market. The broad structure of Indian Capital Market is given in the chart shown below.

Chart - 6.2
Indian Capital Market



CHECK YOUR PROGRESS - 1

i) What do you mean by capital market?
ii) What are the functions of capital market?
iii) What are the sources of long-term funds?

6.3 MONEY MARKET

6.3.1 MEANING OF MONEY MARKET

While capital market takes care of allocations of long-term funds trading, money market deals with short-term requirements of borrowers. The money market, like any other market, is concerned with the supply of and demand for funds required for production of goods or service. A money market handles transactions in short-term government obligations, bankers acceptances and commercial papers. In a money market, funds can be borrowed for short-period varying from a day, a week, a month or 3 to 6 months among different types of securities, such as, bills of exchange, banker's acceptance bonds, etc. A money Market may be defined as "the centre for dealings, mainly of a short-term character, in money assets; it meets the short-term requirements of borrowers and provides liquidity or cash to the lenders. It is the place where short-term surplus investible funds at the disposal of financial and other institutions and individuals are bid by borrowers, again comprising institutions and individuals and also government itself". Thus, in a Money Market the lending and borrowing of short term funds are arranged and it comprises the short-term credit instruments and the institutions and individuals who participate in the lending and borrowing business. A money market is a mechanism through which short term funds are lent and borrowed and through which a large part of the financial transactions of a particular country are of the world are cleared. The development of securities market depends on the development of money market and new innovations in the money market instruments which include Government. Securities, Inter bank deposits, banker's acceptances, certificates of deposit, commercial papers, etc. Money markets provide a non-inflationary way to finance Government deficits. The existence of well developed and integrated money market and diversified money market instruments help in the implementation of monetary policies of the Government.

6.3.2 IMPORTANCE OF MONEY MARKET

Short-term funds are required for all types of business organizations to meet the short-term obligations. They arise during the course of business activities and they have to be met with the short-term funds. Manufacturing concerns cannot survive unless they have adequate raw-materials. They have to meet wage bills and they have to wait till their finished products are sold and price is realized. They must also have the ability to grant credit to customers. The same is the case with commercial enterprises. Availability of short-term funds contributes a lot in raising the credit standing of a company. The company enjoys better terms for goods purchased, leading to the reduction cost of production on account of the receipt of cash discounts, favorable rates of interest on bank loans, etc. To secure adequate short-term funds companies resort to borrowings from commercial banks and indigenous financial institutions, which constitute money market. As such money market is an essential facility for the smooth conduct of business and in improving the short-term solvency.

6.3.3 FUNCTIONS OF THE MONEY MARKET

The money Market performs a diversity of functions in the banking structure of the economy. The important functions of a well-developed money market are given as under:

i) It provides various kinds of credit instruments suitable and attractive for different sections. A money market augments the supply of funds.

ii) Efficient working of money market helps to minimize the glut and stringencies in the money market that arise on account of seasonal variations in the flow of and demand for funds.

iii) A money market helps to avoid wide seasonal fluctuations in the interest rates.

iv) A money market, by augmenting the supply of funds and making them readily available to the legitimate borrowers, helps in making funds available at cheaper rates.

v) A well organized money market, through quick transfer of funds from one place to another helps to avoid the regional glut and stringencies of funds.

vi) It enhances the financial liquidity available to the entire country.

A money market by providing profitable investment opportunities for short-term surplus funds, helps to enhance the profit of financial institutions and individuals.

6.3.4 MONEY MARKET INSTRUMENTS AND INSTITUTIONS

Though, there is no statutory definition for the terms of money market and capital market, different instruments dealt with in these markets, can be identified with their maturity profile. The maturity profile of money market instruments generally varies from one day to one year providing liquidity to the holders of such instruments. As the main purpose of the money market is to provide short term liquidity, different instruments/securities have been developed to suit the requirements of the savers-both institutions and individuals. A broad classification of money market instruments depending upon the type of issuer is given below.

1. Government and Quasi Government Securities
   a. Treasury Bills
   b. Government dated securities/gilt edged securities

2. Banking Sector Securities
   a. Call and Notice Money market
   b. Term money market
   c. Certificate of Deposit
   d. Participation Certificate

3. Private Sector Securities
   a. Commercial Paper
   b. Bill of Exchange
   c. Inter-corporate deposits
   d. Money market mutual funds

These securities differ from each other in their characteristic features relating to maturity, liquidity risk return complexion, marketability and negotiability.

Following are the financial institutions, which operate in the money market.

i) ***Central Bank of the Country:*** The Central Bank is the apex institution in the money market of a country. In India, as is well known to you, the Reserve Bank of India is the Central Bank. It controls money market through two main instruments viz. The Bank Rate and Open Market Operations. Thus Central Bank of a country has more of monitoring, supervising, and controlling functions. However, it facilitates as and when required the smooth flow of short-term funds by refinancing operations. It is to be noted that the effectiveness of the control of the Central Bank depends upon the development of money market in the country.

ii) ***Commercial Banks:*** The Commercial Banks are the most important constituents of money market. They use their short-term deposits for short-term financing of trade and commerce. They also invest their funds in discounting of exchange bills and treasury bills.

iii) ***Non-Banking Financial Institutions:*** Financial companies and business corporations having surplus short-term investible funds also lend to the borrowers in the money market. Chit Funds, Nidhis, and money lenders also help the companies in selling short term funds.

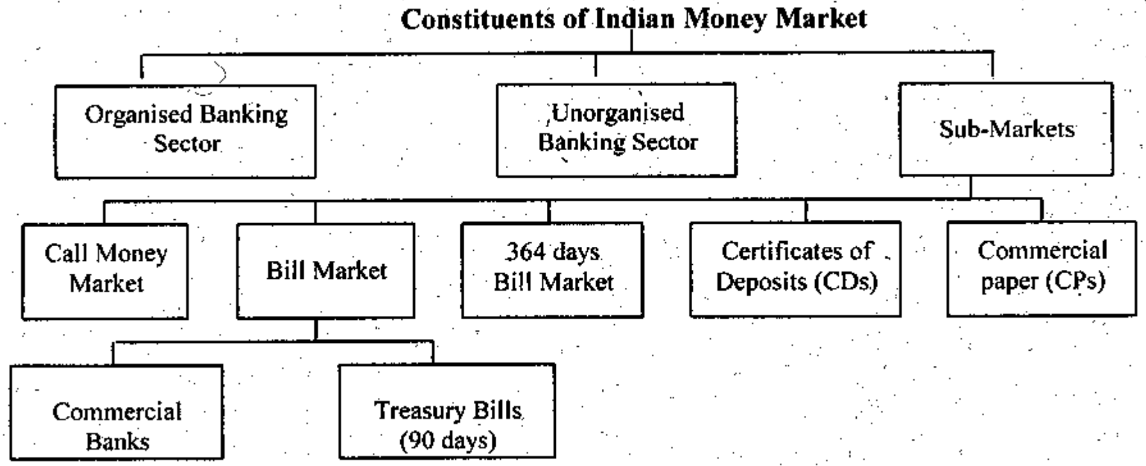
iv) ***Acceptance House:*** The acceptance houses specialize in the acceptance of commercial bills. They accept exchange bills on behalf of their customers. Acceptance houses are formed only in the industrially developed countries where money market is well developed.

Now we have acquired a fair knowledge about concepts of money market, functions of money market and instruments of money market. We will now discuss the constituents of Indian money market and its deficiencies. You may have broad view of constituents of money markets from chart 6.3 given below.

6.3.5 CONSTITUENTS OF MONEY MARKET

Chart - 6.3

Constituents of Indian Money Market



The broad structure of Indian money market consists of organized banking sector, unorganised Banking sector and different sub-markets. Each sub market deals with a specialized function such as call money market, bill market, commercial paper, certificates of deposit etc. The Reserve Bank of India occupies apex position in the Indian money market as it controls the flow of currency and credit into the market. The organised sector comprises of Reserve Bank of India and its associate banks, the nationalised banks and other private sector banks both Indian and foreign. The un-organised sector consists of indigenous bankers who undertake the banking business on traditional lines.

Following are the deficiencies of Indian Money Market.

1. Existence of unorganized money market.
2. Absence of integration
3. Diversity in rates of interest
4. Seasonal stringency of money
5. Absence of the Bill Market
6. Highly volatile call money market
7. Absence of well organized banking system

Though, the Indian Money Market is characterized by the defects identified above, of late several reforms in the Indian Money Market have been initiated in the context of de-regulation of Indian Financial System. Based on the recommendations of Sukhmoy Charkravarty Committee on the review of the working of the monetary system. Further the Narsimham Committee report on the working of the financial system in India made important recommendations for the development of Indian Money Market. Following are the recent developments/reforms in the Indian Money Market.

1. Relaxation of Interest rates.

2. Introduction of new instruments in the money market. These include among others 182 days treasury bill, 364 days treasury bills dated Government securities, certificates of deposits, commercial paper.

3. Setting up of Discount and Finance House of India Limited which would enable the Banks and Financial Institutions to invest their idle funds for short periods in bills and short dated paper. The DFHI is expected to promote bill market in India.

4. Money Market mutual funds: The Government has announced the setting up of Money Market Mutual Funds (MMMFs) with a view to bringing money market instruments within the reach of individuals.

6.4 DISTINCTION BETWEEN CAPITAL AND MONEY MARKETS

For a thorough understanding of the nature of both the markets, their distinctive features are to be noted. A business enterprise requires money for two purposes: (i) for the purchase of capital equipment and other fixed assets, and (ii) for the holding of stocks of raw materials and finished goods and also for making payment towards operating costs. The former requirement is referred to as fixed capital or long-term capital, and the market for provision of such long-term funds is the capital market. The market providing funds for raw-material and others is called as money market. The capital market and money market are inter-dependent. A relative rise in the rate of interest in the money market may increase the demand in the capital market, and a relative increase in the rate of interest or yield in the capital market will increase demand in the money market. However, the line of demarcation between the money market and the capital market is fast tending to be thin partly due to a changed concept of liquidity in recent years and partly to the preponderance of fixed deposits in commercial banks. When the dividend or interest is paid on the industrial or Government securities, the funds in the money market swell-up although it is the result of operations in the capital market. In addition, the constituents of these markets would altogether have been different in the absence of the other. The absence of short-term money market may lead to increased pressure on the capital market. Further more, the expressions 'short-term' and 'long-term' as applied to distinguish the two markets are ambiguous in themselves. Thus it is very difficult to determine with precision the area of operations of the two markets. Nevertheless there is a convention to separate one from the other, "Short-term Credit Contracts are generally included in what is known as the money market; the long-term debt contract and equities are capital market instruments".

After having studied various aspects of capital market, let us now try to differentiate money market. From capital market earlier it is understood that money market is concerned with the supply and demand for short term funds.

Theoretically, money market is distinguished from capital market on the basis of maturity condition of funds. But in the real life situation there is practically little distinction between the two. The same financial institutions, for example commercial banks, operate in the money markets as well as in the capital market. Commercial banks in India, in recent times, have come forward with the new policy of investing their resources in term lending operations.

Some times the term capital market is used in a very broad sense to include market for short-term funds also. For instance, H.T. Parekh in his 'Indian Capital Market-past, present and future' states "By Capital market, I mean the market for all the financial instruments, short-term and long term as also commercial, industrial and government paper". When 'Capital Market' is used in such a broad sense, it embraces, obviously, the money market also. However, in most cases, the term capital market is used to refer to the market for long-term loanable funds as distinct from the money market which deals in short-term funds.

CHECK YOUR PROGRESS - 2

i) What is money market?
ii) What are the functions of the money market?

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....
....
....

6.5 PRIMARY AND SECONDARY MARKETS

From the stand point of marketing of long term securities such as equity shares, preference shares, debentures and bonds issued by both public and private sector companies the capital market may be divided into two segments viz., primary market and secondary market. Let us discuss about these markets in India and developments taking place in recent years.

1. ***Primary Market:*** As stated earlier, the primary market refers to the market of new issues for mobilization of resources by the companies and Government undertakings for new projects and also for expansion, modernization, etc. Primary market operations include new issue of shares by new and existing companies, right issues to existing share holders, issue of debt instruments such as bonds, debentures, etc. Following are the intermediaries associated with the primary market.

    1. Merchant banker/book building lead manager
    2. Registrar and transfer agent
    3. Underwriter/Broker to the issue
    4. Adviser to the issue
    5. Banker to the issue
    6. Depository
    7. Depository participant

The Indian Primary market has witnessed a spectacular growth in terms of both quantitative and qualitative aspects. Table 6.1 indicates the expansion of the primary market in terms of number of issues and the amounts raised through issues during the last 13 years from 1987-1988 to 2000-2001

As can be seen from the table, the number of issues and the amount raised through such issues reflected the inactivity and less developed nature of the Indian capital market during the pre-reform period. The post reform period particularly the period 1993-97 witnessed tremendous growth and development of Indian capital market. With the abolition of control over capital issues in 1992; there is no need to take prior approval for capital issue proposals. Hence many companies both new and existing entered the capital market from mobilization of funds. However, we observe steep fall in the member of public issues and the amount raised during the last four years. The reasons for this phenomenon are continuing inactivity, investor's empathy consequent to the phenomenal losses, lack of investor confidence in market practices and lack of demonstrable punishment to the thousands of fly-by-night and scams. The economic slow down and the political climate have also aggravated the scenario. However, we witness recovery of the capital in terms of number of issues (124) and amount raised (Rs.6618 crores) during the year 2000-2001

Table - 6.1
Resource Mobilization

Year	No. of issues (equity / public)	Amount (Rs. Crore)
1987-88	122	1628
1988-89	151	1297
1989-90	187	2793
1990-91	141	1704
1991-92	196	1711
1992-93	528	6061
1993-94	770	13443
1994-95	1343	13312
1995-96	1428	11822
1996-97	753	11648
1997-98	62	3061
1998-99	32	7911
1999-00	65	7673
2000-01	124	6618

The following table 6.2 gives the data pertaining to rights issue and public issue for the period 1995 to 1998 -99

Table - 6.2
Issues Launched

(Rs in corres)

Types of Issues	1995-96		1996-97		1997-98		1999-2000	
		Amount		Amount		Amount		Amount
Rights		6564.12		2719.20		1708.01		568
Public		14239.53		11556.78		2861.94		7673
Total		20803.65		14275.98		4569.95		8241

It can be seen from the table that the primary market for fresh issues by the new companies had been very active and buoyant till 1995 but since then the market had not witnessed high volumes – both in terms of number of issues and amount mobilised. There was steep fall in a number of Rights Issues and public Issues from 1,726 in the year 1995 to 77 by 1998-99. However, the year 1998-99 witnessed the recovery of the primary market (Rs.7673 crores)

Table - 6.3
Issue-type distribution of fund mobilization **(Rs. in crore)**

Type/Year	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99
Domestic Market	27519	39456	47897	29724	27901	42254	27738
Public offers	13490	18926	24993	18284	15042	13276	10571
Rights Offers	12166	12908	11683	6132	2657	2003	3422
rivate Placement	1862	7622	11221	5309	10202	29976	13745
Euro Issues	754	7986	7883	2618	5679	1103	-----
Total Flotations	28273	47441	55780	32342	33580	46358	27738

The table on composition of the fund mobilisation by issue type reflects changing methods of fund mobilisation. The relative significance of public offers and rights offers declined perceptibly followed by growing importance of private placements that accounted for 49.6% of the total funds mobilised. Further greater part of the private placements are for mobilisation of debt. Phenomenal growth in the private placement of debt is observed in recent years. The Euro Issues that accounted for 16.9% share in the fund mobilisation have fallen to 0 level in 1998-1999.

The following table shows the amount mobilised in the form of debt and equity during the period 1996-97 to 2000-01.

Table - 6.4

Debt Equity Composition of Funds Mobilised **(Rs. Crore)**

Year	Debt Amount	%	Equity Amount	%	Total Amount
1996-1997	6977	60	4671	40	11648
1997-1998	1929	63	1132	37	3061
1998-1999	7407	94	504	6	7911
1999-2000	4698	61	2975	39	7673
2000-2001	4139	63	2479	7	6618

It can be observed from the table that debt accounted for 60% of the total amount raised through public issues in 1996-97 and accounted from its highest share of 94% in 1998-99. Mobilisation to equity shares was only Rs.504 crores and it accounted for only 6% of total amount raised in the year 1998-99. Primary market remained very dull and sluggish in 1997-98. Thus, debt continued to have dominant position in terms of mobilsation of resources through public issues.

The Indian Capital Market – both primary and secondary markets remained stagnant during pre-reform period because of several restrictions imposed on functioning of the capital market. A major break through in the functioning of the primary and secondary markets has been achieved with the repeal of Control of Capital Issues Act and with the enactment of Securities and Exchange Board of India in act 1992. The SEBI started functioning as a non-statutory body since January, 1992 and it has been playing very important role as a regulator of the Indian Capital Market. SEBI has introduced a number of guidelines for capital issues in the primary market. These guidelines are discussed in a separate lesson.

6.6 DEVELOPMENTS IN PRIMARY MARKET

Several developments have taken place in the Indian Primary Market consequent upon the initiation of reforms in the primary market. Some of the developments in the primary market are given below.

1. Public sector bonds have been brought under the purview of SEBI. Any public sector undertaking wishing to raise resources through PSU bonds will have to seek the clearance from SEBI.

2. Merchant bankers made are more responsible and accountable.

3. AMBI, RAI, AMFI, etc., registered as self-regulatory bodies – upon the insistence of SEBI, Association of Merchant Bankers of India (AMBI) has been registered as a self-regulatory body and is registered under section 25 of the Companies Act. Similarly, Registrar Association of India, Association of Mutual Funds in India, Association of Depository Participants etc. have been registered with SEBI as self-regulatory organizations.
4. SEBI directed the merchant bankers and underwriters to honor their underwriting commitments.
5. Public representative/SEBI nominee is to personally present at the time of approving the basis of allotment of shares or debentures.
6. Number of mandatory collection centers were reduced to metropolitan cities and regional centres.
7. Proportional allotment is allowed in case of oversubscribed issues.
8. Minimum subscription for new issues raised from Rs.1,000 to Rs.2,000
9. Code of conduct for advertisers has been made applicable.
10. Debenture trustees were brought under SEBI purview.
11. Introduction of new capital market instruments.
12. Entry of private and foreign mutual funds. Open ended mutual fund schemes were launched.
13. Due diligence responsibility is fixed on merchant bankers.
14. Book building concept is introduced
15. Appraisal of project/dividend track record is made mandatory for new issues.
16. Allotment period is reduced to 30 days
17. Bank account details are made compulsory in new issues.
18. Issues can be floated in demat segment.
19. Draft offer documents of public issues are to be made public for everybody's knowledge.
20. Credit rating is made compulsory for debt issues.
21. Euro Issues and GDR Issues are made attractive
22. Concept of sweat equity and employee stock option schemes is introduced.
23. Issue of securities in electronic form is permitted.

6.7 INDIAN SECONDARY MARKET

As already mentioned secondary market is a place where scrips are traded after they are initially issued in the primary market. There is no exaggeration to state that secondary market is considered as lifeblood to the financial system of a country in general and to the capital market in particular. Needless to say that the growth of the secondary market is dependent upon the growth and development of primary market. With the entry of a large number of companies in the primary market, the volume of trade in the secondary market also increases substantially. As mentioned earlier, trading activities in secondary market are taking place through recognized stock exchanges. The secondary market in India consists of 23 stock exchanges including Over the Counter Exchange of India (OTCEI), National Stock Exchange of India (NSE) and The Inter-Connected Stock Exchange of India.

The Secondary market operations involve buying and selling of securities through the members of the stock exchange. The companies hitting the primary market are statutorily required to list their shares on one or more Stock Exchanges in India including a Regional Stock Exchange. The following intermediaries are important players in the secondary market.

1. Broker/member of Stock Exchange – Buyers broker and sellers broker
2. Portfolio manager
3. Investment adviser
4. Share transfer agent
5. Depository
6. Depository participant

The SEBI has issued number of guidelines on the regulation of the secondary market and some of the guidelines will be discussed in a separate lesson.

Following are the functions of the secondary market.

1. The secondary market provides ready marketability to the investors, which in turn results in improved liquidity to investors without requiring them to hold the securities indefinitely.
2. The secondary market helps in fixing the offer price of new issues of firms in the Primary market. Even the issue price of rights shares of a company is fixed based on the demand position as exhibited in the secondary market.
3. The ownership of a firm's securities gets widened, as many investors get easy access to the secondary market and can make direct purchases. The share price of a firm's securities that is quoted in the secondary market influences the net worth of a firm and in turn would reflect in the intrinsic value of shares. A firm's profitability has a direct bearing on the market price of shares.

Table 6.4
Growth of the secondary market during the last decade

	1-1-1981	1-1-1986	1-1-1992	1-1-1994	1-1-1998	1-1-2000
No. of Stock Exchanges	**8**	**14**	**22 (including OTCEI)**	**23 (including NSE)**	**23 (including OTCEI, NSE)**	**23 (including OTCEI, NSE and ICSE)**
No. of listed companies	2,265	4,344	6,700	7,200	8,000	8,500
Paid up capital of listed companies (Crores)	3,972	9,723	18,000	4,500	6,000	10000 (estd)
No. of Depositories	----	----	----	----	1	2

As can be seen from the above table, there were only eight stock exchanges in India with 2,265 listed companies having aggregate paid up capital of Rs.3,972 crores. Consequent upon reforms, the number of stock exchanges swelled to 23 with 8,500 listed companies having aggregate paid up capital of Rs.10,000 crores by the year 2000.

International comparisons also reveal that Indian Stock Market ranks first position in the world in terms of number of listed companies with 10,000 including all Stock Exchanges as against U.S.A (851) Japan (2387) UK (2046) Canada (1362).

The stock markets of China, Taiwan, Brazil, Malaysia and South Africa have less than 1,000 listed companies. However, in terms of market capitalization India slipped down to 7^{th} position among the emerging markets. The market capitalization in Billion Dollars, of India (BSE) as on April, 2001 was 130 as against China 616, Taiwan 284, South Africa 210, Brazil 205, Korea 172 and Mexico 142.

SEBI has taken several measures to control and regulate the secondary market in our country. These measure are: expansion of stock exchanges and their integration, improvements in trading system and settlement procedures, registration of brokers and sub-brokers, prohibition on inside trading, bringing greater transparency in trading activities, on line trading, trading in demat mode, compulsory dematerialization of identified scrips, restructuring of stock indices, eligibility norms and capital adequacy norms, etc.

Over the Counter Exchange of India (OTCEI), National Stock Exchange (NSE) and Inter-Connected Stock Exchange of India (ICSE) are other three important landmarks in the development of secondary market. Mutual funds have also been brought under the strict purview of SEBI. SEBI guidelines have made takeovers, transparent and fair. SEBI has also made registration mandatory for merchant bankers, sub-brokers, investment advisers, portfolio managers and spot dealers. Internet trading has also been introduced in India in February, 2000. The trading in derivatives (index futures) has also been introduced.

With the expansion of National Stock Exchange into smaller cities (through V-SAT), the investor cult is spreading deeper into the country. NSE has a presence in over 300 cities including 23 stock exchange cities.

6.8 SECONDARY MARKET REFORMS

The constitution of SEBI has heralded a new era in the Indian Stock Market as it seeks to protect the interest of investors and regulates the securities market and intermediaries. The registration of brokers and sub-brokers under the provision of SEBI Act 1992 is on the basis of certain eligibility norms such as capital adequacy, infrastructure etc. SEBI has also made rules for making relationship between client and broker more transparent. SEBI regulations curbing the inside trading and for achieving transparency are expected to have positive impact on the functioning of the stock market. However, price rigging and manipulations in stock market price quotations could not be curbed as amply proved in the case of M.S. Shoes Limited. According to SEBI regulations. The governing body of stock exchanges should undergo reconstitution. The Government has allowed foreign institutional investors such as pension funds, mutual funds, investment trusts, asset management companies to invest in the Indian Stock Market after their registration with the SEBI. Another important development in stock market is enactment of Depositories Act in 1996 with the objective of promoting depository system in our country. The system aims at eliminating paper work, removing delays in settlement, providing efficient service at low cost, ensuring safe and secure transactions, Credit Analysis and Research Limited (CARE 1993) have come into existence to rate the debt issues in the capital markets.

A number of special institutions to look after deposit and custodial services have come into existence and the foremost of them - Stock Holding Corporation of India (SHCIL). Specialized institutions in the area of Housing Finance such as Housing Development Finance Corporation (HDFC), Housing and Urban Development Corporation of India (HUDCO) and National Housing Bank (NHB) have come to play important role in the capital market. It may be added at the end that the Narsimham Committee set up by the Government of India to bring about reforms in the financial system has suggested several measures. The aspect of capital market reforms is a continuous process and it has been taking place in our country subject to the regulations formulated from time to time by the Reserve Bank of India and SEBI that have played pivotal role.

6.10 SUMMING UP

Capital market and money market constitute the major segments of the financial system. Their stage of development is closely associated with the level of development of the economy. Capital market denotes all buyers and sellers of capital funds as well as the entire mechanism for facilitating and effecting long term funds. As against this, money market deals in short term funds and comprises the purchaser and seller of short-term bills. However, it is difficult to draw a dividing line between them. Both have organised and unorganised sectors comprising individuals and institutions operating under strict legislative framework and without such rules and regulations respectively. Further capital market has two distinct segments viz. primary and secondary. The most important function of capital market is the supply of and demand for long term funds for various investment purposes. The Indian Capital Market is fast developing due to Government policy of liberalisation and deregularisation.

6.11 CHECK YOUR PROGRESS: MODEL ANSWER

1. i) Capital market is concerned with long-term funds. It refers to facilities and institutional arrangements for the borrowing and lending of long-term funds.

   ii) i) It helps to promote savings and investment; (ii) It makes an afficient allocation of funds among various fields which need investment; and (iii) It provides for capital stock for growth purposes.

   iii) i) Ultimate, savers of the funds i.e., direct investors; (ii) The investment and financial intermediaries i.e., private and public institutional investros.

2. i) It is concerned with supply of and demand for short term funds required for production of goods and services. It is a mechanism through which short term funds are loaned and borrowed.

   ii) i) It augments the supply of funds by providing various kinds of credit instruments; (ii) It helps to minimise the glut and stringencies in the money market; (iii) It helps to avoid wide seasonal fluctuations in the interest rates; (iv) It provides for quicker transfer of funds from place to another; (v) It enhances the liquidity in the entire economy.

As can be seen from the above table, there were only eight stock exchanges in India with 2,265 listed companies having aggregate paid up capital of Rs.3,972 crores. Consequent upon reforms, the number of stock exchanges swelled to 23 with 8,500 listed companies having aggregate paid up capital of Rs.10,000 crores by the year 2000.
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SEBI has taken several measures to control and regulate the secondary market in our country. These measure are: expansion of stock exchanges and their integration, improvements in trading system and settlement procedures, registration of brokers and sub-brokers, prohibition on inside trading, bringing greater transparency in trading activities, on line trading, trading in demat mode, compulsory dematerialization of identified scrips, restructuring of stock indices, eligibility norms and capital adequacy norms, etc.

Over the Counter Exchange of India (OTCEI), National Stock Exchange (NSE) and Inter-Connected Stock Exchange of India (ICSE) are other three important landmarks in the development of secondary market. Mutual funds have also been brought under the strict purview of SEBI. SEBI guidelines have made takeovers, transparent and fair. SEBI has also made registration mandatory for merchant bankers, sub-brokers, investment advisers, portfolio managers and spot dealers. Internet trading has also been introduced in India in February, 2000. The trading in derivatives (index futures) has also been introduced.

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The constitution of SEBI has heralded a new era in the Indian Stock Market as it seeks to protect the interest of investors and regulates the securities market and intermediaries. The registration of brokers and sub-brokers under the provision of SEBI Act 1992 is on the basis of certain eligibility norms such as capital adequacy, infrastructure etc. SEBI has also made rules for making relationship between client and broker more transparent. SEBI regulations curbing the inside trading and for achieving transparency are expected to have positive impact on the functioning of the stock market. However, price rigging and manipulations in stock market price quotations could not be curbed as amply proved in the case of M.S. Shoes Limited. According to SEBI regulations. The governing body of stock exchanges should undergo reconstitution. The Government has allowed foreign institutional investors such as pension funds, mutual funds, investment trusts, asset management companies to invest in the Indian Stock Market after their registration with the SEBI. Another important development in stock market is enactment of Depositories Act in 1996 with the objective of promoting depository system in our country. The system aims at eliminating paper work, removing delays in settlement, providing efficient service at low cost, ensuring safe and secure transactions, improving liquidity etc. Another important development in the stock market is introduction of book building. Book building is a process of marketing a public offer of equity shares of a company. SEBI announces guidelines for book building in 1995. Book building refers to the collection of bids from investors and these bids indicate the price range, which would help the fixation of issue prices. Category 'A' merchant banker would be appointed as book runner to carry out the whole process of book building. The bids received from investors would indicate the demand for shares of the issuer company at various prices.

CHECK YOUR PROGRESS - 3

1. Distinguish between money market and secondary market.
2. Mention the functions of secondary market.

The developments and reforms in the secondary market can be listed as under:

1. SEBI has prescribed capital adequacy norms for brokers consisting of base minimum capital and additional capital related to volume of business.

2. National Stock Exchange and Inter-connected Stock Exchange appear on capital market scene.

3. Circuit breakers system was introduced at stock exchanges – it is used to regulate trading in shares. Trading is halted for half an hour if during the trading session, the BSE sensitive index fluctuates beyond 5 per cent of the opening index. Circuit breakers in individual scrips (200) and rolling stock companies are presently 16 per cent. For others, it is 12 per cent.

4. Forward trading banned.

5. Entry of foreign brokers and institutional investors.

6. On line trading introduced at all major stock exchanges.

7. Strict monitoring of listed companies through listing agreement.

8. Increase in trading time at all stock exchanges.

9. Insider trading banned.

10. Check against price rigging and unfair practices.

11. Introduction of service tax on broking services.

12. Buy-back of securities allowed.

13. All transactions in the demat segment have to be settled on a rolling settlement (T+5) effective from January 15, 1998

14. Concept of market lot abolished in demat segment. Now even one share can be traded.

15. Book closure period reduced for compulsory demat stocks.

16. Derivative trading in stock index futures is introduced.

6.9 STRUCTURAL DEVELOPMENTS IN INDIAN CAPITAL MARKET

As discussed above, several developments have been taking place in both primary and secondary markets which constitute the Indian Capital Market. In addition to these developments in primary market and secondary market, we can identify some structural developments that have taken place in Indian Capital Market and they are outlined below.

The Development Financial Institutions such as IDBI (1964), ICICI (1955), UTI (1964), IFCI (1948) have come into existence after independence. These institutions have been actively participating in the capital market.

Commercial Banks as important constituents of capital markets have been participating in term lending through subscription of shares and debentures of special financial institutions. These commercial banks are also setting up the financial subsidiaries, mutual funds, venture capital companies, leasing companies, etc to mobilize funds for investment in Industrial Securities.

The non-banking finance companies (NBFCs) have been expanding their role in the capital market. As the functioning of (NBFCs) is characterized by defaults to depositors lack of transparency manipulations, etc., the Government of India enacted R.B.I Amendment Act 1995 conferring a wide ranging powers on the R.B.I for controlling the functioning of non-banking financial companies.

The merchant banking institutions have come into existence both in public and private sectors to undertake the issue management. These merchant bankers are also subject to the regulations of SEBI and Reserve Bank of India. The merchant bankers should compulsorily register themselves with the SEBI for carrying out their operations.

A number of leasing companies have come into existence for providing long term finance to industrial ventures.

The mutual funds constitute important segment of capital market. The monopoly of Unit Trust of India has been broken by the entry of a number of private sector mutual funds. SEBI has also formulated guidelines for the regulation of mutual funds.

A number of venture capital funds have come into existence to encourage and promote innovative ventures based on new technology.

Credit rating institutions such as Credit Rating and Information Services of India Limited (CRISIL, 1988), Investment Information, Credit Rating Agency of India Limited (ICRA) and

Credit Analysis and Research Limited (CARE 1993) have come into existence to rate the debt issues in the capital markets.

A number of special institutions to look after deposit and custodial services have come into existence and the foremost of them - Stock Holding Corporation of India (SHCIL). Specialized institutions in the area of Housing Finance such as Housing Development Finance Corporation (HDFC), Housing and Urban Development Corporation of India (HUDCO) and National Housing Bank (NHB) have come to play important role in the capital market. It may be added at the end that the Narsimham Committee set up by the Government of India to bring about reforms in the financial system has suggested several measures. The aspect of capital market reforms is a continuous process and it has been taking place in our country subject to the regulations formulated from time to time by the Reserve Bank of India and SEBI that have played pivotal role.

6.10 SUMMING UP

Capital market and money market constitute the major segments of the financial system. Their stage of development is closely associated with the level of development of the economy. Capital market denotes all buyers and sellers of capital funds as well as the entire mechanism for facilitating and effecting long term funds. As against this, money market deals in short term funds and comprises the purchaser and seller of short-term bills. However, it is difficult to draw a dividing line between them. Both have organised and unorganised sectors comprising individuals and institutions operating under strict legislative framework and without such rules and regulations respectively. Further capital market has two distinct segments viz. primary and secondary. The most important function of capital market is the supply of and demand for long term funds for various investment purposes. The Indian Capital Market is fast developing due to Government policy of liberalisation and deregularisation.

6.11 CHECK YOUR PROGRESS: MODEL ANSWER

1. i) Capital market is concerned with long-term funds. It refers to facilities and institutional arrangements for the borrowing and lending of long-term funds.

   ii) i) It helps to promote savings and investment; (ii) It makes an afficient allocation of funds among various fields which need investment; and (iii) It provides for capital stock for growth purposes.

   iii) i) Ultimate, savers of the funds i.e., direct investors; (ii) The investment and financial intermediaries i.e., private and public institutional investros.

2. i) It is concerned with supply of and demand for short term funds required for production of goods and services. It is a mechanism through which short term funds are loaned and borrowed.

   ii) i) It augments the supply of funds by providing various kinds of credit instruments; (ii) It helps to minimise the glut and stringencies in the money market; (iii) It helps to avoid wide seasonal fluctuations in the interest rates; (iv) It provides for quicker transfer of funds from place to another; (v) It enhances the liquidity in the entire economy.

3. i) Capital market is divided into Primary market and Secondary market.

Primary market is the market of new issues whereas the secondary market is the market in which scrips are traded after they are inially issued in the primary market. The growth of the secondary market is dependent on the growth of primary market. Primary market operations include new issue of shares by new and existing companies, rights issues and issue of debt instruments. The secondary market operations involve buying and selling of securities through the members of the stock exchange.

ii) i) It provides ready marketability of the securities;
ii) It helps in fixing the offer price of new issues of companies in the primary market;
iii) It provides access to many investors.

6.12 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in about 30 lines each.

1. Discuss the importance of the capital market in the economic development of a country.
2. How do you distinguish between capital market and money market?
3. What are the developments in money market in India?
4. What are the developments in the capital market in India?
5. What are the defects of the money market in India?
6. What are the money market instruments?

II. Answer the following questions in about 15 lines each.

7. What are the various sources of supply and demand for funds in the Capital Market?
8. What are the different constituents of the capital market?
9. What are the different constituents of the money market?
10. What are the developments in secondary market in India?
11. What are the developments in primary market?

6.13 RECOMMENDED BOOKS

1. **H.R. Machiraju** : **Indian Financial System,** Vikas Publishing House Pvt. Ltd, New Delhi.

2. **Sanjiv Agarwal** : **Guide to Indian Capital Market,** Bharat Law House, New Delhi.

3. **Prasanna Chandra** : **Financial Management: Theory and Practice,** Tata McGraw Hill, New Delhi.

4. **Vasant Desai** : **Indian Financial System,** Himalaya Publishing House, Bombay.

5. **M.Y. Khan** : **Indian Financial System,** Tata McGraw Hill, New Dehli.

6.14 GLOSSARY

Average Market Capitalization : Average value of listed stock to the Gross National Product.

Capital Market : It is a market which supplies long-term funds.

Money Market : It is a place where the lending and borrowing takes place.

Mutual Fund : Institutional arrangement for the mobilisation of funds from small resourees with investment intentions.

Stock Exchange : It may be defined as the place of the market where securities of joint stock companies and of government or semi-government bodies are dealt in.

UNIT – 7 : PUBLIC ISSUE OF SECURITIES, UNDERWRITING OF SECURITIES AND REGULATION OF PUBLIC ISSUES

Contents

7.0 AIMS AND OBJECTIVES

The aim of this Unit is to discuss the various methods of issue of securities; the underwriting of issue of securities and the SEBI guidelines underlying the issue of securities.

After studying the Unit, you should be able to :

- explain different methods of issue of securities;
- state the SEBI guidelines for pricing of issues;
- list out the SEBI guidelines for issue of debentures;
- explain different types of underwriting;
- explain the recent trends in capital issues in India;
- have an idea of the two enactments concerned viz., Securities Contracts (Regulation) Act, 1956 and SEBI Act 1992.

7.1 INTRODUCTION

"Issue of Securities" is the sale of securities by the companies with a view to secure funds from the public for the purpose of meeting corporate financial requirements.

The Capital Issues (Control) Act, 1947, defines the term 'issue of capital' as 'issue of any security whether for cash or otherwise, and includes capitalization of profits for the purpose of converting partly paid shares or increasing the par value of shares already issued"

In view of the above definition, the issue of securities means and includes (i) the sale of securities like equity, preference, and debentures for cash or otherwise for the first time to the public (ii) the subsequent issue of securities (iii) issue of right shares and (iv) issue of bonus shares.

Issue of securities depends upon factors such as savings of the people, market prices etc. As the sale of securities is a highly specialized activity, it requires marketing skill and experience. Success in raising capital must be well planned, as otherwise the securities issued by a corporation will only remain as legal abstracts and the capitalization merely as a blueprint of financial planning. The process and documents used in the first issue as well as in the subsequent issues will always be the same. In order to secure a fair price for the issue, both the image of the corporation must be high and the market conditions should be responsive, otherwise the issue of securities may result in under subscription. In the absence of a stable market value for the securities, all the shareholders will be exposed to various risks. Moreover, favorable market for the corporate securities will result in congenial conditions for subsequent issues.

Public issue of securities like, shares and debenture is made in the primary market. Funds mobilised through the primary market constitute investment. Issue of shares and debentures may be made through among others (1) prospectus; (2) offer for sale; and (3) private placement. Wide publicity about the offer is, of course, made through different media-newspapers, periodicals and television. There is also the direct mailing of the application form and prospectus. The intermediaries who organise the entire effort are merchant bankers. To engage in issue-activity one has to register oneself as a merchant banker with the Securities and Exchange Board of India (SEBI).

7.2 CLASSIFICATION OF INVESTORS

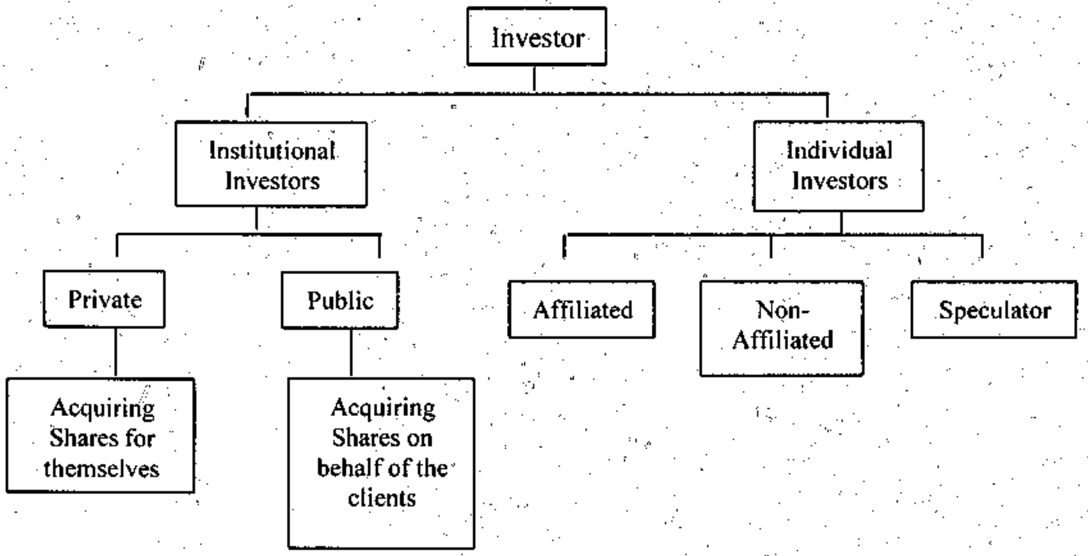
The sources of investment are the savings available with individuals and institutions. Therefore, the investors can be broadly classified as

i) Institutional
ii) Individual

Institutional investors may further be divided into two categories. First is the private institutional investors. This again consists of two types of investors viz., category of private institutional investors which invest on their own account, such as, banks, commercial and industrial concerns, and private institutional investors which invest on behalf of their clients. Second, the public institutional investors comprising of governmental agencies.

Individual investors are large in number but they may be grouped into three broad categories (i) individuals who are affiliated with the issuing company, e.g., old shareholders, creditors, and employees (ii) individuals who are not affiliated with the issuing corporation. Such persons are usually those who have accumulated investible surplus funds. As a matter of fact, they are to be regarded as real investors (iii) speculators who buy shares with an idea to gain by probable fluctuations in share values in stock exchange. The following chart presents a precise idea about various types of investors.

Chart – 7.1



7.3 METHODS OF ISSUE OF SECURITIES

Now, we will discuss the methods adopted for issue of securities. The selection of a particular method depends upon market conditions, size of the issue and creditworthiness of the issuing company.

Following are the important methods of marketing of securities available to the issuing company.

1. Public issue through prospectus (Initial Public Offer – IPO)
2. Offers for sale
3. Agency sale
4. Private placement
5. Right issue
6. Bonus issue
7. Issue by tender

These seven methods of issue are explained hereunder. After explaining these methods of issue two important concepts/methods relating to the issue namely Book Building (7.4) and Underwriting (7.5) are also discussed.

1. Public Issue through Prospectus

Public issue is made by the company through prospectus for marketing a fixed number of shares at a stated price. Before submission of application to SEBI, the company issuing shares has to discuss the draft prospectus with the merchant banker. The abridged prospectus was earlier vetted by SEBI before public issue or an acknowledgement card was issued to ensure

Private placement offers access to capital more quickly than the public issue which may take six months to one year. On the other hand, it is possible to raise funds through private placement within 2 to 3 months.

Confidentiality is ensured in private placement especially for private limited companies and closely held public limited companies which do not want to make public issues for fear of takeover, wealth tax hassles and institutional interference.

As compared to public issue, private placement is quite inexpensive on account of absence of various mandatory and non-mandatory expenses. Some public companies are too small to afford a public issue. Such companies choose private placement.

Further, the requirement of companies may be smaller than the minimum stipulated for public issue of shares. Finally, private placement unlike primary market is not influenced by the prevailing bull or bear phases in the stock markets. The attitude of institutional investors towards the regular issuers of securities in private placement market is more stable and continuous.

5. Right Issue

An already existing company may decide to raise funds by the issue of new shares for expansion or for some other purposes. Section 81 of the Companies Act provides that such new shares must be first offered to the existing equity shareholders of the company in proportion to their holding. The logic behind this arrangement is not to dilute the controlling powers of the existing equity shareholders. The additional shares so offered to the existing shareholders is known as **rights issue**. It is relevant only with equity shares and not with preference shares. A right is an option given to equity shareholders to buy the securities issued by the existing corporation during a stated period at a stated price. It is also called **privileged subscription**. It is the right of an equity shareholder to maintain his proportion of ownership by participating in any new issue of shares. When the issuing corporation has to make right issue the question of investment banker or underwriter will not arise. While accepting the right issue, the existing shareholders are to be doubly certain that the investment will result in good yield because of expansion programmes. The right issue of shares will have the following advantages.

a) Existing shareholders can purchase shares below the current market price.

b) The cost of marketing of securities will be very much low for the issuing corporation.

c) Speculative activity with regard to value of shares will be relatively less because of the old share holders do not like to take such risk.

d) Status-quo will be maintained in the matter of voting power of shareholders leading to the maintenance of control over the effective functioning of the company.

6. Bonus Issue

The issue of bonus shares implies the payment of dividend in the form of shares instead of cash to the shareholders. When a corporation issues and allots the new shares of fully paid up value to its equity shareholder in proportion to their existing holding, out of its accumulated profits and reserves, it is known as bonus shares. This also known as capitalization of undistributed profits. With the issue of bonus shares, issued and paid up capital of the corporation increases without disturbing the asset structure of the issuing corporations. Important advantages of this method are (i) the liability of corporation will not be disturbed, (ii) the net profits of the corporation may not appear to be unduly high as compared with its paid-up capital, (iii) it entitles the shareholders to receive dividend, and (iv) number of shares held by each shareholder will increase in relation to the ratio of bonus shares issue.

7. Issue by Tender

This method can be adopted where the price differential on newly issued shares is likely to be high. The important characteristic of this method is that the public is invited to apply for the available securities at par or above certain minimum price depending upon the market conditions. Ultimately, the allotment is made to the highest bidder. However, this method is not popular.

Of all the methods of issue of securities discussed above, the direct selling method of public issue (Initial Public Offer), the right issue and bonus issue are popular in India.

CHECK YOUR PROGRESS – 1

1. What is meant by prospectus?

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2. What are the different methods of issue of securities?

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7.4 BOOK BUILDING

Book building is a process of price discovery. It is a market-related process of demand and price determination. Book building is a transparent and flexible pricing method, based on the feedback from the investors. In book building, new shares are valued on the basis of a demand feedback from the investors and is a viable alternative, to the existing rigid system of fixed pricing, or which is to a large extent unavoidable at a retail level. The objective of book building is to find the highest market clearing price from high quality long-term investors, in order to reach appropriate allocation decisions.

The concept of book building is in vogue in the international equity issue management and practised by investment bankers in the US, has been adopted by the SEBI in an issue of securities to the public, through the prospectus. SEBI adopted book building based on the recommendations of the Committee under the Chairmanship of Y.H. Malegam in October, 1995. SEBI's guidelines treat book building as an alternative method of pricing that portion of the issue, which is reserved for institutional and corporate investors.

SEBI allows the method of book building to discover the price of the portion of public issue allotted to the institutional investors, where the issue exceeds Rs.100 crores. According to the Working Group on the Companies Act (1997), "Book building is an international practice which refers collecting orders from investment bankers and large investors based on the indicative price range. In a capital market with sufficient depth, such a pre-issue exercise enables the issuer to get a better idea of the demand and the final offer price of an initial public offering.

According to the SEBI guidelines, in an issue of securities to the public, through a prospectus, the option of book building shall be available to the issuer company, subject to the following main conditions.

a) The size or issue exceeds Rs.100 crore

b) Only as an alternative to and to the extent of the percentage of the issue, which can be reserved for firm allotment as per the existing guidelines

c) Book building process to be separately identified/indicated as a placement portion category in the prospectus

d) Underwriting will be mandatory to the extent of net offer to the public

e) One of the lead merchant bankers to the issue shall be nominated by the issuer company as a book runner and his name shall be mentioned in the draft prospectus that is to be submitted to the SEBI.

Advantages of Book Building

Book building has definite advantages as compared to the fixed price method. In a fixed price offer, it is the underwriters and issuers who decide the price, whereas in book building, it is the investors. The initial public offer did not have any flexibility either in terms of price or in the number of shares, whereas book building is flexible process as the price and quantity are decided on the basis of demand. Investors in the initial public offer method had to lock up their funds and sacrifice liquidity between the application and the allotment period. They cannot consider any other investment opportunity during this period. In book building, investors do not have to commit their funds since they pay only at the end of the pricing process. Further, the public offer method does not permit the issuer to choose investors by quality, since allocations are to be made on the basis of a prescribed formula. On the other hand, book building offers the right to choose the investors by infrastructure for raising future funds, by roping in the involvement of syndicate members. Book building helps to eliminate large scale developments, by adopting a price that clears the market. The incidence of issue failing, large scale development arising from the intervening market changes and manipulations of the issuer, would be avoided.

7.5 UNDERWRITING OF SECURITIES

According to Gerstenberg, underwriting is an agreement entered into with the issuing corporation by a group of persons or a body of persons prior to the issue of shares to the public that is in the event of the public not taking up the whole of them or the number mentioned in the agreement, the underwriter will for an agreed commission, take the allotment of such part of the securities for themselves.

Apart from the guaranteed sale of securities the underwriters also offer the following services both to the issuing corporations and to the investors:

a) With vast experience in the business of issue and marketing of securities, the underwriters help the corporation to raise funds at a reduced cost.

b) Availability of capital is guaranteed because of underwriting agreements.

c) A contract with a reputed firm of underwriter increases the goodwill and marketability of the securities.

d) Underwriters provide an expert advice to the corporation in drafting their financial plan on sound lines.

e) They stabilise the market price of the securities during and after the preliminary selling and avoid the irregular price fluctuations in the market.

f) Underwriters also advise the investors about the investment opportunities best suited to their needs and keep vigilance over the company.

Importance of Underwriting

In view of the above services, underwriting of securities assumes greater importance for the industrial development of a country. By inspiring confidence in corporate investment the underwriters mobilize individual resources on the one hand and offer guidance and direct the small investors in a popular way on the other hand. Underwriting of securities ensures that the whole of the issue will be successful and corporation will start functioning without experiencing shortage of capital. Indian Companies Act, provides that if a new corporation does not receive minimum subscription amount within 120 days of the issue of prospectus, the corporation cannot proceed to allot shares and ultimately it has to go into liquidation. The underwriting agreement comes to the rescue of issuing corporation in a big way to avoid such an unpleasant situation for a new corporation. As stated earlier, issues are underwritten so as to ensure that in the case of under subscription they are taken up by underwriters. No person can act as an underwriter without obtaining a certificate of registration from SEBI, although merchant bankers and stockbrokers registered with SEBI do not need separate registration for underwriting. There are 42 underwriters registered with SEBI at the end of March 31,2000

Major underwriters are all-India financial institutions, commercial banks, merchant bankers and members of stock exchanges. The lead manager, in consultation with the company, arranges underwriting. In the selection of an underwriter, financial strength is a major consideration. The other aspects taken into consideration are: experience in the primary market, past work of investor clientele and defaults, understanding underwriting commitments, the network of investor clientele of the underwriter and overall reputation. If any part of the issue is underwritten, the prospectus shall contain a statement that the underwriters have sufficient resources to discharge their obligations.

The underwriter on his part has to assess the company's standing and record, competence of the management, objects of the issue, project details, offer price and other terms of the issue and off-balance sheet liabilities before accepting the underwriting obligation.

As stated earlier underwriting agreement is a contract between the company and the underwriter can be a merchant banker, financial institution such as UTI, and other mutual funds, LIC or ICICI. Under the agreement, the underwriters agree to subscribe or procure subscription to a portion of the capital to be issued in case the issue is not fully subscribed. This type of assistance, in the case of public issues, is known as underwriting assistance; and in respect of rights issues, stand-by assistance. The maximum liability of the underwriter is restricted to the amount underwritten by him.

7.6 TYPES OF UNDERWRITING

Generally the underwriting agreement between the issuing corporation and underwriters takes any one of the following forms:

1. Firm underwriting
2. Stand-by underwriting
3. Sub-underwriting, and
4. Syndicate underwriting

Firm Underwriting

Under this form of agreement the underwriters agree to purchase the issue of securities outright by themselves, at the time of entering into contract with a view to resell and distribute through their own organisational arrangements. At times the underwriters may not be able to resell what they have purchased. In such event the underwriter has to keep the balance of shares for themselves. Since, the risk involved under this method is large, the underwriting commission will also be high.

Stand-by Underwriting

When the underwriter undertakes to purchase the securities offered by the issuing corporation, in case they are not sold within stipulated time is called stand-by underwriting. It is so called, because underwriters stand behind the offer assuring the issuing corporation about the disposal of the securities. In other words, this method entails an agreement by the underwriter with issuing company to sell securities that, for one reason or another, remained unsold with the corporation. This type of agreement may arise in case of right issues. For example, if a corporation issues 20,000 equity shares to its equity shareholders through its pre-emptive agreement to assure itself that the entire issue will be successful, the issuer signs a stand-by agreement with an underwriter to take up securities that are not sold through the pre-emptive right process.

Sub-Underwriting

This form of underwriting is more popular in Germany. When an underwriter is not able to carry the whole risk by himself he may transfer a part of it to some other underwriters by entering into a sub-underwriting agreement. As a matter of fact the issuing corporation will not be a party to this agreement.

Syndicate Underwriting

Syndicate is a system where two or more issue houses or underwriting agencies together underwrite a large issue jointly in a pre-determined ratio with a view to diversify the risk. Under this method originally two agreements are made: (a) contract between the issuing corporation and the underwriters, and (b) agreement among the underwriters. In the first agreement the names of the underwriters and number of securities they agree to purchase and the name of the manager are indicated. It may also provide in the agreement that if any of the underwriters fail or refuse to purchase the agreed securities, the remaining underwriters will have the right to take up that portion with the consent of the issuing corporation.

SEBI Guidelines on Underwriting

SEBI has made underwriting optional since October, 1994 for public issues to subject to the condition that if an issue was not underwritten and was not able to collect 90 per cent of the amount offered to the public, the entire amount collected would be refunded to the investors.

The requirement of a minimum of 90 per cent subscription will not apply for exclusive debt issues, provided the issuer makes adequate disclosures about the alternative sources of finance that have been tied-up.

Number of underwriters can be decided by the issuer. The lead managers must satisfy themselves about the networth of underwriters and the outstanding commitments and disclose the same to SEBI. The underwriting arrangement should be filed with the stock exchange.

In October, 1993, regulations for underwriting of capital issues were announced. Among others, one of the important regulations is that the underwriters should register themselves with SEBI. An underwriter has to be registered amd should have a minimum networth of Rs.20 lakh. The regulations set out the general obligations and responsibilities, procedures for inspection and disciplinary proceedings in case of default. Total underwriting obligations at a point of time should not exceed 20 times of an underwriters networth. The underwriters can arrange for sub-underwriting at his risk; in order to ensure transparency in the operations of underwriters, he is obliged to enter into an agreement with each body of corporate on whose behalf underwriting is taken up.

7.7 UNDERWRITING IN INDIA

Though the SEBI has initially made underwriting of an issue compulsory, it proved costly for the corporates to raise funds. Further, the boom conditions in the market helped the corporates in receiving favourable response from the investors. Consequently, most of the issues have got full subscription and some times over subscription. The SEBI therefore, has made the underwriting as an option of the issuer with effect from 10/10/1994 with the result companies are now able to save the issue expenses. The following table gives the particulars of the number of issues the issue size and amount underwritten for the period 1992 – 93 to 1998-99.

Table 7.1
Underwriting in India during 1992-93 to 1998-99

(Rs. in Crores)

Year		No. of Issues Under - written		Issue Size (Rs.)	Amount Under-written	% of Amount Underwritten to the Issue Size
1992-93		518		6060	5775.20	95
1993-94		754		12544	8952.0	71
1994-95		1094		13311	10286.1	77
1995-96		440		11822	3257.0	30
1996-97		65		11648	912.1	8
1997-98		10		3061	268.6	9
1998-99		7		7911	158.5	2

Table 7.1 presents the number of total issues and issues that were underwritten in India during the period 1992-93 to 1998-99. The table also presents the size of the issue and the amount underwritten for different years. It can be seen from the table that during the period of compulsory underwriting (upto 1994) companies chose to get the issue amount underwritten in the range of 71% to 95%. In the later years, as the underwriting was made optional, many companies were not going for underwriting. The declining percentage of amount underwritten in issue size reflects the same. In 1995-96 alone there was reduction 60% in the number of companies opting for underwriting and 216% decrease in the amount underwritten as compared to the previous year.

CHECK YOUR PROGRESS - 2

i) What is meant by Book Building?

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ii) What is Underwriting?

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iii) What are the different types of underwriting?

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7.10 REGULATION OF CAPITAL ISSUES

Control of capital issues was introduced for the first time in India under Defense of India Rules during the Second World War. The main purpose of this control was to prevent the diversion of scarce resources to activities that made no contribution to the prosecution of the war. The objectives of capital issues control are:

a. To achieve healthy growth of corporate sector as per the planned economic policies of the country,
b. To channelise funds for all the sectors of the economy keeping in view the national interest,
c. To achieve balanced capital structure of companies,
d. To prevent concentration of economic power; and
e. To ensure the growth of a strong and healthy capital market.

The functioning of the Indian Primary Market under the system of CCI was far from satisfactory because of the conservative attitude of the CCI in fixing the price of the issues and also on account of over regulatory nature of the rules. Consequent upon economic liberlisation, the Capital Issue Control Act 1947 was repealed on May 29, 1992. On account of this, the issue of capital and pricing of issues had become free from the approval of Controller of Capital Issues (CCI). The Securities and Exchange Board of India Act 1992 had replaced the Capital Issues Control Act with the result the SEBI constituted under the Act has started playing as a regulator of both primary and secondary market. The SEBI has given several guidelines and regulated the public issues. With a view to ensuring proper disclosure and investor protection, the Union Government empowered SEBI as the sole regulating authority for the issuance and transfer of the shares of listed companies.

The guidelines broadly cover the requirements as to the first issue by new companies and existing private/closely held companies and also further issues of capital by other companies by way of shares, debentures and bonds. The guidelines will apply to all issues of capital.

General Guidelines

Subscription list: SEBI guidelines stipulate that subscription list for public issues should be kept open for 3 working days and it should be mentioned in the Prospectus. In the case of right issue, it should not be kept open for more than 60 days. The gap between closure dates of various issues, e.g. Rights and Indian public, issues should not exceed 30 days. Announcement of the closure of issue shall be made only after 90 per cent has been subscribed.

Minimum number of Shares and Application Money

i. In case of public issue at par, the minimum number of shares for which the application is to be made should be fixed at 200 shares of the face value of Rs.10 each (29-10-1996)

ii. Where the issue is at a premium or comprise of debentures whether convertible or non-convertible, the amount payable in all, in respect of each instrument, (i.e. on application, allotment and calls) by each applicant shall not be less than Rs.5000/-, irrespective of the size of the premium. It is subject to applications dealing with a multiple of tradable lots.

iii. The successful applicants will be issued share certificates / instruments for the eligible number of shares/instruments in tradable lots e.g., in case of shares of face value of Rs.10 each, the tradable lots shall be 100 or 50 shares.

iv. The minimum application money to be paid shall not be less than 25 per cent of issue price. The minimum number of instruments for which an application has to be made shall in any case be not less than the marketable lot.

Oversubscription: The quantum of issue (rights or public issue) should not exceed the amount specified in the prospectus/letter of offer. No retention of oversubscription is permitted.

Guidelines for Pricing of Issues

As per SEBI Guidelines the companies are divided into three categories in respect of issue of shares on the basis by number of years in commercial production, track record and nature and background of the promoter. The details of these guidelines are given hereunder.

1. **First issue of new companies:** A new company has been defined as one which has not completed 12 months of commercial operations and its audited operative results are not available and where it is set up by entrepreneurs without track record. **Such companies will be permitted to issue capital public only at par.**

2. **First issue of existing private / closely held companies**

   Existing companies will include –

   a) Existing private companies;
   b) Existing closely held public companies including deemed public companies; and
   c) Existing unlisted companies.

   Above such companies

i) With a three-year track record of consistent profit ability shall be permitted to freely price the issue and list their securities on the stock exchanges.

ii) If the companies do not have a three-year track record of consistent profitability, the issue has to be made at par.

iii) Not less than 20 per cent of the equity should be offered to the public.

iv) The pricing would be determined by the issuer and lead managers to the issue and would be subject to specific disclosure requirement includes:

   a) Disclosures of the net asset value of the company as per the last audited balance sheet; and
   b) Justification for the issue price.

3. Public issue by existing listed companies.

a) These companies will be allowed to raise fresh capital by freely pricing their further issues at par or at a premium.

b) The issue price will be determined by the issuer in consultation with the lead manager (s) to the issue.

c) With regard to disclosures the draft prospectus will be vetted by SEBI to ensure adequacy of disclosures.

d) The prospectus or offer documents shall contain the net asset value of the company and a justification for the price of the issue.

e) High and low price of the shares for the last two years must be mentioned in the prospectus.

According to SEBI guidelines the issuing company should provide details of the company under nine heads as given below.

1. General Information
2. Capital structure of the company
3. Terms of the present issue
4. Particulars of the issue
5. Company, Management and Project
6. Financial performance of the company for the last five years
7. Whether all payments/refunds, debentures, fixed deposits, interest on fixed deposits, debenture interest, institutional dues have been paid-up to date, if not details of the arrears if any to be stated.
8. Particulars in regard to the listed under the same management
9. Management perceptions of risk factors (e.g. sensitivity to Foreign Exchange rate fluctuations, difficulty in availability of raw materials or in marketing of products, cost/time overturn).

Guidelines for Debentures

In the case of fully convertible debentures (FCD), SEBI restricts the conversion period to 36 months. Credit rating is required for all debentures. Conversion beyond 36 months is permissible only if the conversion is made optional with put and call options. Premium amount or conversion has to be pre-determined and stated in the prospectus. The company is free to determine the rate of interest payable. In the case of non-convertible debentures a debenture redemption reserve has to be created (DRR). The names of debenture trustees must be stated in the prospectus and the registration of debentures trustees is mandatory. Any conversion in part or whole of the debentures will be optional at the hands of debenture holders if the conversion takes place at or after 18 months from the date of the allotments but before 36 months.

In the case of non-convertible debentures and partially convertible debentures if the maturity period is less than 18 months, it is not necessary to create a charge or appoint a trustee or create DRR. In the case of PCDs the premium amount at the time of conversion shall be determined and stated in the prospectus. Redemption amount, period of maturity, yield on redemption of PCD/NCD shall be indicated in the prospectus. Roll over of non-convertible portion of PCD/NCD with or without change in interest rate can be done only on positive consent and not on the passive consent. It is compulsory for the companies to give an option to those debentureholders who want to withdraw and encash the debentures. The disclosures relating to the raising of debentures should include, among others, existing and future net equity ratios, servicing behavior payment of interest on due dates, etc. Trustees to the debenture issue should be vested with requisite powers to protect the interest of the debenture holders including right to appoint a nominee director on the board of the company in consultation with the debentureholders.

7.9 SECURITIES CONTRACTS (REGULATION) ACT, 1956

One important legislation governing capital issues in India is Securities Contracts (Regulation) Act, 1956. The Act is applicable to the securities traded in the secondary markets like stock exchanges. Its important objective is to maintain a strong and investment market. It is also aimed at discouraging undesirable speculative trends so that public may invest their savings with full confidence. This Act is administered by the Central Government.

The objectives of the Act are:

1. To empower the Central Government to control the stock exchange in India;
2. To provide reasonable uniformity in respect of the rules and bye laws of the different stock exchanges in the country;
3. To ensure an orderly and healthy development of the stock exchanges;
4. To protect the interests of the investors; and
5. To prevent unhealthy speculations and other undesirable activities on the stock exchanges.

Salient Features of the Act

The following are the salient features of the Act:

1. Centralization of control

With a view to achieving unitary authority over the stock market, the Central Government is vested with vast powers to control the working of every stock exchange in the country. As a matter of rule, no stock exchange can operate without being recognized by the Central Government. The Central Government prescribes the conditions for the grant of recognition as to the qualifications of members, representation of the Government on the stock exchange, etc. The Central Government is also empowered to supercede the governing body of stock exchange and appoint any person in that place. It can suspend the business of stock exchange for a period of 7 days. It can also withdraw recognition granted to it if it does business contrary to the rules.

2. Regulation of speculation

The Act is applicable to both forward and ready transactions that take place in stock markets. Contracts for the sale or purchase of any security can be prohibited if they are likely to result in an undesirable speculation.

3. Listing of securities

If the Central Government thinks that the issue of securities by any public limited company is expedient in the interest of the public, it can require the issuing company to get its securities listed in any recognized stock exchanges.

4. License for Dealers

The stock exchange dealers and brokers have to obtain license from the Central Government to carry the business of trading in securities. This is meant to prevent unscrupulous people from entering into exchanges.

5. Regulation of Blank Transfers

The Act indirectly regulates the practice of blank transfer. It means that every transfer of shares, by one holder to another must be informed to the company and transfer without such formal approval is a blank transfer. It is necessary under the Act that the dividend will be paid to only those persons whose names are included in the register of members as owners of securities. Unless the transferee gets the security registered in his name within 15 days from the date dividends become due, he is not eligible to receive the dividends from the company even though he happens to be the true owner. To get the dividend it is immaterial whether one is in possession of the securities or not but registration is important.

6. Regulation of Working of Stock Exchanges

For ensuring smooth, healthy and regulated functioning of stock exchanges the Act has a few provisions. For example, the Act regulates the hours of trading, ceiling on the day's transactions, prescribing the margin requirements, terminating, rescinding the contracts, limits on the volume of business done by an individual member, supply of information required by the government, levy of fines and penalties, etc. All these impositions are meant to ensure a healthy capital market.

7. Security Listing

Shares of a company shall not be traded on a stock exchange unless the following conditions are satisfied:

1. a) The minimum issued equity capital of the company should be Rs.3 crores.

   b) The minimum public offer of equity capital should not be less than Rs.1.80 crores. For this purpose, public offer would include the subscriptions by the Central Government, State Government and their agencies and public financial institutions. The subscriptions of approved Mutual Funds may be included as a part of the public offer to be approved on a case by case basis.

2. New companies have to make a public offer at least 60 per cent of the issued capital of the company is required under Rule 19 (2) (b) of the Securities Contracts (Regulation) Act.

3. Retention of oversubscription shall be normally permitted upto 15 per cent of the amount issued.

4. The listing application must be filed with the stock exchanges before the issue of prospectus or its filing with the Registrar of Companies.

5. Allotment of Shares / Debentures should be made on the basis of allotment laid down by standing committee of the Presidents of the Stock Exchanges.

7.10 SECURITIES AND EXCHANGE BOARD OF INDIA

The promulgation of ordinance No. 9 of 1992 dated 29-5-1992 announced the abolition of the office of the Controller of Capital Issues (CCI) and repeal of Capital Issues (Control) Act, 1947. In order to replace in unit the SEBI ordinance the Government of India introduced SEBI Bill and it was passed by the both the Houses of Parliament. The SEBI Act has come into operation and provides for establishment of statutory board with 6 members. SEBI's activities are divided into five operation departments. These are Primary Market Department, Issue Management & Intermediaries Department, Secondary Market Department, and Institutional Investment Department. According to the preamble of SEBI Act, following are the objectives of the SEBI.

(a) To protect the interests of investors in securities
(b) To promote the development of securities market
(c) To regulate the securities market

Following powers have been given to SEBI with the enactment of SEBI Act and repeal of Capital Issues (Control) Act.

i) Power to call for periodical returns from recognized stock exchanges.

ii) Power to call for any information or explanation from recognized stock exchanges or its members.

iii) Power to direct inquiries to be made in relation to affairs of stock exchanges or its members.

iv) Power to grant approval to bye-laws or recognized exchanges.

v) Power to make or amend bye-laws of recognized exchanges.

vi) Power to declare applicability of Section 17 of the Securities Contracts (Regulation) Act in any State or area and to grant licenses to dealers in securities.

vii) Power to compel listing of securities by public companies.

viii) Power to control and regulate stock exchanges.

SEBI has issued a series of guidelines on various aspects of functioning of primary and secondary markets. These include, among others; guidelines for portfolio management, stock invest, free pricing of issues, disclosure and investor protection, stock brokers, insider trading, merchant bankers, mutual funds, underwriters, foreign institution investors, depositories, venture capital funds, buy back of securities, employees stock option, credit rating agencies etc.

Steps taken by SEBI in Capital Market

SEBI has initiated several steps to promote, develop and regulate the capital market in the country. These have taken place in primary as well as secondary market. These include:

1. Introduction of stock investment instrument – reduction in its validity period from 6 to 4 months. Companies and banks were prohibited from using stock invests.

2. Public sector bonds were brought under SEBI purview.

3. Vetting of prospectus and letter of offer by SEBI (during initial period)

4. SEBI insists on underwriters and merchant bankers for honoring of underwriting obligations.

5. SEBI nominee to be present at the time of finalization of basis of allotment for oversubscribed issues. (More than 2 times of premium issues and five times for par issues).

6. Risk factors are to be disclosed prominently in prospectus, letter of offer and all issue related advertisements.

7. Lock-in period for promoter's quota shares and stringent conditions for promoters to bring their contribution in advance.

8. Private placement of shares banned.

9. Credit rating is made compulsory in case of fixed deposits and debt instruments having a maturity period of more than 18 months.

10. Underwriting of issues made optional and networth prescribed for underwriters.

11. All financial intermediaries are to be registered with SEBI.

12. Registration of foreign institutional investors for development and growth of Indian Market.

13. Private mutual funds for the benefit of small investors to provide investment avenues must be managed by experts and portfolio managers.

14. Minimum number of shares to be subscribed in new issues raised from 100 to 500 (Rs.5,000), again brought down to 200 shares (Rs.2,000)

15. Proportional allotment allowed in case of oversubscribed issues.

16. National Stock Exchange, Over the Counter Exchange of India and Inter-connected Stock Exchange of India made operations.

17. Steps to ensure transparency in secondary market operations by making most of the exchanges screen based.

18. Insider trading declared illegal and regulation made to prevent fraudulent and unfair trade practices.

19. Forward trading and carry over banned and reintroduced in modified form.

20. Substantial firm allotment to institutions in public issues.

7.11 SUMMING UP

Issue of securities means the sale of securities to public like (i) Equity, Preference shares, Debentures, for cash or otherwise for the first time; (ii) Subsequent list of securities; (iii) Issue of right shares; and (iv) Issue of bonus shares for the purpose of corporate business. The sources of investments are the surpluses available with the individuals and institutions. Thus, the investors are broadly classified into institutional and individual. The securities can be issued to investors by adopting various methods like issue through prospectus, agency sale, private placement, right issue bonus issue and issue by tender.

Book building and underwriting are the two important concepts relating to the issue of securities. Book building is a process of price discovery. Its objective is to find the highest market clearing price from high quality long-term investors. Book building has many advantages as compared to the fixed price method. Underwriting is a contract under which the underwriters agree to subscribe to portion of the capital to be issued in case the issue is not fully subscribed. Generally, the underwriting agreement can be of four types i.e., firm underwriting, stand-by underwriting, sub-underwriting and syndicate underwriting. In India capital issues are regulated by the SEBI. It has issued guidelines for different types of issues. The SEBI has issued general guidelines, guidelines for pricing of issues, guidelines for debentures, guidelines for bonus shares, etc. Another important legislation governing capital issues in India is securities Contracts (Regulation) Act, 1956.

7.12 CHECK YOUR PROGRESS : MODEL EXAMINATION

1. i) Prospectus is an invitation to the public to subscribe for shares and debentures of a company.

   ii) The following are the important methods of securities issues:

      i) Direct Sale (Public issue or Initial public offer)

      ii) Sale by Agency

      iii) Right issue

      iv) Private placement

      v) Bonus issue

2. i) Book building is a process of price discovery. It is a flexible pricing method based on the feedback from the investors.

ii) Underwriting is a contract in which the underwriters agree to subscribe or procure subscription to a portion of the capital to be issued in case the issue is not fully subscribed.

iii) Different types of underwriting are:

   i) Firm underwriting;

   ii) Stand-by underwriting;

   iii) Sub-underwriting; and

   iv) Syndicate underwriting.

7.13 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in about 30 lines each.

1. Explain the significance of underwriting to investors and issuing corporation.
2. What are the different types of underwriting agreements?
3. What is book building? What are the advantages of book-building?

II. Answer the following questions in about 15 lines each.

4. What are the different methods of sale of securities?
5. What aspects should an investor examine while taking a decision to buy securities directly?
6. What do you mean by 'Private Placement'?

7.14 RECOMMENDED BOOKS

H.R. Machiraju : **Indian Financial System,** Vikas Publishing House Pvt. Ltd, New Delhi.

Sanjiv Agarwal : **Guide to Indian Capital Market,** Bharat Law House, New Delhi.

Prasanna Chandra : **Financial Management: Theory and Practice,** Tata McGraw Hill, New Dehli

Vasant Desai : **Indian Financial System,** Himalaya Publishing House, Bombay.

M.Y. Khan : **Indian Financial System,** Tata McGraw Hill, New Dehli.

7.15 GLOSSARY

Bonus Shares : Payment of dividend in the form of shares instead of cash to shareholders.

Debentures	: An acknowledgement of debt by a company.
Underwriting of shares	: Giving guarantee to the company for Some consideration to sell certain number of shares or to purchase the unsold shares by itself.

UNIT – 8 : FUNCTIONS OF STOCK EXCHANGE

Contents

8.0 AIMS AND OBJECTIVES

This Unit explains the meaning of stock exchange and enumerates its functions and services.

After studying this unit, you should be able to:

- define a stock exchange;
- describe the functions and services of stock exchanges;
- explain the management and organization of stock exchanges;
- identify the role of speculators,
- enumerate various kinds of speculative dealings; and
- mention the different types of speculative activities.

8.1 INTRODUCTION

Stock exchange is one of the important components of the organized sector of the capital market. It helps in providing necessary capital to companies and directs the flow of investible surpluses into profitable enterprises. Therefore stock exchanges are described as citadels of capital or fortresses of finance. It creates a link between the buyers and sellers of securities. It is an organized market where "second hand" securities are bought and sold for investment and speculation. The securities traded on a stock exchange consist of shares, debentures and bonds already issued by companies, corporations and Government bodies to the public.

8.2 DEFINITION AND MEANING

Hasting, in his book "Management of Business Finance" defined a stock exchange as "the securities market comprising all the places where buyers and sellers of stocks and bonds or their representatives undertake transactions involving the sale and purchase of securities". Thus stock exchange is a market place for the purchase and sale of securities, like any other market.

In the words of Husband and Dockeray 'Securities or stock exchanges are privately organized markets which are used to facilitate trading in securities." This definition indicates that they are market places of securities organized by group of private people. The Securities Contract (Regulation) Act 1956 states that "Stock exchange means any body of individuals, whether incorporated or not, constituted for the purpose of assisting or controlling the business of buying and selling or dealing in securities".

Stock exchange is a net work that provides facilities for trading in securities. The securities dealt in stock exchanges include shares and debentures of listed companies, the government securities, the bonds issued by semi-government bodies like Life Insurance Corporation of India, etc. Therefore, the stock exchange is otherwise described as stock market, securities exchange and securities market.

From the above definitions, it will be understood that stock exchange:

i) provides the network with place or places for the buyers and sellers of securities or their agents for transacting in securities,

ii) helps the investors, through bankers and other intermediaries, in dealing with their investments in securities,

iii) creates an environment for genuine or legitimate speculation so as to make the market continuously responsive to the forces of demand and supply of funds, and

iv) frames rules and regulations to avoid undue fluctuations in the value of securities and prevent unfair dealings.

8.3 FUNCTIONS OF STOCK EXCHANGE

The following are the important functions of stock exchange:

1. A stock exchange provides continuous market for the sale and purchase of securities. It will work as a means of converting locked up capital in securities into ready cash by selling them. It provides a network or/and a meeting place for buyers and sellers or their representatives creating conditions of ready marketability.

2. Prices of securities are determined by the market forces supply and demand through stock exchange on a continuous basis. Such prices will be normally based on the perceptions or expectations of the investors on the present and future income yielding prospects of various companies. This function of price fixation is most important to investors as it promotes healthy speculation in trading of securities. Further the prices

at which transactions take place are recorded and published in the form of market quotations.

3. Since the working of stock exchange is regulated by the provisions of Securities Contracts (Regulation) Act, equity and safety in dealings are assured. This is necessary to promote and inculcate just and equitable principles of trade. Stock exchange, through its set of rules, checks overtrading, illegitimate speculation and manipulations. This would ultimately strengthen the investors confidence and stimulate the large investment in corporate securities.

4. Stock exchange helps in mobilization of savings of individuals, business firms, and corporations for investment in corporate securities. In this way, it facilitates capital formation and assists the process of economic development. The surplus funds available with individuals and institutions would not have found remunerative channels had there been no stock exchange. Wide network of stock exchange operations promote savings and investments.

5. The securities market facilitates the process of distribution of capital among different plants, industries and regions. It channelises the flow of funds into most productive ventures because it checks the flow of capital when an industry or an enterprise begins to show diminishing returns.

6. Stock exchange secures good public response even to the fresh issue of shares if routed through it. Thus costs of underwriting of such issues are likely to be less.

7. The stock market is a barometer of business activity. The prices quoted for different securities on the trading network of stock exchanges indicate their profitability. Funds tend to be attracted by the companies of good standing and securities of losing concerns attract no investors. Thus stock exchange always reflects the market conditions. Husband and Dockeray stated that a stock exchange functions like a traffic signal, indicating a green light when certain fields offer the necessary inducement to attract capital and blazing a red light when the outlook for new investment is not-attractive.

8. The changing economic health of a country is reflected in the operations that are carried on in the securities exchanges. Booms and depressions find their echoes in the dealings on the trading networks of stock exchanges.

9. Stock exchanges frame their rules and regulations. Any company, which wants to get its securities listed, has to comply with these rules and regulations. Thus, stock exchanges exercise a healthy influence on the working and management of companies.

8.4 SERVICES OF STOCK EXCHANGE

The above listed functions of stock exchange reveal that its operations are beneficial to the community, investors and also to companies. The following are a few such services:

a) Service to Community

i) It inculcates savings habit among the people and helps in capital formation in the country. Thus it is an important intermediary promoting the economic development of the country. The enormous increase in industrial activity in the country would not have been possible but for the important part played by the stock exchanges.

ii) Stock exchanges continuously publicise the prices of all the listed securities through notifications and circular letters. This will enable the investors to make comparative study of the enterprises and decide to invest only in high yielding securities. In this way stock exchange is instrumental in allocating financial resources of the community among the companies of good prospects.

iii) Stock exchange indicates the various avenues of investments for the individuals with savings. It motivates the investors to further invest their earnings in the securities viz., dividends and interest in the shares and debentures of new companies. This process of investment and reinvestment of earnings lead to capital formation. Edward Meeker graphically expressed this aspect in the following manner. Silently, day after day, week after week, year after year this great flow of capital through the stock exchange into industry' and the ebb of dividends, interest and profits (or losses) back from industry to the public, goes on'.

iv) Since stock exchange engages in continuous mobilisation, allocation of savings of the community and publication of prices of securities of various companies, it portrays the prevailing economic situation in the country.

b) Service to Investors

Stock exchanges work like investment guides to the people with savings. It always keeps up the confidence of investors in securities by providing price information. The following are a few benefits that accrue to investors due to stock exchange:

i) Liquidity of investments in securities is preserved by securities market as it brings buyers and sellers together continuously. The sellers of securities will get buyers through the trading network of stock exchange whenever they want to withdraw their investment.

ii) The securities of listed companies will have negotiability. As such, for temporary accommodation, any investor can pledge his security holdings with some banks and raise funds. Thus short-term needs can also be met with the help of listed securities.

iii) Purchase of listed securities of stock exchange by anybody is less risky. The brokers who deal in listed securities are duly registered and approved by the SEBI. Therefore investors develop confidence in their choice of investment.

iv) Daily price quotations of listed securities are notified by stock exchange to its members and general public. This helps the investors to assess the value of the investment.

v) Constant observation and study of published price quotations of listed securities even by the people with little interest in investment may slowly develop a liking for the dealings on stock exchange. In this process such persons ultimately become potential investors in corporate securities.

vi) Guidance to the investors regarding the choice of securities to be purchased is provided by the pattern of transactions that take place in stock exchange.

vii) Undue fluctuations in prices of listed securities are avoided by balancing operations of speculators and hedgers.

c) Service to Companies

As companies have to essentially raise capital through stock exchanges, they are entitled to various benefits. The following are a few of such facilities.

i) The creditworthiness and goodwill of the corporation will be enhanced when its securities are listed on stock exchange. This will enable the companies to secure wide investor base to the issue of their securities.

ii) Market for the listed securities is expanded once they are quoted in stock exchange. This will increase the demand for the shares of listed companies consequent to which reputation will also be built up. Further, wide dispersal of shareholders over the length and breadth of the country is beneficial to the management of companies because there is a little scope for the not-so serious investors to come together as a group building up opposition.

iii) A company which gets itself admitted into stock exchange and its shares listed will be able to command better response from the investors than a non-listed company. Such company is considered as a sound and a genuinely widely held company with reference to shareholding.

iv) The market price of listed shares tend to be higher in relation to earnings, reserves and dividends because of their easy marketability and attractiveness. This would enhance the financial status and increase its bargaining power in collective ventures, mergers, etc.

v) Companies that intend to raise capital through public issue have to get their shares listed on exchange as per the regulations of SEBI. Thus, stock exchanges regulate the price fluctuations of listed securities. Therefore the listed securities on such stock markets always maintain confidence of its investors and others who deal with it.

CHECK YOUR PROGRESS – 1

i) Define stock exchange.

ii) What are the functions of stock exchange?

8.5 ORGANISATION AND MANAGEMENT

As per the Securities Contracts (Regulation) Act, a stock exchange is a body of individuals, whether incorporated or not. Therefore it is managed by a governing board or executive committee or council of management. The members of this body are elected from among the members of the concerned stock exchange. In the day-to-day management, the governing board is assisted by a number of committees; such as Listing Committee, Arbitration Committee, Discipline Committee, Admission Committees, etc. The governing board is empowered to make rules and regulations in consultation with the government and the members of the stock exchange.

8.6 MEMBERSHIP

Only the members of a stock exchange can have direct access to the trading network and /or enter its trading hall to carry on business. A non-member can buy or sell securities through a member. In order to become a member, a person must have sound financial position and sufficient experience in this field. Every stock exchange has its own rules and regulations for the admission of members. A qualified person who is willing to become a member is required to pay entrance fee, membership deposit and annual subscription. Corporate members can also seek admission. Every exchange will have a trading network and/or "ring" or "floor" to settle the transactions. Members of stock exchange can be either a jobber or a broker. Any member can act as a 'broker' or both but not simultaneously.

Jobbers: They are merchants engaged in purchases and sale of shares, debentures etc. independently on their own account. They purchase and sell the securities with a view to earn profit due to price fluctuations. They constitute the core and center of the market. Jobbers purchase securities as owners and hold them for shortest possible time for selling them for profit, known as 'jobbers' return'. Therefore, a Jobber is a specialist in judging the worth of the securities and make correct forecasts. They play the market for quick returns and therefore are called Market Makers.

Brokers: Brokers or commission agents are those who act as intermediaries between buyers and sellers of securities. They do not purchase the securities as Jobbers, on their own account. They work as intermediaries between buyers and sellers to strike a bargain. For this intermediation they get some commission from the clients for whom they are acting as agents. Investors who do not have adequate knowledge of securities and technicalities of stock exchange greatly depend upon the expertise of brokers.

Brokers sometimes get orders from investing public and execute such orders not by finding a seller but by assigning such orders to jobbers. In such case brokers are entitled to a prescribed scale of brokerage. Thus broker's functions is to act as a 'medium to bring together the supply and demand' for securities.

Tarawaniwalas: Tarawaniwalas are essentially jobbers. A jobber specializes in one or more listed securities. By trading in and out of the market, he gets a difference in the price which is his spread. He helps to maintain a liquid and continuous market for the shares of his specialization. In order that his self interest and his client's interests do not conflict a jobber is supposed to deal on his own hebalf and not on behalf of any client. But tarawaniwala is a jobber who deals in securities on his own account and also acts as a commission agent like a broker for his clients. Tarawaniwalas are securities dealers who are normally found in BSE. Tarawaniwalas, basically being Jobbers, provide ready and wide market for the sale and purchase of securities. The disadvantage of having tarawaniwals in the exchange is their dealings on own account and as agents of clients may lead to speculative activities and their own transactions may become repugnant to the interest of their clients. Reforms are however being gradually introduced to remove the disadvantages associated with having tarawaniwalas.

A broker can appoint few sub-brokers who are called authorized clerks to deal on their behalf. Sub-brokers enter into deals with member-brokers of the exchanges. They can trade on their own account or on behalf of the investors. The number of sub brokers allowed to enter into the trading ring on behalf of a member-broker of the exchange is limited.

A person to be elected as a member must satisfy certain criteria. They are:

i) he should be an Indian citizen;

ii) he should be atleast 21 years of age;

iii) he should not have been adjudged bankrupt or insolvent;

iv) he should not be engaged in any other business on employment.

Members of a stock exchange are allowed to appoint certain agents to do business on their own behalf. These non-members who can carry on business on the floor of a stock exchange on behalf of the members are of two types:

i) **Remesiers:** Remesiers are the agents of brokers. They are appointed by brokers for procuring business for them. They get commission out of the brokerage collected by the brokers from the clients. They are subject to similar restrictions as are applicable to member brokers.

ii) **Authorised clerks:** The members are permitted to employ a specified number of authorized clerks to transact business on their behalf. Members have to pay entrance fee and annual subscription at the prescribed rate for each of their authorized clerk appointed to work for them on the floor. Members are held responsible for all the dealings done by their respective authorized clerks.

While there is no functional distinction between members of stock exchanges, informal responsibilities are usually taken up by the members as commission brokers, floor brokers, dealers in non cleared securities, odd lot dealers and dealers in government securities.

8.7 INVESTORS

It is learnt earlier that Stock exchange is a place where buyers and sellers of securities trade in shares and debentures. Buyers of securities on a stock exchange can broadly be divided into two categories depending upon their motives – (i) Investors and (ii) Speculators.

An investor is a person who is willing to commit his investible funds by buying shares, debentures, and government bonds for the sake of earning an expected return. Investors normally keep their securities for a long time to have long term gains and periodical income over a period of years. They are interested in the safety of their funds but not in whirl wind profits arising out of sudden price variations of the securities. Thus investors participate in primary market or secondary market in the expectation of earning a reasonable return in the long haul – profit maximization in the short run and wealth maximization in the long run.

8.8 SPECULATORS

Speculation is an activity that is quite contrary to its literal meaning of its original Latin word *speculare* which means to watch and examine closely. By speculating a person assumes high risks, often without regard for the safety of his invested principal, to achieve large capital gains. The time span in which the gain is sought to be made is usually very short. The shorter the term, the more speculative the investment is. Thus speculators are those who buy securities with a view to sell when the price differentials are favourable to give a margin of profits. They take short term view. They are not interested in dividend cheques which come once or twice a year. Instead, they are interested in making quick profit on their money, and for this they are prepared to take a big risk.

CHECK YOUR PROGRESS – 2

i) What are the different Committees that assist the Governing Board of a Stock Exchange?

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ii) Who is a Speculator?

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8.9 ECONOMIC SIGNIFICANCE OF SPECULATION

i) Speculation implies well-thought out expectations of future trends of security prices in the short run. Price fluctuations of securities as observed by speculators will indicate the ups and downs in the general trade, industry and commerce.

ii) Speculation provides a ready market for the investors so that they can buy the securities on competitive terms.

iii) Speculation brings about equilibrium of demand and supply in the market and tends to promote stability in security values. Thus it helps in ironing out violent fluctuations in share values and sustains investors' confidence.

iv) The turnover in stock exchange would not have been so high if no speculators do business. Stock market becomes active and sensitive due to speculators' activities of buying and selling.

8.10 TYPES OF SPECULATORS

At a particular moment of time, for particular securities, some speculators may foresee a rise in prices and some may expect a fall for the same type of securities. Depending upon the nature of behaviour, speculators are classified into bulls, bears, stags and lame ducks. A brief description of these four types of speculators is given below.

Bull: A bull is a stock market operator who believes that share prices are going to rise, and keeps buying to sell later at a profit. With his attacking posture bull gives an upward thrust. The bulls actions causes buying pressure in the market place and pushes up share prices. Bull position is called as long position. An extended period during which share prices are generally rising and the stock market indices show an upward trend is called bull cycle.

a) **Thorough bread bulls:** are the bulls who enter into forward contracts of purchase with an intention to take delivery of the securities and pay for it.

b) **Tired Bulls/Unloading Bulls:** are the bulls whose optimism gets tired waiting as the price rise doesn't take place for a long time or after going up a bit, remains there for quite some time. As a result, they decide to liquidate their long position and unload.

Thus bulls cause prolonged rise in the price of shows, sustained by buying pressure of actual investors or Bulls. News of favourable economic growth, decontrol, political developments, economic and financial sector reforms, lifting of price controls, certain budgetary concessions etc are exposed by the bulls by factoring them in their interest of buying shares in expectation of rise in their prices. Thus bulls help markets to have extended upward movements/trend by buying without making a corresponding sale, hoping to sell the shares at a higher price when the market has risen.

However, bulls may also drive an erratic movement of share prices upwards, encouraging investors to buy in anticipation of further rise in prices. When the market corrects itself, the prices come down, trapping unwary investors.

Bear: A stock market operator who expects share prices to fall and keeps selling (to pick up the shares later at a lower price for actual delivery), causing selling pressure and lowering the prices further. As, at present, SEBI doesn't permit short selling. However, if an investors, who purchased shares with an intention of holding them for a long time, starts selling his shares expecting a Fall in the share prices, it also is bear operation. Bears help stock markets by spotting the troubled scrips before normal investors could do.

Bear hammerings is the main disadvantage of having bear operators in the exchange where in bears bring the prices of shares down by their persistent selling pressure.

Spectail: Spectail is a speculator-cum-retail dealer of shares. He is basically a broker who handles retail client accounts, but whose main occupation is speculative trading on his own account. Spectails normally does tailgating. It is buying or selling of a share by a broker on his own account, after a client, presumed to have special information, has placed an order. Sometimes the size of such an order placed by his client would prompt the broker to do tailgating.

Wolf: is a successful speculator who made a stock market kill.

Lame Duck: A member of the stock exchange who is unsuccessful with his speculation and there by fails to meet his obligations.

Lambs: Are investors, more often than net, who are one time players entering the stock market for illusory gains.

Stag: A stag is an applicant to new issue, who applies with a view to resell the allotted shares at a premium one the shares are listed and traded. He subscribed to a good number of shares of the issue expecting that his bulk-offer will push the prices at which he can sell them later to make a quick profit.

8.11 SPECULATIVE ACTIVITIES

Speculative activity is carried on through the following type of transactions.

1) **Options contract:** An options contract confers the right to buy or sell a specific quantity or a number of a particular asset at a specific price at or before some date in the future. It confers on the buyer the right but not the obligation to honour the contract. The obligation rests only with the seller or the writer of the contract. If the buyer chooses not to exercise his option, the maximum loss he suffers is the premium he has paid to the writer of the contract.

2) **Futures Contract:** A contractual agreement to buy or sell a specified quantity of a commodity, currency or shares at a particular price on a fixed date in the future. It differs from an option in that it does not provide an option to buy or sell, but is a definite contract to do either. Futures are a hedge against price Fluctuations. For those who must buy at future dates. There are speculators who buy and sell these contracts for price. A bought futures contract can only be cancelled by a sales contract.

Margin Buying: Buying some shares with cash, and paying for additional shares by borrowing from the stock broker. For this a client has to open a margin account. There are regulations on the limit up to which shares can be bought on the margin, and that limit may be changed from time to time. If the margin requirement is 35%, it means that the investor has to pay 35% of the value of purchase in cash, and can borrow only 65% of the total sum required.

Churning: Needless and frequent buying and selling of client's shares by stock brokers in order to generate more brokerage fees. The activity churns the account, and the broker collects the cream.

Day Trading: Buying and selling the same share during a single day, hoping to make a profit from price fluctuations.

In-and-out Trading: One who buys and sells the same share in the course of the trading day, hoping to profit from sharp price movements. He keeps no overnight position.

Incestuous Share Dealing: Buying and selling of shares by two Jobbers from each other's account for financial gain.

Gum Jumping: Trading in shares on information before it is made public, e.g., information that a large, successful company has decided to take over a company which has been sick and closed for a long time. Also, securing orders for a company's shares not yet registered.

Carry Over: Some times due to adverse market situations a speculator may not be in a position to pay for or deliver the securities and may seek postponement. This results in carryover transactions, which are known as badla transaction. In the process the expenses incurred are called carry over charges. These type of speculative transactions are common on the stock exchange when forward trading is prominent.

Blank Transfer: When the name of the transferee is left blank on a share transfer Form or the Demat Transfer Form, it constitutes a blank transfer. A person depositing shares with a stock broker for immediate or eventual sale, signs a blank transfer Form. It is also done when shares are mortgaged, so that in the event of non-payment the mortgage can fill in his own name in the transferee column and sell the share. Blank transfer provides several advantages and encourages speculation.

Arbitrage: It is a highly specialized and skilled speculative activity. It is described as traffic in securities. Arbitrage involves buying of securities at a lower price at one market and selling it at a higher price simultaneously in the other market. It can be even selling of securities at a higher price in one market and simultaneously buying it at a lower price in another market thereby making a profit.

8.12 PROCESS OF TRADING

As the non-members are not allowed to transact on the floor of stock exchange, investors are to find out a broker to buy the securities on his behalf. Investors should deal in shares only through SEBI registered brokers or sub-brokers. Investors should also get themselves registered with the broker or sub-broker, as the case may be by filling client registration form and enter into client-broker agreement. This agreement inter-alia prescribes rights and obligations of the investors vis-à-vis broker/sub broker.

Placing an order

After entering into client-broker agreement, the investor may place order for purchase or sale of securities either over telephone, fax or by sending on e-mail. The orders can also be placed through the internet.

Types of orders

When an investor trades through his broker or sub-broker he should clearly specify the scrip, quantity and price at which he wants to buy or sell the scrip.

Investor has to give an instruction to the share broker to buy or sell particular shares in a particular way which is called a purchase order. Once accepted by the broker, the purchase order becomes a legally binding purchase contract.

The purchase order placed by the investor may be any one of the following types:

a) **All or none:** Is an instruction to the brokers specifying that either the entire order has to be filled or it has to be let go but not partial execution has to be done.

b) **Fill or kill order:** An order to the stock broker to buy or sell a particular share or shares immediately. If the order is not executed at once, it should be treated as concelled.

Firm order: A buy or sell order to the stock broker which can be executed without the client's confirmation.

Good-Till-Cancelled order (GTC): A client's order to buy or sell shares; usually at a specified price, which remains valid till executed.

Immediate-or-cancel orders: An order to buy or sell, wholly or partly, as soon as bidding on the floor starts. The part of the order that is not executed is cancelled. Such instructions usually accompany large order.

Not held order: This order gives the floor broker discretion in deciding the best time and price at which to trade. The investor agrees not to hold the broker responsible if the best price is not obtained.

Open order: An order to buy or sell which has not been executed but which is pending and valid.

Sell the book order: An order by the holder of a large block of shares to a broker to sell as much of it as can be absorbed by the market at the current bid price.

Stop limit order: A sell order which stipulates that a share is to be sold only after a stop price has been reached. eg. if the stop price is Rs. 54 per share and the market has reached it, the share is to be sold at Rs. 55 (the limit price).

Stop loss order: A client's order to his broker to sell a share if its market price falls to a certain level below the current price. It is a means of protecting one's profit, or reducing one's loss, while waiting for the market to recover. For example, one may have bought Satyan at Rs.300. The price rises to Rs. 450, and is expected to rise, further. The investor wishes to protect his profit already made while waiting for further rise. He may therefore give a stop loss order to his broker to sell at Rs. 425, so that his entire profit does not melt away.

Switch order: A two-part order in which the subsequent part is dependent on the fulfillment of the antecedent. eg. Sell 100 Satyam at Rs. 450, then buy 200 HLL at Rs. 250.

An investor can place any of the above orders according to his need. If he specifies the rate, then it is called a 'limit order'. In case he is interested in execution of an order at the prevailing market rate, then he should specify the same. This is called market order. The market orders are matched at the touchline price which is nothing but the best buy and sell price prevailing at that moment in the order book.

According to the instructions of client the broker makes a record of orders received. He enters the order on the screen and accordingly executes the order. Once order is executed, brokers issue contract notes for trades done on behalf of their clients within 24 hours of the execution of the transaction. The sub-brokers, however, cannot issue contract notes. But they issue confirmation memo confirming the execution of orders from the clients. Such contract note or confirmation memo issued will clearly specify the SEBI registration number of the brokers sub-broker and details of trade such as, order number, trade number, scrip, quantity, price of execution, trade time, and trade identification number generated by the exchange system, brokerage charged, settlement number, details of other levies, and signature of the authorized representative. The final stage of the trading process is settlement. For this there is a pay-in of money and securities at the exchange. The pay-in means the buyers are required to deposit money with the exchange for the securities purchased by them and sellers are required to deposit securities sold by them. The pay-out follows after few hours, say around 3 hours, on the same day. The 'pay-out' means the selling brokers' bank accounts are credits with scale proceeds of securities and securities purchased are credited to the buyers brokers pool account or directly to the beneficiary accounts of the clients. The brokers, in turn, pay the monies and deliver the securities to their clients within 48 hours of the declaration of pay-out by the exchange.

8.13 SETTLEMENT PROCEDURE AT THE BSE

To understand how the settlement takes place, let us go through the settlement procedure followed at the country's first, Asia's older and the second largest stock exchange in India, the Stock Exchange, Mumbai (BSE).

For the purpose of settlement, transactions which take place in the market have been divided into three distinct groups. Companies whose equity securities are very actively traded and whose transactions take place in market lots of trading or multiples thereof are grouped under 'specified securities' or 'A' group. The equity shares of the remaining companies and all bond/debenture issue, where again transactions take place in market lots of trading or multiples thereof (at present market lot is one share) and whose securities are not so actively traded are classified under "non-specified securities" or 'B' group. Equity issues of companies listed on other stock exchanges and traded on this exchange against code numbers allotted by it, popularly called permitted securities, are also classified under third group. Transactions in preference securities, permitted securities for which code numbers are not given, as well as those in odd lots (other than in the market lot of trading) are classified under 'C' group.

However, in the recent past the classification of scrips has been changed. The securities traded on the exchange are classified into equity, derivatives and fixed income securities. The equities are further divided into large cap, medium cap, and low cap to represent their market capitalization as well as liquidity (A group, B1 group and B2 group). BSE has created a group of investor unfriendly companies (Z group) consisting of companies that have failed to comply with listing requirements and/or failed to resolve investor complaints or have not made the required arrangements with both the depositories (NSDL and CDSL) as mandated by SEBI. When the order is being placed for scrips pertaining to this group, a warning message is flashed on the trading terminals.

In order to introduce the best international trading and settlement practices, SEBI has man dated that trades in all the equity shares listed on the stock exchanges should be settled on T+3 basis. The trades are required to be settled by payment of money by the buyer and delivery of securities by the seller on T+3 basis where T stands for the Trade Date and 3 days are working business days excluding bank holiday, Saturdays and Sundays. In case of purchase transaction, since the time involved is less, the client should remit funds at the earliest to his/broker sub-broker. Similarly, in case of sale transactions, the investor should [approach his Depository participant to give instructions for transfer of shares from his beneficiary owner account to the depository account of the broker.]

or

[transfer his shares to the broker immediately.] The procedure can be listed as follows:

a) **Submission of Transaction Details:** At the end of each working day every member is required to submit to the computer center a SAUDA sheet giving details of all the purchase and sale transactions concluded by him during the business session.

b) **Verification:** The computer center checks whether the data reported by the members match. Transactions which match fully are fed into the computer. Unmatched transactions are reverted to the members.

c) **Advice to members by the computer Center:** The computer center (exchange system) process the information and issues to each members the following information:

   i) Money settlement showing payable/receivable and the pay/receive slips.
   ii) Delivery/ receive orders for shares.
   iii) Carry over margin settlement in case of carry over transactions.

d) **Filing of 'Balance Sheets':** On the basis of the advice received from the computer sections each member has to file a 'Balance Sheet' which reflects the details of pay/receive slips with the clearing house. Along with the 'balance sheet' cheques/drafts are paid securities are handed over as per the delivery order.

e) **Payments and delivery by the clearing house:** After processing the cheques, drafts and securities received, the clearing house effects payments and delivers securities to the members who have to receive them on the payment day.

8.14 STOCK MARKET REPORTING

Activity in the stock market is reported in various media. These include, daily newspapers, business periodicles, and radio and television news details, are published in the financial dailiey such as economic times, business standard or financial express. On following day of the transaction. Comprehensive details can be obtained from the Daily official quotation list of the BSE/NSE or the respective stock exchange.

The stock market information provided in the news papers may be explained with the help of an illustration. In Economic Times April 16, 2003 the prices of Infosys shares are reported as follows.

c)	Infosys	(2990)	2870	2960	2740	2810
1	2	3	4	5	6	7

Since Infosys shares par value is Rs. 10/- nothing is reported to the left of the company's name. If par value of the share is other than Rs. 10/-, then with in brackets to the left side of company's code name, the par value will appear.

From the above gradation the following can be understood.

(par value other than Rs. 10)	(eg. (5))
company name	(eg. Infosys)
Last trading day's (closing price)	(eg. 2990)
Opening price of current trading day	(eg. 2870)
Highest price traded during the day	(eg. 2960)
Lowest price traded during the day	(eg. 2740)
Closing price of the trading day	(eg. 2810)

Thus, the number in the bracket to the right of the company's name is the previous closing quotation. The first unbracketed quotation after this represents the opening price of the share on that day. Subsequent numbers represent other prices at which the share was traded during the day, with the last number indicating the closing price for the day.

Jobbers Scheme

1. The jobbers are required to deal with a minimum quantity of shares or work an amount which ever is lower. (say 500 shares or Rs. 50,000), against each quote given by him, after which a quote can be revised. However, in case the value of minimum lot is more than the specified amount, then he will have to deal in minimum trading lot.

2. The jobber is required to continuously give a two way quote for the scrip in which he is authorized to act as a jobber.

3. Each jobber has to act in two nominated scrips and maximum of five scrips.

4. Each jobber has to maintain a stock of a specified quantities of shares or shares worth a specific value (say 10,000 shares or Rs. 10 lakhs), whichever is lower, in each of the scrips, where in he is a jobber.

5. Buying and selling spread will be determined by supply and demand conditions prevailing in the market subject to a maximum of a specified rate or a specified rupee amount per share (say 5% or Rs. 2/-, which ever is higher.

6. The jobbers are required to give the two way quotes before a specified time daily in the trading hall and can revise the quotes after the first transactions or after a specified time (say 11.55 a.m. and 12.05 p.m.), whichever is earlier.

8.15 SUMMING UP

Stock Exchange comprises all the places where the facilities for the sale and purchase of securities are provided. It helps the brokers and other intermediares in rendering useful service to the investors. Every stock exchange will have certain rules and regulations which govern the enrolment of members and their trading procedures. These stock exchanges render services to the investors on one hand and help in mobilizing savings for the company and community on the other hand. They are managed by a Board or Executive Committee with an elected Chairman as the executive head. The members of a stock exchange could be classified as speculators and investors depending upon their trading motives. Speculative activities have some economic significance like ensuring price stability, etc. Depending upon the nature of behaviour speculators are classified into bulls, bears, lame duck, stag, etc. However, all these transactions are subject to the rules and regulations of the Exchange.

8.16 CHECK YOUR PROGRESS: MODEL ANSWERS

1. i) As per Securities Contact (Regulation) Act 1956 stock exchange means and body of individuals, whether incorporated or not, constituted for the purpose of assisting or controlling the business of buying and selling or dealing in securities.

   ii) a) In provides a continuous market for sale and purchase of securities.

   b) It evaluates company's performance.

   c) It helps in mobilizing savings.

   d) It channalises the flow of funds into most productive ventures.

   e) It reduces the cost of underwriting the issue of securities.

   f) It is a barometer of business activity.

   g) It encourages healthy working and management of companies.

2. i) Listing Committees, Arbitration Committee, Defaulters Committee and Admission Committee.

   ii) Speculator is one who buys securities with a view to sell when the price differentials are favourable to secure a margin of profit.

8.17 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in about 30 lines each.

1. What are the services that stock exchange renders to community, investors and to company?
2. Who is a speculator? State the functions of different types of speculators.
3. Describe the procedure of buying securities in stock exchange by an investor.

II. Answer the following questions in about 15 lines each.

4. State the functions of stock exchange.
5. What is the economic significance of speculation?
6. Differentiate between jobber and broker.

8.18 GLOSSARY

Arbitrage	:	Buying securities in one market at a cheaper rate and selling the same in another market at a higher price.
Bear	:	A Speculator who anticipates the prices to fall in near future so that he can sell at a higher contracted price.
Bull	:	A speculator who expects prices to rise in near future.
Carry Over	:	Badla
Debenture	:	A written acknowledgement of debt issued a company.
Lame-duck	:	A (speculator) struglling to meet his commitment.
Securities	:	Certificate or other evidence of ownership or of money lent.
Speculation	:	A risky investment of money for the sake of profits.
Stag	:	An applicant for a new issue who applies with a view to resell.
Stock Exchange	:	A market place for purchase and sale of securities such as shares, bonds, etc.
Tarawaniwalas	:	Member of a stock exchange who trade on their own account as well as act as commission agents on behalf of clients.
Underwriting	:	Guaranteeing money or shares, accepting liability.

UNIT – 9 : REGULATION AND CONTROL OF STOCK EXCHANGE

Contents

9.0 AIMS AND OBJECTIVES

This main purpose of this Unit is to explain the meaning and need for listing of securities followed by an attempt to survey the existing legal provisions concerning the operations of stock exchanges and capital market in India.

After studying this Unit, you should be able to know:

- the meaning of listing of securities;
- need for listing of securities;
- the requirement of listing;
- the drawbacks in the operations of stock exchanges;

- the need for control and regulation of stock exchanges;
- the salient features of Securities Contracts (Regulation) Act;
- the role of Securities Exchange Board of India (SEBI) in reforming the operations of capital markets in India.

9.1 INTRODUCTION

In the preceding lesson you have understood that different types of speculative and trading transactions that take place on the floor of stock exchange through middlemen. Brokers and jobbers carry out purchase and sale activities relating to securities for the investors. There is a possibility of creating artificial scarcity as well as supplies in the stock market by these middlemen. Hence there is a need to regulate the activities of capital market including stock exchange. This process of regulating starts with restricting the purchase and sales of recognized securities of the recognized companies, which is achieved through listing.

Listing of corporate securities constitutes and integral part of the machinery to stock exchange. It is to be noted that stock exchanges do not deal in all the securities of all the corporations. It will deal in the securities of those corporations which are included in its official trade list. On the application of the companies the stock exchange will consider whether their shares can be allowed to be bought or sold through the stock exchange. The stock exchange operations are regulated by the provisions of Securities Contracts (Regulation) Act Securities Exchange Board of India keeps a close watch on the trends of stock markets and issue guidelines from time to time. Hence to know the protective measures offered to investors, a study of the above is essential.

9.2 NEED FOR LISTING OF SECURITIES

In simple words listing of security can be understood as the approved list of companies whose securities are allowed to be transacted on the floor of stock exchanges. In other words, the shares of all companies cannot be traded in the stock exchange though it is a recognized place of meeting of buyers and sellers of shares, debentures bonds etc. Stock exchange generally provide the financial information of the companies, the market trend analysis of shares etc., to the members. Unless the companies whose shares are proposed to be traded are recongised by the exchange, the financial information etc., cannot be collected and analysesd. A close watch on the activities of the companies could be effective only when the companies in question agree for it.

9.3 MEANING OF LISTING

Listing of securities may be defined as "the admission of securities in the official list of stock exchange for the purpose of trading". It is believed that dealing in securities by their very nature are susceptible to undesirable practices by vested interest. Further they cause erratic fluctuation in the prices of securities. Therefore, stock exchanges should ensure that only those securities which can meet certain prescribed standards of legality and security are listed in its official lists for trading . In other words, the stock exchange offers an open market for listed securities where buyers and sellers meet together through their agents viz, brokers on terms of equality. This will lead to the creation of competitive market conditions. The business transacted in stock exchanges is subject to a well-designed code of bye – laws and regulations. Further, wide publicity is also given to each and every transaction. This will keep the investors informed about the legality and solvency of the company Listing , therefore, creates a favorable impression in the minds of investors. Thus, the main objective of listing of securities is to safeguard the investors, companies and general public. Listing will also improves the marketability, negotiability, and liquidity to the securities.

The companies whose securities are listed have to comply with certain conditions and requirements with regard to submission of certain documents and disclosure of certain information at the time of listing. Information has to be provided to stock exchange as long as the securities continue to be on the official list. Violation of any of these rules is liable for delisting of securities or suspension of dealings in these securities by the stock exchange.

However, it may be pointed out that stock exchanges neither sponsor the listed securities nor do they guarantee the investment value. But listing ensures the development of higher standards of corporate practice and procedure. However, price determination and estimation of interest value involve constant scrutiny and assessment of each company from the business, financial, legal and technical points of view which are the basic requirements for investment decisions taken by the prospective investors.

a) There must be adequate public participation in the companies i.e., 49% of the share capital must be held by large number of share holders.

b) Securities should be fully paid up equity share of a company other than a banking company.

c) These securities should not have been included in the cleared securities list of any other stock exchange

d) These securities must have been enlisted for dealings for a least three years on any stock exchange

9.4 STEPS INVOLVED IN LISTING

The process of listing of securities involves four steps. The first step is to seek initial listing before offer of securities to the public and registration of prospectus with the Registrar of Companies as required under section 60 of the Companies Act, 1956. This step involves simply making a simple application in the form prescribed by the stock exchanges accompanied by the payment of initial listing fee as prescribed by the respective stock exchanges. The second step is to seek final listing of securities that has been offered to the public by entering into a listing agreement with the appropriate stock exchange concerned in the prescribed form. The third step is to enlist (register and place on record) the securities openly for the trading by the registered members of the stock exchange and for official quotation / announcement of its price for the benefit of the public who intend to deal with such securities. The fourth step is to continue to remain listed on the exchange until it is delisted from the record either at the option of the company or at the option of the stock exchange concerned and also to list the further issue of securities so long as the existing securities are listed on the stock exchange. The stock exchange lists the Securities offered to the public in terms of its bye laws governing the listing provisions.

SEBI is entrusted with the power under its Act to give direction to the stock exchange from time to time to amend the provision of the listing agreement for the purpose of regulation on business in the stock exchange and securities market in the interest of investors and for promoting orderly development of securities market . SEBI has been given adequate powers under SCRA 1956 & SEBI Act 1992 to direct the stock exchanges to amend the provisions of the listing agreement from time to time in the interest of protection of investors interest and to promote an orderly development of securities market through implementation of corporate governance.

LISTING AGREEMENT

The listing agreement is an agreement entered in to between stock exchange as first party and the company, which proposes to enlist its securities as second party. The listing agreement contains its provisions in accordance with the Securities Contracts (Regulations) Rules 1957 which can be modified, amended and altered from time to time in consonance with the securities market prevailing in the economic environment. The stock exchange Division of the Ministry of Finance has issued many circulars, notifications and guidelines from time to time to amend the listing agreement more compatible and adaptable to the changing capital market environment.

9.5 LISTING REQUIRMENTS

Prior to the enactment of the Securities Contract (Regulation) Act, 1956 the listing of securities in stock exchange was voluntary even for the public limited companies. However, under Section 73 of the India Companies Act, 1956, if a company states in its prospectus its intention to enlist its securities in stock exchange, it must apply for permission within 10 days from the issue of prospectus.

Under Section 21 of Securities Contract (Regulation) Act, the Central Government is empowered to compel any Public Limited Company to get its securities enlisted in any stock exchange in the interest of trade, commerce and industry in the country.

As per the Securities Contract (Regulation) Rules, 1957 framed by the Government under the Securities Contract (Regulation) Act, 1956, an application for listing has to be made in the prescribed form to the stock exchange authorities. Further a prescribed fees accompanied by the following supporting documents should be filed with stock exchange by the intending companies.

a) Certified copies of Memorandum and Articles of Association Prospectus or the statement-in-lieu of prospectus, Directors Report, Balance Sheet and underwriting agreement, should also be submitted.

b) In case of debenture issue, copy of the debentures trust deed.

c) Specimen copies of application for shares, letters of allotment, acceptance, renunciation etc., and debentures certificate

d) Particulars of capital structure.

e) A statement explaining the pattern of the distribution of shares.

f) Particulars of dividends and cash bonus paid during the last 10 years (not applicable to new company).

g) Particulars of shares or debentures for which permission is sought.

h) A copy of the consent of SEBI

i) A summary of the company's activities since its incorporation (not applicable to new companies).

j) The company should undertake that it will provide necessary facilities for transfer of shares, such as transfer instrument, transfer receipt certificates. After effecting transfers the company should provide balance certificates, new share certificates etc. They should be made available to the stock exchange within the prescribed period.

k) The company should appoint a compliance officer who will take care of the entire compliance of all regulations under all applicable Acts.

l) The company should file the tripartite agreement entered into between the company (the issuer), the Registrar and Share Transfer Agent (RTA) and NSDL (the depository, or CDSL (the depository) for the demand facility of shareholders and transfers.

9.6 ADVANTAGES OF LISTING THE SECURITIES

Listing arrangement is made to serve the dual purpose of ensuring stability of prices of securities and also to supply adequate information so as to judge the merits of the securities traded on the stock exchange. The advantages of listing the securities with stock exchange can be classified into three groups.

i) Advantages to investors;
ii) Advantages to companies; and
iii) Advantages to general public.

1) Advantages to Investors: The following advantages accrue to the investors an account of listing of securities.

a) The listing of securities will make the investor to believe that the issue of securities is legal, the company is legally incorporated and it is financially solvent.

b) It protects the investor against unreasonable commission and low standards of business practices.

c) The securities are subject to much narrower fluctuations as compared to the unlisted ones.

d) It helps to evaluate the holding of investor in a proper and fair manner as he receives constant quotations as to the value of the securities.

e) It imparts liquidity to the investors as they can sell the securities whenever they require cash.

f) It is also advantageous in the matter of assessment of income-tax, wealth tax, estate duty and other taxes payable by the shareholders.

g) Since the listed securities are rated high in market quotations they are preferred as collateral securities by banks for lending money to their holdings.

ii) Advantages to Companies: The following are some of the important advantages that accrue to the companies which have enlisted their securities on the stock exchange.

i. Free dealing and public ownership of shareholders qualify the companies for substantial tax relief.

ii. Listing confers on the company a higher status which contributes to the expansion of its activities and helps its growth by facilitating future financing and gaining wider public support in the sale of company's products.

iii. Listed securities are generally preferred for investment as they command a much higher value in the market.

iv. Several tax advantages also accrue to the companies as it helps assessing the income tax, wealth tax, and other taxes payable by the shareholders and assesses.

iii) Advantages to General Public: Listing of securities safeguard the interest of the general public also in the following manner:

a) It enforces timely disclosure of corporate information relating to dividends, bonus shares, new issues of capital etc.

b) It insists upon giving due notice in advance of closure of transfer books and of record, redemption and payment dates.

c) It provides reasonable facilities for transfer, registration of rights, and for fair and equitable allotment.

On account of the above numerous advantages, Hasting remarked that' a listed security will receive more attention from investment advisory services than an unlisted one". Therefore listed securities help the investors, companies and general public consequent to which the sound investment opportunities in the economy will improve.

9.7 DISADVANTGAGES OF LISTING

There are many people who consider a stock exchange as a race-course or gambling den where fortunes are made or lost. These uncomplimentary remarks are true only when the dealings in stock exchanges are grossly misused by some unscrupulous operators to meet their selfish ends. The following are some of the demerits:

i) The erratic oscillations in the market price of securities due to the trading activities of uninformed and weak speculators resulting in the depressed sale of securities. Such activities lower the creditworthiness of the company in the eyes of creditors.

ii) The trading of securities on stock exchange may encourage the management to indulge in speculation very effectively with their inside affairs and may be benefited by it in a big way at the cost of companies, welfare.

Issue Framework

Against the traditional issue method that has many disadvantages than advantages, SEBI has, to take advantage of the technology and the changes in stock markets of the developed countries, brought in various amendments to its guidelines and directives to the issues and intermediaries and to the stock exchange in particular.

Among those, most important are :

1. Online issue of shares
2. Book building
3. Constant amendment to various outstanding guidelines and issuing of new guidelines.
4. By back of shares
5. Compulsory rolling settlement

1) Online issue of shares

The company proposing to issue shares on line shall have to enter into an agreement with the stock exchange which have the reguisite systems of on line offer of securities. The agreement shall legally bind both the company as well as the stock exchange. The agreement shall state the rights, duties, responsibilities as well as the dispute resolution mechanism of the parties.

The brokers to the issue are collective centers. They will accept the application as well as place the orders with the company. The brokers will have terminals and shall stand responsible for payment for the shares allotted if their client fails to pay the money when demanded . The broker shall collect the client registration form duly filled up and signed from the applicants.

The issuer company shall appoint a Registrar to the issue having electronic connectivity with the stock exchange through which the securities are offered under the system. The issuer company shall also appoint a lead manger to the issue who shall be responsible for co-ordination of all the activities among various intermediaries connected to the issue. The broker shall ensure to refund the margin money collected earlier, within 3 days of receipt of basis of allocation, to the applicant who did not receive allocation. If the minimum subscription as disclosed in the prospectus is not received, the issue proceeds shall be refunded to the applicants. Applicants shall have an option to directly apply to the Registrars. In such cases applicants who have applied directly or by post to the Registrar to the issue, and have not received allocation, the Registrar to the issue shall arrange to refund the application money paid by them with in the time prescribed.

2. Book Building

Basing upon the recommendations of the Malegam Committee which studied the issue of disclosure requirement, SEBI implemented Book building, a new optional device to raise ownership or borrowed funds through public issues in the capital market.

In the book-building system, the issuer company ties up with a selected group of individuals and agencies for private placement. The entire exercise is done on wholesale basis whereas, in the conventional system, a large number of brokers and underwriters are involved. It is called book building process because one of the lead manager builds his order book by forming a syndicate of eligible potential buyers.

The option of book-building was earlier available to the companies which wanted to offer securities to the public exceeding Rs 100 crores through a prospectus. But subsequently
The minimum limit of Rs.100 crores has been removed by SEBI and issue of any size can be made through the book building process.

Book building is a process by which the issuer company before filing of the prospects, builds up and ascertains the demand for the securities being issued and assesses the prices at which such securities may be issued and ultimately determines the quantum of securities to be issued.

The Salient Features of Book Building

1. Book building is normally resorted to by public companies for mega issues.
2. The price of the security is not decided in advance. It is fixed on the basis of offers by the potential investors.
3. The issue in the book building system is divided into (i) Placement, and (ii) Public issue portion (Fixed price portion)
4. The facility of book building may be utilized for the placement proportion of the issue which can reserve, as per the SEBI guidelines, for firm allotment. Therefore maximum 75% or even 100% of the issue may be offered through book building. These securities are separately identified as the 'placement portion category' in the prospectus. These securities may be allotted to eligible "Non-Resident" Indians (NRI), institutional investors, mutual funds, financial institution and other agencies.
5. The public issue portion (minimum 25%) is separately identified as not offered to the public. This part may be offered to the public by the conventional system.
6. The entire management of the book building process is done by one of the lead merchant bankers called a book runner. The book runner is nominated by the issuer company .

7. The under working of the securities offered to the public (not offer to the public) is mandatory in the book building process.
8. The securities are offered for the placement and to the public at the same price.

The main advantages of the book building are :

i. Since the issue price is based on demand elicited, the company is fully justified in making the issue at a predetermined price. The price is investor driven and based on market forces of demand and supply.

ii. Since the quantity of issue is also predetermined the problem of retention of excess subscription money by the company beyond the statutory time limit, default and delay in remittance of refunds etc., are taken care of. However, it may have some dangers such as manipulation to lure investors, creation of artificial response to offers and artificial hike in issue prices.

3. Amendments to Various Outstanding Guidelines Issued by SEBI

SEBI has been issuing guidelines and regulations concerning almost every activity transaction and player' in the stock market. Such guidelines and regulations are constantly updated, clarifications are issued, and circulars are issued on related aspects as and when there is a need.

Important among the guidelines and regulations issued SEBI by are as follows:

1. SEBI (Disclosure and Investor Protection) Guidelines 2003.
2. SEBI (Credit Rating Agencies) Regulation 1999.
3. SEBI (Depositories and Participants) Regulations 1996.
4. SEBI(Merchant Bankers) Regulations 1999.
5. SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to securities market) Regulations 1995.
6. SEBI (Issue of Sweat Equity) Regulation, 2002.
7. SEBI (Procedure for holding Enquiry by Enquiry Officer and Imposing Penalty) Regulations, 2002.

In addition to these, there are several other guidelines issued by SEBI that are amended from time to time. They included the issues related to participation of OCB, in the limited two-way fungibility of ADRs/GDRs, Depositories, and participants consideration of applications for granting certificates of registration for various intermediaries, fee payable stock brokers etc.

1. SEBI (Stock Brokers and Sub-Brokers) Regulations, 1992.
2. SEBI (Portfolio Managers) Regulations, 1993.
3. SEBI (Registrors to the issue and share Transfer Agents) Regulations 1993.
4. SEBI (Underwriters) Regulations 1993.
5. SEBI (Debenture Trustees) Regulations 1993.
6. SEBI (Bankers to an Issue) Regulations 1994.
7. SEBI (Custodian of Securities) Regulations 1996.
8. SEBI (Foreign Institutional Investors) Regulations 1995.

9. SEBI (Venture Capital Funds) Regulations 1996.
10. SEBI (Collective Investment Schemes) Regulations 1999.
11. SEBI (Foreign Venture Capital Fund) Regulations 2000.
12. SEBI (Prohibition of Insider Trading) Regulations 2002.

4. Buy Back of Shares

As per the provision of section 77(1) of the Companies Act, 1956 a company was not allowed to buy back its own shares. However the Companies (Amendment) Act, 1999 and the guidelines issued by the SEBI in this regard allowed companies to repurchase their own shares or other securities subject of certain conditions.

The following conditions have to be satisfied by the company to be eligible to buy back:

a) The buy back is authorized by the articles of the company.
b) A special resolution has been passed in the general meeting of the shareholders authorizing the company to buy back its own shares.
c) The amount of total payment buy back of equity shares in a year shall not exceed the aggregate of 25% of the paid up equity capital and the free reserves of the company
d) The post buy-back ratio of debt to equity capital and free reserved should not exceed 2:1.
e) Only fully paid up shares are qualified for buy back . No partly paid-up shares can be bought back by a company.

The important SEBI Regulations for buy back are as follows:

a) Notice of Special resolution about the buy back has to be duly given with the explanatory statement and it has to be duly passed
b) Buy back can be through tender offer or through stock exchange.
c) The company should make true and full disclosure in the letter of offer and the public announcement.
d) Bonus shares should not be announced when the buy back offer is open.
e) All payments should be made only by cash/cheque.
f) Locked-in shares should not be bought back.
g) Buyback offer should not be withdrawn after public announcement.
h) The details regarding number of shares bought, price, total amount invested in buy back, details of shareholders from whom more than 1% of the total shares were bought and the consequent change in the capital structure showing the shareholding pattern before and after buy back should be announced in a national daily within 2 days after completion of buy back.

5. Compulsory Rolling Settlement

In India lending and borrowing of securities has been there for quite a long time. SEBI has a securities lending scheme 1997 which is not very popular. Automatic Lending and Borrowing Mechanism (ALBM) of NSE and Borrowing and Lending of Securities Scheme (BLESS) of BSE were approved products under this scheme. Brokers used 'Badla' for carrying forward their positions from one settlement to another. However, ALBM/BLESS and as well as 'badla' have been banned by SEBI. Instead compulsory rolling settlements have been introduced in a phased manner starting with large number of actively traded stocks. In this respect, SEBI declared that;

i) All scripts which are included in the ALBM/BLESS in any stock exchange will be traded only in the compulsory rolling settlement on a nation wide basis i.e., on all stock exchanges from July 2, 2001.

ii) In addition, if there is any scrip which is included in the BSE 200 list, will also be included in the compulsory rolling settlement on a nation wide basis.

iii) The stock exchanges will therefore have to develop software (if necessary) before the opening of the rolling settlement itself.

As present the compulsory rolling settlement is T+2 though attempts are being made to bring down the period to T+1. In T+2, T represents trading day and 2 means two working days (i.e.), trading obligations for a trading day will be settled on the second working day.

iv) The disclosure of certain vital information by the companies as per the listing agreement may prove to be very costly and harmful as that information may reach the labour leaders and trade rivals.

v) The trading of securities on stock exchanges sometimes may result in transfer of control from the existing management to the interested parties who buy a substantial portion of shares in the company. Thus it may create a lot of confusion and chaos in the management of the company. Here, it will be relevant to the case of Swaraj Paul Vs. Escorts management, which created big controversy in India.

CHECK YOUR PROGRESS - 1

1. Define listing of securities

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2. What are the different types of listed securities?

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Inspite of listing of securities to prevent unscrupulous company promoters to make easy money, stock exchanges have become places of speculation and unscrupulous dealings. Hence let us examine the shortcomings of stock exchanges in India.

1. There was no centralised control of stock exchanges resulting in the diversities in the matter of rules, regulations relating to the working of stock exchanges, speculation and disclosure of information etc.
2. There was no restriction on the membership of stock exchanges. Consequently several undesirable and unscrupulous persons utilized the opportunities of making easy money by adopting unhealthy practices.

3. Lack of proper check on unhealthy speculation associated with inadequate financial support and lack of experience of speculators contributed much to the increase in speculative activities like kerb trading, option dealing , blank transfers etc.

4. For want of rules prescribing the margin requirement i.e., the restrictions as to the amount of business to be transacted under margin trading the speculators, very frequently, used to exceed their limits in purchase and sale of securities.

5. In the absence of any control on the listing of securities, companies with weak capital structure could also get their securities quoted on the stock exchanges. It had further aggravated the un healthy speculation.

6. There used to be much business speculation outside stock exchange. On account of absence of legestative measures, illegal trading on the streets by non-members blocked the normal growth of lawful business inside the stock exchanges.

7. Due to the absence of restrictions on the number of stock exchanges in the country or at one centre, there came into existence multiple stock exchanges. Thus there were many stock exchanges to deal with too little investment business. This had led to overtrading in securities.

9.10 NEED FOR CONTROL AND REGULATION

It is understood from the earlier discussion that the institution of stock exchange is of basic significance to the economic development of the nation. It is considered as indispensable to channelising the savings of the community to corporate enterprises. It is understood that stock exchange is a place where securities are bought and sold at fair process, provided a certain amount of genuine and legitimate speculation is practiced.

But then why do we attempt to regulate markets?

Frequently the answer to that question is a list of the objectives of specific regulatory programs e.g., market surveillance, enforcement, while each of these objectives is significant and important in its own right, the reason for regulation is much broader in scope. The impetus for regulation is to create and maintain a market environment that will inspire investor confidence and promote market growth. While there are other factors that are essential to creating and maintaining a market, a carefully structured regulatory framework is essential. There is no other mechanism for inspiring and maintaining investor confidence. Investors, whether they are hedgers or speculators, go to markets where there is financial safety, where they know market participants are treated equitably and fairly, and where the market functions efficiently.

A regulatory framework is designed to help both self-regulators and market participants to organise and understand the information they need to appraise and manage the risks associated with derivatives trading. International regulators of derivatives markets international regulators of derivatives markets have established a benchmark against which a regulatory framework should be measured. The internationally recognized broad regulatory goals are market efficiency and integrity, customer protection/fairness, and financial integrity. The supporting regulatory programs and mechanisms used to achieve regulatory goals have to be analysed to ensure they do not produce unexpected side effects that could be deleterious to the market.

In simple words, if the stock exchanges are not properly regulated, they are liable to be misused by vested interest like any other institution. Many a time, the stock exchanges were grossly misused to the serious detriment of public interest by some unscrupulous operators in their hunt for easy money. They become notorious for a number of unfair practices and undesirable activities in the name of speculation. On account of unhealthy speculation stock exchanges degenerate into gambling dens. In such case, they cease to be useful in fulfilling the economic objectives of stock exchanges. These unfair practices made many people to believe that stock exchanges are just alternative to race-course where easy fortunes are made or lost. Thus unhealthy speculation in security markets will prove to be a curse to the economy. Therefore, some agency must step in to ensure that the distinction between genuine and unhealthy speculation is observed and regulated so as to eliminate the chances of their misutilisation by vested interests. In brief the basic need for regulation of stock exchange can be analysed as under:

i) To prevent unfair practices injurious to investors.

ii) To provide regulatory machinery for ensuring genuine investment and legitimate speculative transactions by recognized stock exchange, and

iii) To take corrective steps in time to curb violent fluctuations in security prices.

After having understood the defects and the need for the control and regulation of stock exchanges, let us trace out the steps taken before 1956 by the Government to control the activities of capital markets including stock exchanges.

9.11 HISTORY OF STOCK EXCHANGE REGUATION IN INDIA

The need for control and regulation of stock exchanges in India was felt as far back as in 1921 when the legislative council of Bombay appointed a committee to look into the affairs of Bombay Stock Exchange and recommended proposals for its control, direction and regulation. In 1925, the Bombay Securities Control Act was enacted. The Bombay Act held the transactions outside a recognized stock exchanges as void but not illegal. But, till 1944, all-India level legislation was realized only after World War II as there was mushroom growth of stock exchanges with speculative motive and without any listing regulations. In March, 1944 the Government of India undertook an enquiry into the working conditions of stock exchanges through the Department of Monetary Research so as to devise measures to regulate the working of stock exchanges. Subsequently, this work was entrusted to Dr.P.J. Thomas, the then Economic Adviser to the Government of India. Again in 1948 an official committee consisting of representatives of the Government of Bombay, Ministers of Finance and Law, and RBI was appointed to examine the recommendations of Thomas Committee which was submitted in 1947. On the basis of recommendations made by the Committee a draft Bill was prepared by another informal committee for the consideration of the Government. But as there were no representatives of business community and stock exchanges on these two committees, an Informal Committee was constituted in June, 1951, under the chairmanship of A.D.Agarwala. It predominantly consisted of non-official members numbering about 10 in all excluding the Chairman.

The important terms of reference of the Committee were; (a) to consider and report on draft proposal of the government; (b) to submit a revised draft bill, and (c) to make any other recommendation, on the subject if necessary. The Committee submitted its report in July, 1951. This report was also circulated among the principal stock exchanges, chambers of commerce and other interested associations and individuals asking for their comments.

9.12 SALIENT FEATURES OF SECURITIES CONTRACTS (REGULATION) ACT

On the basis of recommendations of the Agarwala Committee and observations of other institutions, from whom the comments were sought, the Government prepared the Securities

Contracts (Regulations) Bill which was introduced in the Parliament on December 24, 1954. It received the assent of the President on September 4, 1956. The Act aims at regulating the stock exchanges in India so as to see that they play a constructive role and do not culminate into gambling dens. This Act, in conjunction with Indian Companies Act, helps in building a sound and healthy investment climate for private sector. The salient features of the Act are as follows:

1. Recognition of Stock Exchanges: According to the Act only the recognized stock exchanges can function in the capital market. In other words, no stock exchange can operate unless it is recognised by the Central Government. A stock exchange has to apply in a prescribed manner to the Central Government along with its bye-laws and rules for recognition. Recognition is granted to an exchange only after the following conditions are satisfied:

a) The proposed rules and bye-laws of stock exchange should conform to the conditions prescribed to ensure fair dealings and protection to investors.

b) Stock exchanges should express their willingness to comply with any other conditions that the Government may impose from time to time under the Act, and

c) Granting recognition should be in the interest of trade and also the public interest.

The Government has the power to refuse recognition after giving an opportunity to it to be heard. It can also withdraw the recognition if found essential in the interest of the trade and the public after serving notice on the Governing Body of the Exchange and after giving it an opportunity to be heard. The rules of recognised stock exchange cannot be changed without the approval of Central Government.

2. Bye-laws of Stock Exchange: The bye-laws of stock exchange must contain the following for getting approval of the Central Government. To get recognition of the stock exchange the bye-laws must be approved by the government.

a) Regulation as to the hours of trading.

b) Method of functioning of clearing house.

c) Publication of particulars of contracts settled or carried over and their submission to the Central Government.

d) Regulation or prohibition of blank transfers, badlas, tarawaniwalas business.

e) Regulation for listing of securities on stock exchange, or prohibition of trading in any specified securities.

f) Settlement of disputes and claims by arbitration and other procedures.

g) Fixing of scale of brokerage and other charges.

h) Regulating the terms and conditions of contracts between members or between members and their constituents; and

i) Emergencies in trade due to cornering or otherwise and the powers to be exercised in such situation including fixing of maximum and minimum prices for securities.

3. Centralisation of Control: The Act gives wide powers to the Central Government to control the operations of recognised stock exchanges. Every stock exchange is required to supply such explanation and information as the Government demands from time to time. They have to furnish periodical returns about their affairs and also copies of annual reports etc. The Central Government can insist on the maintenance of accounts of members and their audit by qualified auditors. It can appoint its own nominees not exceeding three persons to the

Governing Body of stock exchanges. The Central Government is also empowered to order an enquiry into the affairs of stock exchange in the prescribed manner, if it thinks necessary. It can also direct the stock exchanges in the matter of adopting a rule or amending it.

4. Regulation of working of stock exchanges: The Act empowers the Central Government to regulate the day-to-day working of stock exchanges in the following respects:

a) to regulate the hours of trade as per the bye-laws;

b) to impose minimum and maximum limits on the day's transaction;

c) to maintain a clearing house for all the business transacted;

d) to determine and declare the market rates;

e) to determine the conditions for making, terminating and rescinding the contracts;

f) to prescribe limits for the business done by individual members;

g) to prescribe the qualifications of members of stock exchange;

h) to regulate the scale of brokerage, fines, fees, and the margin requirements; and

i) to settle the claims and disputes by arbitration.

5. Curbs on speculation: To prevent undesirable speculation, the Central Government is empowered by the Act to prohibit contracts for sale or purchase in the nature of unhealthy speculation. The Act is applicable to all dealings in securities including forward and ready dealings. It has declared kerb trading as illegal. Kerb trading is the business transacted by dealers in securities outside the stock exchanges and punishable with imprisonment. Prior to this Act the Katri Market of Calcutta and the Grey Market of Bombay were famous centers for kerb trading. However, spot transactions were excluded from the provisions of the Act.

6. Prohibition of options in securities: The Act has declared all option dealings as illegal. If an option was already entered into before the commencement of the Act, it would become void.

7. Regulation of blank transfers: Though, the Act does not prohibit the blank transfers, it discourage the practice in an indirect way. As the provisions of the Act, unless transferee of securities gets them registered in his name within 15 days from the dates when dividends fell due on them, these securities are treated belonging to those persons whose name appears in the books of the company irrespective of the fact that the securities have already changed many hands. However, the Companies (Amendment) Act, 1965 restricts the period of transfer to only two months during which securities are to be got transferred in the name of the transferee.

8. Listing of Securities: The Government has been given the authority to compel any public company to get its securities listed on a recognised stock exchange by complying with such requirements as may be prescribed for the purpose. The Securities Contracts (Regulation) Rules, 1957 promulgated under the Act formulated a code of standardised listing regulations to be complied with by the listed companies.

9. Licensing of dealers in securities: As per the provisions of Act, only those persons who have been granted the licence by the Central Government can carry on the business dealings in any securities in any state. No other person without licence can conduct this business in stock exchange.

10. Powers of supersession and suspension: In extreme circumstances, the Central Government has also the powers to supersede the governing body of stock exchange and appoint any person(s) to exercise and perform the functions of the governing body. It can also order the suspension of the business of any stock exchange for a maximum period of 7 days which can also be extended in the interest of trade, commerce and industry. It can also withdraw recognition granted to a stock exchange when their activities are in contravention of the provisions of the Act.

9.13 DIRECTORATE OF STOCK EXCHANGES

For the proper and effective administration of the provisions of Securities Contracts (Regulation) Act, 1956, the Government of India has set up a Directorate of Stock Exchanges in 1959, under the Department of Company Law Administration. It has its headquarters at Bombay and branch offices in Calcutta and Delhi. The directorate serves as a useful link between the Government and the stock exchanges in the country. As an agent of the Government it performs several functions. The following are the functions of the Directorate of Stock change :

1. It keeps a close watch on the activities of stock markets in the country and individual members and also advises them of corrective steps whenever any undesirable tendency develops in the market.
2. It grants licences to individual dealers in securities in areas outside the recognised stock exchange.
3. It helps in controlling the kerb transactions and preventing the option dealings.
4. It ensures that the companies whose shares are traded on the stock exchanges are complying with the listing requirements properly.
5. It studies the periodical returns submitted by stock exchanges and the members and the appropriate action against any undesirable business practices.

The Directorate, thus, weilds wide authority over all stock exchanges in the country to ensure that exchanges function in conformity with the social and economic interests of the country. Doodha has described the Directorate as a Department of Government which "exerts all the necessary pressure to regulate the market mechanism. In many matters of special interest, the Directorate and the Securities Exchange Board cooperate with one another to settle issues."

CHECK YOUR PROGRESS – 2

i) What is the need for control and regulation of capital market?

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ii) State the agencies empowered with the regulation of securities business.

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9.14 SECURITIES EXCHANGE BOARD OF INDIA (SEBI)

The Capital market in India was being regulated mainly by Capital Issues Control Act, 1947 and Securities Contracts (Regulation) Act, 1956. The act was applicable to all companies formed and registered under the Companies Act, 1956. The capital markets started growing impressively by the end of 1988 and it became necessary to establish a separate regulatory authority for the capital markets in India. Securities and Exchange Board of India (SEBI) was conceived and constituted as an interim administrative body to function under the overall administrative control of the Ministry of Finance, Central Government. SEBI was given statutory powers vide Securities and Exchange Board of India Ordinance, 1992 promulgated on 30th January, 1992. The above ordinance was replaced by the Securities and Exchange Board, 1992 with President of India's assent on 4th April, 1992 as Act No. 15 of 1992, enforced retrospectively from 30th January, 1992.

Legislative Scenario

A mention has already been made about the Capital Issue (Control) Act, 1947, which has since been repealed. It may be recalled that while retaining control on the issue of capital, the Government had thought it fit to control the securities market also particularly because the marketable securities issued by the companies and freely traded in the market came to be subject to a lot of abuse. It was in this context, that the Government enacted the Securities Contracts (Regulation) Act, 1956. By reason of this Act, the Government's intention was to regulate the transactions of the stock exchanges, management of its affairs and also the affairs of its members. Establishment of the stock exchanges without the previous approval of the Central Government was prohibited. By providing for prior approval of the Rules of the stock exchange and also regulations and bye-laws of the stock exchanges concerning dealing in stock exchanges, the Government sought to have effective control for transactions in securities and also inculcate certain degree of discipline and regulation on such transactions. Options trading in securities was prohibited as also some provisions were enacted for control of transactions in securities by ensuring that such transactions take place only between members of the exchange except transactions on spot delivery basis.

With the rapid expansion of industries resulting in manifold expansion in the issue of securities and transactions therein, the present regulating system became insufficient. Besides, in the absence of an independent agency to observe the functions of the securities market both at the primary level and at the secondary level many commissions proposed establishment of an independent and statutory agency to regulate and supervise functions of the securities market. It was in this context, that the Securities and Exchange Board of India Act was passed on April 4, 1992, which replaced the Ordinance promulgated earlier by the Government on January 30, 1992.

The Securities and Exchange Board of India Act, 1992

The SEBI Act provides for establishment of a statutory board constituted by 6 members, with Chairman and two members to be appointed by the Central Government, one member to be appointed by the Reserve Bank and two members having experience of securities market to be appointed by the Central Government. SEBI has been given autonomous status by treating it as a body corporate with perpetual succession and common seal. It may be stated that the preamble of the Act provides that the Board has been established to protect the interest of the investors in securities and to promote the development of and to regulate the securities market and for matters connected therewith. Section 11 which details the powers of the Board clearly states that it should be the duty of the Board to protect the interest of the investors in the securities market. The statutory Board was established on 21.2.1992.

The scheme of the Act lays down that various Rules and Regulations will be issued to enable SEBI to register, regulate and monitor various intermediaries in the capital market. So far, this has been accomplished in respect of brokers, sub-brokers, merchant bankers, portifolio managers, mutual funds, insider trading, share transfer agents and registrars, underwriters, bankers to an issue and debenture trustees.

In the enactment of the new legislation, the Government has for the present ensured dual control over the exchanges (which is since being gradually vested in SEBI alone) and leaving it to SEBI exclusively to regulate primary market by repealing the Capital Issues (Control) Act. In the primary market, SEBI has issued broad guidelines and rules of discipline which various intermediaries should observe, and the breach of which invites penal consequences.

As far as the secondary market is concerned, the Act provides for registration of intermediaries like stock brokers, sub-brokers and others who transact business in the secondary market. Besides, certain powers under the Securities Contracts (Regulation) Act have been delegated to SEBI for regulating the dealings in securities on the stock exchange and outside the stock exchange. It has been vested with powers to inspect and enquire into the affairs of the stock exchange and its members. It can also issue directions for regulating the dealings in securities and also ensuring transparency in the transactions on the stock exchanges and also between the stock exchange and their constituents.

9.14.1 ORGANISATION OF SEBI

After it became a statutory body, SEBI restructured its organization and rationalized it in line with its expanded range and scope of activities. It has divided its activities into five operational departments, each headed by an executive director. Apart from these, there are two other departments viz. Legal Department and Investigation Department, also headed by officials of the rank of executive directors. All these departments are further sub-divided into divisions, each headed by a division chief with specific responsibilities.

1. **Primary Market Department** – looks after all the policy matters and regulatory issues for the primary market and market intermediaries, matters pertaining to SROs and redressal of investor grievances.

2. **The Issues Management & Intermediaries Department** takes care of getting of offer documents and other things like registration, regulation and monitoring of issue related intermediaries.

3. **The Secondary Market Department** – looks after all the policy and regulatory issues for the secondary market, administration of the major stock exchanges and all the other things related to it. The Secondary Market Department-Exchange administration, inspection and non-member intermediaries overseas the smaller stock exchanges and also regulates the non-member intermediaries such as sub-brokers.

4. **The Institutional Investment Department** (Mutual Funds and Foreing Institutional Investment) looks after mergers and acquisitions, research and publications and international relations. It frames policy for FIIs, mutual funds and other sundry things like publications, membership in international organizations, etc. The Legal Department, under the supervision of the General Counsel, takes care of all the legal matters of SEBI. The Investigation Department carries out inspections and investigations under the supervision of the chief of investigation.

SEBI also has two advisory committees, one each for the primary and secondary markets, to provide advisory inputs in framing policies and regulations. These are constituted from among the market players, recognized investor associations and eminent persons associated with the capital market. The committees are however, non-statutory in nature and SEBI is not bound by their advisory committees.

Besides the above departments, SEBI has opened regional offices at New Delhi, Calcutta and Madras, Bombay being the headquarters. The regional offices shall cover operations in northern, eastern and southern regions, respectively.

9.14.2 OBJECTIVES OF SEBI

According to the preamble to the SEBI Act, the objective of setting up SEBI is to protect the interest of investors in securities and to promote the development and to regulate the security market. SEBI has thus three objectives or duties cast upon it by the Act-

a) to protect the interests of investors in securities;
b) to promote the development of securities market; and
c) to regulate the securities market.

The powers of SEBI can be exercised by way of regulations. SEBI cannot act independently. It is bound by directions on questions of policy given by Central Government from time to time in writing. SEBI is obliged to make an annual report to the Government each year giving therein a true and full account of its activities, policies and programmes. A copy of the report and also that of rules and regulations made by SEBI are to be laid before the Parliament.

Powers under Securities Contracts (Regulation) Act transferred to SEBI

Following powers have been given to SEBI with the enactment of SEBI Act, 1992 and the repeal of Capital Issues (Control) Act, 1947:

1) Power to call for periodical returns from recoginised stock exchanges.
2) Power to call for any information or explanation from recognized stock exchanges or its members.
3) Power to direct inquiries to be made in relation to affairs of stock exchanges or its members.
4) Power to grant approval to bye-laws of recognized exchanges.
5) Power to make or amend bye-laws of recognized exchanges.
6) Power to declare applicability of section 17 of the Securities Contracts (Regulation) Act in any State or area and to grant licences to dealers in securities.
7) Power to compel listing of securities by public companies.
8) Power to control and regulate stock exchanges.

Other powers/functions

9) Power to grant registration to market intermediaries.
10) Power to register and regulate working of collective investment schemes including mutual funds.
11) Power to promote and regulate self-regulatory bodies.
12) Power to prohibit fraudulent and unfair trade practices relating to securities.
13) Power to prohibit insider trading.
14) Power to promote investor's education and trading of intermediaries in capital market.
15) Power to regulate substantial acquisition of shares and take over of companies.

16) Power to levy fees.

17) Power to conduct research and other functions.

SEBI, as a regulatory and development board, thus has wide and varied powers. SEBI's efforts so far include measures for efficiency, reforms and transparency in primary and secondary market, regulation of mutual funds and market intermediaries and introduction of Form 2A (abridged prospectus) and stockinvests, free pricing of issues, registration of foreign institutional investors. A lot of investor protection guidelines have also been framed and implemented. SEBI's aforesaid powers and functions are not exhaustive in nature.

9.14.3 FUNCTIONS OF THE BOARD

1) Subject to the provisions of this Act, it shall be the duty of the Board to protect the interests of investors in securities and to promote the development of and to regulate the securities market, by such measures as it thinks fit.

2) Without prejudice to the generality of the foregoing provisions, the measures referred to therein may provide for-

a) regulating the business in stock exchanges and any other securities markets;

b) registering and regulating the working of stock brokers, sub-brokers, share transfer agents, bankers to an issue, trustees of trust deeds, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisers and such other intermediaries who may be associated with securities markets in any manner;

c) registering and regulating the working of collective investment schemes, including mutual funds;

d) promoting and regulating self-regulatory organizations;

e) prohibiting fraudulent and unfair trade practices relating to securities markets;

f) promoting investors' education and training of intermediaries of securities markets;

g) prohibiting insider trading in securities;

h) regulating substantial acquisition of shares and take-over of companies;

i) calling for information from, undertaking inspection, conducting inquiries and audits of the stock exchanges and intermediaries and self-regulatory organizations in the securities market;

j) performing such functions and exercising such powers under the provisions of the Capital Issues (Control) Act, 1947 and the Securities Contracts (Regulation) Act, 1956, as may be delegated to it by the Central Government;

k) levying fees or other charges for carrying out the purposes of this section;

l) conducting research for the above purposes;

m) performing such other functions as may be prescribed.

Registration of stock brokers, sub-brokers, share transfer agents, etc.

1) No stock-broker, sub-broker share transfer agent, banker to an issue, trustee of trust deed, registrar to an issue, merchant banker, underwriter, portfolio manager, investment adviser and such other intermediary who may be associated with securities market shall buy, sell or deal in securities except under, and in accordance with, the conditions of a certificate of registration obtained from the Board in accordance with the rules made under this Act.

Provided that a person buying or selling securities otherwise dealing with the securities market as a stock-broker, sub-broker, share transfer agent, banker to an issue, trustee of trust deed, registrar to an issue, merchant banker, underwriter, portfolio manager, investment adviser and such other intermediary who may be associated with securities market immediately before the establishment of the Board for which no registration certificate was necessary prior to such establishment, may continue to do so for a period of three months from such establishment or, if he has made an application for such registration within the said period of three months, till the disposal of such application.

2) Every application for registration shall be in such manner and on payment of such fees as may be determined by regulations.

3) The board may, by order suspend or cancel a certificate of registration in such manner as may be determined by regulations.

Provided that no order under this sub-section shall be made unless the person concerned has been given a reasonable opportunity of being heard.

9.14.4 MEASURES INTRODUCED BY SEBI

a) Detailed acount of risk factors in offer documents

The Department of Company Affairs by a notification dated 3-10-1991, has laid down the furnishing of management's perceptions of risk factors. This came into effect from November 1991.

SEBI has always ensured that issues give a detailed account of the risk factors in the offer documents. This exercise was started by SEBI much earlier, on 1-5-1991, from which date it took upon itself responsibility of ensuring fair and adequate disclosures, so as to enable investors to make well-informed investment decisions. The parameters of risk factors may be as follows:

i) Constraints on the availability of raw materials.
ii) Constraints on marketing of the product.
iii) The likely cost/time overrun envisaged.
iv) Sensitivity to foreign exchange rate fluctuations.
v) Critical analysis of the promoters/management.
vi) Non-availability of necessary statutory approvals at the time of launch of the issue, etc.

Since SEBI has come into being, investors are provided with a detailed account of risk factors through offer documents, both in case of initial issues through prospectus and in case of existing company offering further issues through rights.

b) Form 2A Memorandum

The salient features of the stockinvest scheme, details of the issues, project, promoters and risk factors are to be supplied along with the application in non-detachable form. By this, investors are given first-hand information about the issue so as to enable them to take a fair, well informed investment decision.

c) Stockinvest Scheme

Stockinvest scheme which has been introduced since March, 1992 at the instance of SEBI, provides for use of 'Stockinvest' which is a legal, non-negotiable instrument like a cheque and is to be used to subscribe to capital issues. The novel idea being that the money which is used to subscribe to an issue will continue to earn interest even after the share application is made by the investor. The underlying principle is that the investor will not lose any interest on the money invested in the capital issue. The advantage to the investors is that their money is not blocked while participating in the primary market issues. The scheme operates as follows:

"A guaranteed payment instrument, the Stockinvest, is to be attached to the new capital issue applications, as against cash/cheque/draft, which means that instead of parting with the funds immediately, the funds remain in the bank under lien till the date of allotment. The money will earn interest for the investor for this period. His account is debited only when the allotment is made and the Registrar to the Issue presents the Stockinvest for payment. In case of non-allotment, the Registrar intimates that there is no attachment and the lien lifted, in which case the account becomes liquid immediately, instead of the investor waiting for a long period for refund order. By this scheme the liquidity of the investors is not affected".

Empirically stated, a sum of more than Rs. 1,500 crores was locked up with companies, due to delay in sending refunds, in 1991. The stockinvest schemes has taken of fairly well, after the initial teething troubles, and should provide to be a boon to the Indian investors, being a notable innovation in the capital market arena.

9.14.5 INVESTOR PROTECTION

Absence of adequate professionalism and fair competition among the various players of the market, indulgence in malpractices like inadequate and at times coloured disclosure of material information while entering into the market, dissemination of manipulated financial information and financial window dressing, price rigging, insider trading, unethical practices in terms of private placement/promoter's quota, etc., high volatility and speculative practices and large scale trading irregularities like non-disclosure to the client of the actual sale/purchase price of shares, debentures, non-delivery of shares/debentures against payment made (or delivered late), shares/debentures sold but payment not made, excess rate charged or short payment made, excess interest charged, excess commission charged, non-furnishing of bill/contracts, statement of accounts, non-settlement of account dues, bad deliveries, documents under objection etc., by brokers, sub-brokers and their agents have generated a large number of complaints from the investors.

Investors are facing a lot of hardships on account of non-receipt/delay in receipt of refund order/allotment advice, share/debenture certificates after transfer/allotment/endorsement/ conversion, etc. non-receipt of or delayed receipt of declared dividend, non-receipt of delayed receipt of interest on debentures, non-receipt of principal amount of debentures after redemption, non-receipt of or delayed receipt of interest on fixed deposits and non repayment of fixed deposits on maturity, non-receipt of rights form, bonus shares, duplicate share certificates although formalities (Indemnity bond, advt.) completed, non-receipt of shares, after transfer/splitting/consolidation, non-receipt of annual accounts and balance sheets, etc.

As part of its role towards investor protection, SEBI has, since its inception, evolved a system or redressal of investor grievances and is consistently taking up investors complaints against companies, brokers and other intermediaries. SEBI issues from time to time "Investors Guidance Series" to clarify, guide and educate the investor community on matters such as mutual funds, grievances and remedies available to investors holding debentures, the stokinvest scheme, investment considerations in the primary market and caution against illegal transactions.

SEBI has also taken direct steps by way of investors education. It has issued a few investor guidance advertisements and published a book regarding 'Investor Grievances Rights and Remedies'. Besides, to increase investors, awareness and to make them come up as a strong community, SEBI has also registered certain active investors' associations.

SEBI has taken various measures to protect, investors such as –

- announcing guidelines on disclosure and investor protection;
- registration and regulation of market intermediaries;
- appointment of SEBI's representative to oversee allotment where issues are oversubscribed; and
- setting up an investor grievances cell to handle investor complaints.

The Securities and Exchange Board of India has decided to share information on investor complaints received by it with its recognized investor associations to facilitate filing of public interest litigations in consumer courts against the erring companies.

The proposed sharing of information will first be done with the Consumer Education Research Centre (CERC), Ahmedabad.

9.15 SUMMING UP

The middlemen in capital market may at times indulge in speculative activities by creating artificial scarcity and supplies. Consequently investors are put to financial losses. Hence there is a need to regulate dealings relating to securities exchange. This process of regulation starts right from the promotion of companies. In the context of stock exchange, regulatory activities commence from disallowing the purchase and sale of securities of unlisted companies. Listing of securities is a prerequisite for trading on the stock exchanges. Listing may be defined as the admission of a security in the official list to stock exchanges for the purpose of trading. Listing can be of cash list or forward list. Further the listed securities can be grouped into cleared securities and non-cleared securities. For getting the securities listed, the companies must comply with the conditions laid down in Securities Contracts (Regulation) Act. Listing procedure confers several advantages to investors, companies and to general public. Of course, listing may make the companies to be more transparent by disclosing all financial aspects resulting in competition etc.

Inspite of restrictions imposed through listing, capital market including stock exchange need a strict regulation and control for (i) preventing unfair practices injurious to investors (ii) ensuring genuine investment; and (iii) taking corrective steps in time to curb violent fluctuations in security prices. The regulatory measures of capital market spring up from Securities Contract (Regulation) Act, the activities of Directorate of Stock Exchanges, and SEBI. In January 1992, SEBI is made an autonomous apex body to supervise, monitor and control the dealings in securities market in India.

9.16 CHECK YOUR PROGRESS : MODEL ANSWERS

1. i) Listing is defined as "the admission of a security in the official list of stock exchange for the purpose of trading".
   ii) Listed securities may be :

A. Cash list and
Forward List.

B. Cleared Securities and
Non- cleared Securities

2. (i) a) To Prevent unfair practices injurious to investors.
b) To ensure genuine investment and legitimate speculative transactions.
c) To take corrective steps in time to curb violent fluctuation in security prices.

(ii) Securities Contracts (Regulation) Act, Securities Contracts (Regulation) Rules, Directorate of Stock Exchange, Indian Companies Act and Securities Exchange Board of India.

9.17 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in about 30 lines each.

1. Explain the shortcomings in the working of stock exchanges in India prior to the enactment of Securities Contract (Regulation) Act.
2. Give a brief historical background of stock exchange regulation in India.
3. State the function of Directors of Stock Exchanges.

II. Answer the following questions in about 15 lines each

4. Explain the need for the regulation of stock exchanges in India
5. What are the requirements for the recognition of stock exchanges by the Central Government?
6. When can the Government of India supersede the Government body of a stock exchange ?
7. What are the new guideline governing the capital market

9.18 RECOMMENDED BOOKS

1. Kuchhal, S.C., : **Financial Management,** Chaitanya Publishing Houses; Allahabad

2. Kulkarni, P.V., : **Financial Management,** Himalaya Publishing House; Bombay.

3. Pandey, I.M., : **Financial Management,** Vikas Publishing House Pvt. Ltd., New Delhi.

4. Van Horne, James., C. : **Financial Management and Policy,** Prentice Hall of India Pvt. Ltd.

9.19 GLOSSARY

Arbitration : Deciding between parties in a dispute.

Capital formation : Raising of money for investment in business.

Liquidity	:	Capable of easy conversion into cash.
Lockouts	:	Closing of factory or office by employers during a trade dispute.
Merchant Banker	:	It is one which provides technical assistance to the entrepreneurs, apart from underwriting the issue of shares, stock, bonds and debentures and acting as a commission agent, or broker of industrial units.
Merger	:	Joining together of business firms.
Mushroom growth	:	Springing up rapidly
Negotiability	:	Transferability from one person to another of papers concerned with payment of money.
Solvency	:	Ability to pay all debts.
Stock Exchange	:	A market for purchase and sale of securities such as share, bonds etc.,
Underwriting	:	Guaranteeing money or shares; accepting liability for.
Voting Shares	:	The securities carrying the voting rights.

UNIT - 10 : FOREIGN CAPITAL AND COLLABORATION

Contents

10.0 AIMS AND OBJECTIVES

The main objective of this Unit is to explain the meaning of foreign capital and collaboration, and types of foreign aid and also the advantages of each type. Further, this unit also discusses the sources of foreign capital in India, the implications and impact of foreign capital on economic development.

By the end of this Unit, you should be able to know -

- the meaning of foreign capital and collaboration;
- the types of foreign aid;
- role of foreign capital in economic development;
- advantages and disadvantages of foreign capital and collaboration;
- the sources of foreign capital in India and Government policy in this regard; and
- the impact of foreign capital on Indian economy.

10.1 INTRODUCTION

The growth and development of an economy depends on the available savings in the economy, on the one hand, and the investments made in the economy on the other hand. Almost all developed countries of today at one stage or other, for the sake of a rapid economic development, depended on foreign capital. For the developing economies like India, when there are classical gaps, foreign exchange gaps, and the one between domestic savings and investments, foreign capital is, but the only major source. Therefore, foreign capital is not only important for developing countries but is also required for developed countries. However, the need of foreign capital for developing countries is manifested and debated more as its absence harms developing countries more than it does for the developed and less developed countries. For instance, England borrowed from Holland as early as in the 17th and 18th centuries. America received the support of men, material and money from Europe in the 19th century. The USSR also obtained assistance from Western Europe during 1890-1914. Thus foreign capital has been an important input for economic development of a country in general and of developing economy in particular.

10.2 MEANING AND DEFINITION

Capital, as one of the constituent factors, helps the production. Hence the amount of capital formation in the country is very important. The capital formation results from both domestic and foreign savings. Though domestic capital is seen in terms of money saved in financial assets, the formation of foreign capital can be in the form of currency, equipment, skills, and technology. In fact, foreign capital is the investment received by a country from other countries which are not under its political governance. While generally the investment received is either in the form of equity or loan, irrespective of its form, it is used to finance the long-term needs of the domestic enterprises. Capital accumulation is the kingpin of the development profile of an underdeveloped country. While foreign capital is normally secured in any of the forms of foreign currency, equipment, skills and more importantly in the form of foreign technology. It is true that technological advancement has its contributions to make in raising the output capacity of a country. In fact, capital is nothing if it does not take the form of production-methods or a set of techniques. Nor can production-methods become alive without the flesh and bones of capital. It is therefore, necessary that the flow of foreign capital takes the shape of foreign currency, equipment, skills and technology. Further, the financial form of flow of foreign capital can be in the form of equity or debt. When it is in the form of equity, it may or may not confer rights of management on the investing agency, but it is eligible to receive dividends. When it is in the form of long-term debt, the foreign agency is entitled to receive servicing charges viz., interest but do not enjoy a participating right in the management. An economy normally receives foreign capital in either of the forms i.e., equity or loan which have to be repaid as obligated. However, an economy also receives funds that need not be serviced or repaid. Such funds are offered for the development of the important social infrastructure, specially for the long-term projects. These are called 'grants'.

10.3 NEED FOR FOREIGN CAPITAL

Earlier we have noted that the function of foreign capital is to fill up savings gap, trade gap and technology gap. In the initial stages of economic growth foreign capital is very important. Developing countries like India are characterized as 'capital poor' or 'low-saving and low investing' economies. There is not only small capital stock but also a slow rate of capital formation.

To achieve the economic development for the country as planned immediately after independence, govt. of India promoted modernization, adoption of new technology and introduction of new methods of production and distribution. Given its mass poverty, low per capita income and high unemployment rate, India, a developing economy, cannot aim for adequate capital formation for its economic development domestically. As it has to pursue its development programmes, it has been depending upon the foreign capital. Hence, there are many reasons for which foreign capital is required. Few of the important reasons are as follows:

a) Domestic capital in under developed and developing countries will be inadequate for the purposes of economic growth. As developing countries aim at rapid industrialization, they need huge capital that can be secured by large assistance from foreign countries. Further, for want of experience, domestic capital and entrepreneurship may not flow into certain lines of production. Foreign capital can show the way for domestic capital.

b) Under developed countries lack in economic overheads which directly facilitate more investment. The railways, roads, canals, power projects provide the necessary infrastructure for development. Since they require very large capital investment and have long gestation periods, under developed countries cannot undertake them without foreign assistance.

c) There may be potential savings in a developing economy like India but this may come forward only at a higher level of economic activity. It is therefore, necessary that foreign capital should help in speeding up economic activity in the initial phase of development.

d) It may be difficult to mobilize domestic savings for the financing of projects that are badly needed for economic development. In India, in the early stages of development, the capital market was itself underdeveloped. During the period in which the capital market is in the process of development, foreign capital is essential as a temporary measure.

e) Underdeveloped and developed countries will not be in a position to start basic and key industries by themselves, particularly in the initial stages. Steel, machine tool, heavy electricals, chemicals are few basic industries which require huge investment. Foreign capital can help establish all such industrial units. In India, the steel plants at Bhilai, Rourkela and Durgapur have been started with the assistance from USSR, UK and Germany respectively and the use of foreign capital in these lines may encourage total enterprise to take up related industries at reduced costs.

f) Underdeveloped countries in general do not possess the requisite modern technology for taking the economy into sophisticated areas of production and consumption. These goods necessitate the import of technical know-how and capital. It is the Foreign Capital that brings with it other scarce productive factors, such as technological know-how, business experience and knowledge which are equally essential for economic development.

10.4 ROLE OF FOREIGN CAPITAL IN ECONOMIC DEVELOPMENT

Economic development is a complex process. It involves the establishment of different types of industries using modern methods of production. The domestic capital will be insufficient to finance these industries in under-developed countries. Hence, this problem of financing can be solved to some extent by inviting investment from foreign countries. Foreign capital is also helpful in creating an environment conductive to rapid industrialization in under-developed countries. It acts as counter-force to the frigid domestic capital and points to new areas for industrial investment. For instance, the Indian investors are much eager to participate in the new venture started and sponsored by the US investors. Investors in under developed countries always believe (which is true to a large extent) that the foreign capital tends to seek the innovative type of investment.

Apart from the above mentioned psychological aspects, foreign capital serves two immediate purposes. First, it provides the ways and means by which under-developed countries can mobilize local factors of production for improving the secondary sector, viz., industrial activity, secondly, it provides the foreign exchange for importing foreign factors of production. Foreign capital makes possible the import of foreign factors which serve as active links in the growth process. The balance of payment difficulties of under-developed countries can also be solved to some extent with the help of foreign capital. Further, foreign capital may help to attain higher rate of growth without curtailing the present rate of consumption.

CHECK YOUR PROGRESS - 1

i) Define foreign capital.

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10.5 TYPES OF FOREIGN INVESTMENT

Foreign investment may flow into the aid receiving countries in many ways. It is difficult to give a comprehensive picture of different forms of foreign capital because various agencies evolve various methods of funding from time to time depending upon the need, purpose, capacity, and expediency. From the point of ownership, foreign capital may be private foreign capital or public foreign capital. Foreign investment may also take the form of collaborations and grants. In brief, foreign investment may flow into recipient country in the form of (i) private foreign capital (ii) public foreign investment (iii) foreign collaborations and (iv) grants. All these sources are briefly discussed hereunder.

i) Private foreign capital

It may take the form of direct and indirect investment.

a) **Direct foreign investment:** The foreign investing agencies exercise defacto or dejure control over the assets created in the capital importing country by means of that investment. Again direct investment may take place in the following manner in the aid receiving country: (a) Starting a subsidiary of a company already established in the investing country; (b) Formation of concern in the capital importing country, financed exclusively by the existing company in investing country; (c) Starting a company in the investing country for the specific purpose of operating in the importing country; and (d) Creation of fixed assets in the capital importing country by the individual investors of the capital exporting country.

b) **Indirect foreign investment:** It is popularly known as "portfolio" or "rentier" investments. It comprises investments by foreign parties in transferable shares and debentures issued by the companies established in importing countries. Such securities can also be issued by the government of capital importing country and such issues are guaranteed by the government. Such holdings do not confer the right to control the company, but the shareholders are entitiled to get the dividends. In recent years, multilateral indirect investment have also been made. Under this method, the nationals of a country purchase the bonds of the International Bank for Reconstruction and Development (IBRD) floated for financing a particular project undertaken by the receiving country. Equity holdings by non-residents in the recipient country's joint stock companies also come under this category.

ii) Public Foreign Capital

It may consist largely of loans offered by the governments of foreign countries to the aid receiving countries. These loans may be "bilateral" and "multilateral" loans. Bilateral loans are given by the foreign government directly to the government of the aid receiving country. Multilateral loans mean contribution of foreign government to international agencies for assisting the under-developed countries. For instance contributions made to Aid India Club, Colombo Plan, etc.,by the member countries, come under this category. Loans made available by the various international agencies like IBRD, IFC, IDA, ADB, Special United Nations Fund for Economic Development (SUNFED), United Nations Development Programme (UNDP), etc., come under this category.

iii) Foreign Collaboration

In recent years, foreign and domestic agencies have been jointly undertaking the financing of business. This type of participation of foreign capital with domestic capital in the establishment of industrial and business organizations is known as foreign collaboration. India has been encouraging this type of foreign capital for a long-time. Foreign collaboration may be of the following types: (a) Joint participation of private parties (b) Collaboration between firms and capital importing government and (c) joint participation of foreign and capital importing governments.

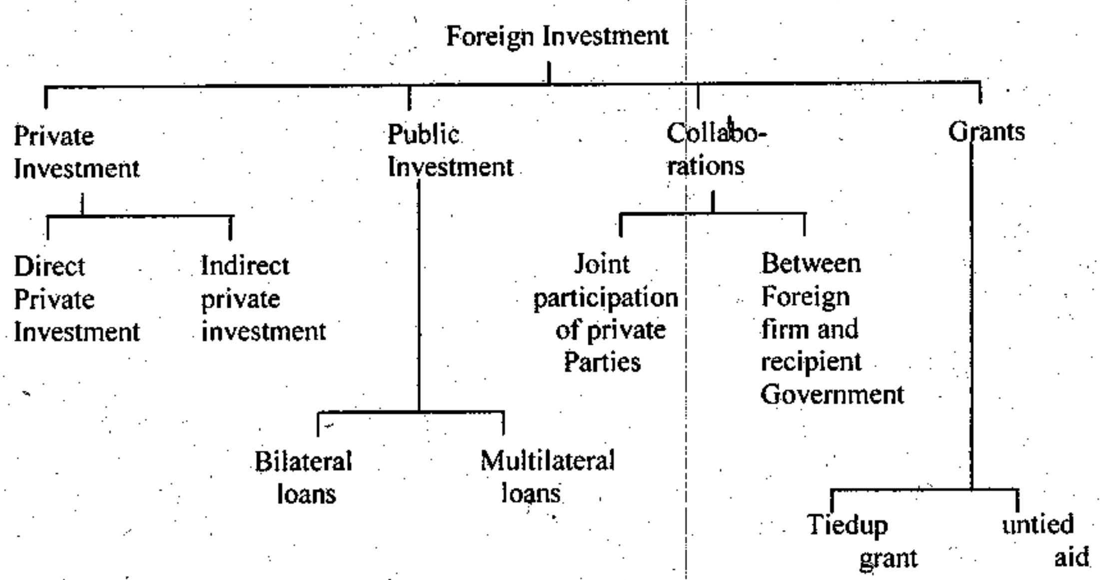
iv) Grants

Foreign government and non-government agencies may sometimes extend assistance in various forms without repayment obligation on the part of the capital importing country. Such non-repayable investment is called foreign grants. It may come to the receiving country in the form of foreign currency, technical and managerial skill, consumer goods, etc. In the strict sense, the term "foreign capital" may not cover the grants given by the foreign agencies. However, when it comes in the form of long-term capital contribution "grants" may also be categorized as foreign capital.

Based upon the terms and conditions attached to the foreign capital, a distinction can be drawn between tied and untied aid. While extending the assistance the foreign agency may at times impose certain conditions as to its use for a particular purpose, project a programme. In such case it is described as 'tied up aid'. As such the aid may be tied by source, project and commodities or it may be tied both by project and source (double tying). Besides the above mentioned, foreign capital may take any other form also depending upon the circumstances concerning the aid giving and aid receiving countries.

The above discussion leads us to chart out the various types of foreign investment in the following manner.

Chart – I



10.6 FOREIGN CAPITAL AND FOREIGN TRADE

Foreign trade is different from foreign investment although they are closely related in the case of under-developed countries.

Marshall has observed that "the causes which determine the economic progress of nations belong to the study of international trade". Dennis Robertson is also of the opinion that foreign trade is the "engine of growth". Trade is a channel not only for physical goods but also for ideas, skills, management and technology. Geographical specialization in certain resources enables the country to produce certain goods at cheaper rates than others. As such, through foreign trade certain goods are made available at cheaper rates than the domestically produced goods. This sort of supply of goods at cheaper prices enables the importing country to generate some savings which can be directly utilized for capital formation which is the ultimate function of foreign capital. Thus foreign trade indirectly achieves the results of foreign capital. Foreign exchange is essential for economic development in backward economies. Foreign capital and foreign exports are the main sources of foreign exchange. When a country's import are greater than its exports, the government or the trading agency may seek foreign capital. Thus the gap between exports and imports is finally set right by foreign investment. Capital borrowing from foreign countries increases the output, employment and real incomes in backward countries. As such, foreign trade and foreign capital go together.

10.7 ADVANTAGES OF FOREIGN CAPITAL

The following are some other benefits that under-developed countries secure from foreign capital.

1) Foreign capital breaks the vicious circle in which the developing countries are caught up. Underdeveloped countries are characterized by low production and productivity and consequently by low incomes. Therefore, the purchasing power of the people will also be low. On account of poor incomes the economy will be starving for want of savings and investments. Foreign capital could supply this and help in expanding economic activity.

2) Foreign capital with the latest technical know-how may be available to the recipient countries which will provide an impetus to industrial activity and expansion.

3) Foreign capital plays a vital role in supplying the fruits of years of scientific and industrial research, accomplished by the older industrial countries.

4) External assistance, more specially which comes in the forms technology, managerial expertise and skills, without having to face inherent inflationary pressures of development expenditure. Thus it is anti-inflationary in character.

The aid giving-countries enjoy the following advantages by assisting the under-developed countries:

1) Export of capital goods to less developed countries will lead to stabilization of prices in their home markets.

2) Investments in under-developed countries bring more remunerative outlets to capital exporting countries than those available internally.

3) Different countries are at different stages of economic development. Some are having enough savings for investment and some others have opportunities for investment, but without having the requisite resources. The former can profitably invest their surplus resources in those countries lacking them. Thus the savings of the world will be put to their best use.

10.8 DISADVANTAGES OF FOREIGN INVESTMENT

Foreign capital is viewed with suspicion but the economic history of many developed countries does not justify it. However, the following are some of the disadvantages of foreign investment.

1) The use of external funds makes the recipient country dependent on foreign countries. This may impede the attainment of self-reliance.

2) The profits generated in the country will be taken out of the country in the form of dividends, interest, etc., Consequently, the recipient country gradually may become impoverished.

3) The capital borrowing country may lose economic independence. The economic domination by a foreign country with its vested interests may lead to exploitation and political interference. All these come in the way of the economic progress of the country.

4) Foreign capital worsens the unemployment situation in the country. The foreigners, generally, employ their own people, and may practise racial discrimination in the matters that relate to recruitment, promotions, etc.

5) If basic, key and defence goods industries are controlled by the foreign investors, the national security will be under threat.

6) Foreign capital may be exploiting the natural resources of the borrowing country in order to enrich the lending country.

7) Foreign investors prefer to invest in the industries where possibility of profit is very high. They may not pay attention to growth oriented industries. Consequently the outcome will be a lopsided economic and industrial development.

The above mentioned disadvantages, as a matter of fact, particularly concern the countries under colonial rule. But the politically independent under-developed countries can plan their economic activity and adopt independent and cautious policies towards foreign capital. If the foreign assistance is kept under native management and control, the disadvantages of the foreign capital may, perhaps, be minimized or avoided.

CHECK YOUR PROGRESS - 2

i) What are the different types of foreign investment ?

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ii) What is foreign trade ?

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10.9 SOURCES OF FOREIGN CAPITAL

Foreign capital has come to India mainly in the form of loans and grants. Profolio investment has also been expanding gradually in our country. On the whole, in our country, the amount of foreign aid has been showing an increasing trend. The aid has been obtained for financing various kinds of activities from capitalist countries, socialist countries, and international institutions. Very recently foreign aid in the form of foreign currencies and crude oil has been sought from petroleum producing countries. Broadly, these sources can be grouped into four categories. The first category is of consortium countries. In this category, Austria, Belgium, Canada, Denmark, France, West Germany, Italy, Japan, Netherlands, Norway, Sweden, the U.K and the U.S.A., the IBRD and its affiliates, the IDA will figure. The World Bank group (IBRD and IDA) and socialist countries come under second and third categories respectively. The socialist countries which make investment in India are Bulgaria, Czechoslovakia, Hungary, Poland, the USSR, Yugoslavia, GDR and Romania. Further, countries like Australia, Newzealand, Switzerland and the European Economic Community also assist India with foreign investment. The largest amount of foreign assistance has come from consortium members, with both the member countries and the World Bank group contributing sizeable aid. In terms of groups, the next is that of socialist countries. Of the principal donor countries, USA has extended the largest aid which far exceeds the aid from any other single source. The second position is that of the U.K., followed by the OPEC, Japan and the USSR in that order.

Foreign Collaboration : Foreign collaboration is one of the forms of obtaining foreign capital by developing countries or multinationals through foreign capital with native entrepreneurs for establishing business organistions. Foreign collaboration may be for securing technical know - how and for financial resources. Foreign collaboration will be either through the establishment of branches of foreign companies or the floating of subsidiaries incorporated in the importing country. In these subsidiary companies the foreign agency may have majority or minority control through equity participation. Pure Technical Collaborations (PTCs) are preferred to foreign equity participation. The PTCs are created by agreements between the two countries, viz., the aid receiving and the aid giving countries. These PTC agreements will check the flow of foreign exchange in the form of dividends which are otherwise payable on the equity holdings of the foreign agencies. However, there is likely to be an outflow of foreign exchange on account of collaboration but it will be relatively less than the total profits payable. The outflow of funds due to collaboration will be in the form of (i) royalties for import of technical know how; and (ii) payment of technical fee.

While Indian Policy towards foreign collaborations remained restrictive and selective during the pre-liberalisation period, it is not so in the post liberalization period. Foreign collaborations- are permitted liberally in priority areas, more specially those in which we had not developed our capabilities. In the recent past i.e., after 2000, government revised its policy very liberally towards foreign collaborations. For instance, in one go, in the month of April 2003, Indian govt cleared 47 proposals pushing the foreign invest figures by Rs. 285 crores. Of these foreign collaborations major investment proposals pertain to business process outsourceing/ back office operations, logistics, wholesale marketing, distribution, supply, import, export, distribution of high performance polyolefin products, manufacture of design and development of systems and application software development transportation air freight and ocean freight forwarding and development of integrated township/model towns

Foreign collaborations mainly, are of two types:-

(i)Technical approvals involving payment for technology; and (ii) financial approval involving equity capital of an existing or new undertaking up to Rs. 6000 crores. The Industry Ministry accords approval on the advice of Foreign Investment Promotion Board (FIPB), but large projects over this limit are approved by Cabinet Committee on Foreign Investment (CCFI).

In recent years India has been greatly encouraging this form of import of foreign capital. There are three types of foreign collaborations – joint participation between private parties, between foreign firms and Indian Govt. and between foreign govts. and Indian govt.

10.10 NRI INVESTMENTS

Since 1960, investment by Non-Resident Indians (NRIs) in the bank deposits and corporate securities of India has become one of the important sources of foreign capital. In almost every country of the world there is a sizeable population of Indians. Although they become citizens of other countries, their social, cultural and emotional ties with India and Indians have continued to be strong. As result of their hard work and initiative, they accumulated large resources of investible funds. There are about 12 million NRIs spread across the globe. The Government has recognized the fact that NRIs command sizeable resources in terms of finance, scientific talent, and technical know-how. The Government of India has adopted a liberal policy in recent years for the promotion of NRI investment in India. The investment channels include bank deposits, direct investment in industries, portfolio investment in corporate securities, Government securities, units of mutual funds etc.,

In 1991, various schemes were launched by the Government of India to attract NRI funds. The central budget for 1991-92 has permitted the NRIs to acquire property in India without any elaborate procedural formalities and permitted to make also capital gains on a repatriable basis. Dollar bond scheme under Foreign Exchange Bonds (Immunities and Exemption) Act 1991 has also been launched by the Government.

To bolster foreign exchange reserves, Indian government, offers many incentives to NRIs. For instance, the interest rates offered on such deposits were higher as compared with the global market rates. However, with improved access to international capital markets and increasing inflow of foreign investment in recent years, there is no need to continue with high costs to attract the NRI deposits. The interest rates on such deposits are therefore lowered progressively.

Under the non-resident bank account/deposit schemes, an Indian national and person of Indian origin residing abroad can open bank account in India freely out of funds remitted from abroad or foreign exchange brought in from abroad or out of funds legitimately due to them in India. Reserve Bank of India in accordance with the open foreign investment policy of Indian has granted general permission to bank in India which are authorized to deal in foreign exchange (authorized Dealer) to open such accounts freely. There are five types of non-resedent accounts which can be maintained by authorized dealers.

1. Foreign Currency Non-Resident Account (FCNRA)
2. Non-Resident (External) Rupee Account (NR(E)RA)
3. Foreign Currency Non-Resident (Bank) Account (FCNR(B))
4. Non-Resident (Non-Repatriable) Rupee Deposits (NR(NR)RD)
5. Foreign Currency (Bank and Other) Deposits (FC(B&O)D)

The Government of India liberalized its policy towards foreign investment in 1991 to permit automatic approval for foreign investment up to 51% equity in 34 industries. The FIPB processes the application of the cases not covered by automatic approval during 19921-93. Several additional measures were taken to encourage direct foreign investment, portfolio investment, NRI investment etc.

1. The dividend – balancing condition earlier applicable to foreign investment up to 51 percent equity is no longer applied except for consumer goods industries

2. Existing companies with foreign equity can raise it to 51 per cent subject to certain prescribed guidelines. Foreign direct investment has also been allowed in exploration, production and refining of oil and marketing of gas, coal mines can also be owned and run by private investors in power

3. NRIs and Overseas Corporate Bodies (OCB) predominantly owned by them are also permitted to invest up to 100 per cent equity in high- priority industries with repatriability of capital and income. NRI investment up to 100 per cent of equity is also allowed in export houses, trading houses, star trading houses, hospitals, EOUS, sick industries, hotels and tourism related industries and without the right of repatriation in the previously excluded areas of real estate, housing and infrastructure.

4. Disinvestment of equity by foreign investors has been allowed at market rates on stock exchange from 15 September 1992 with permission to repatriate the proceeds of such disinvestment.

5. India has signed the Multilateral Investment Guarantee Agency Protocol for the protection of foreign investors on 13 April 1992.

6. Provisions of the Foreign Exchange Regulation Act (FERA) have been liberalised as a result of which companies with more than 40 per cent of equity are also now treated at par with fully Indian-owned companies.

7. Foreign companies have been allowed to use their trade marks on domestic sales.

In January 1997, this limit was raised to 74 per cent in case of foreign investors and 100 per cent for NRIs.

As a consequence of the measures taken by the Government, during August 1991 and August 1998, the Govt, approved total foreign investment of the order of Rs. 1,73,510 crores about 137 times the Rs. 1,270 crores of foreign investment in the last decade (1981-1990). All these measures were taken to promote the inflow of foreign capital by offering a large number of concessions. This is in sharp contrast to the policy followed during the first four decades of planning. Obviously, this indicates that the Govt, has been quite successful in changing the climate for the entry of foreign investment.

The Foreign investment policy as amended upto 2002 has the following highlights.

1. Automatic clearance of foreign equity participation up to 51% in a wide range of industries, which is available till now is also available for even tiny units.

2. Investment above 51 per cent equity is also permitted on the basis of case by case approval by FIBS.

3. Foreign equity participation is allowed with or without foreign technology.

4. 24 per cent of foreign equity participation in Small Scale Industrial (SSI) units is allowed.

5. Foreign investment up to 51 per cent in trading companies engaged in export activities is allowed and such companies will be on par with domestic trading and export houses.

6. Reputed foreign pension fund companies are permitted to invest in equities of Indian companies.
7. Higher royalty payment of 8% in the case of export production is allowed.

8. Automatic approval for foreign technological agreements in high priority industries is given.

9. No permission is required for hiring of foreign technicians.

10. No restriction on repatriation of dividend profits etc.

NRI INVESTMENT POLICY

The highlights of the NRI investment policy as amended upto 2002 are as follows:

1. Equity investments in existing companies through stock exchange up to 25 per cent by the NRIs or their overseas corporate bodies.

2. NRIs and the OCBS can invest up to 100 % equity in high priority industries.

3. Investment in real estate/housing sector is permitted.

4. NRIs can import every six-months 5 kg of gold of nominal customs duty.

5. Exemption from income and wealth tax on investment in bank deposits.

The Secretariat for Industrial Assistance (SIA), the FIPB and CCFI have been playing a major role in promoting foreign capital flows into India. As mentioned earlier, up to Rs. 600 crores the Industry Ministry accords approval on the advice of Foreign Investment Promotion Board (FIPB), but larger projects over this limit are approved by Cabinet Committee on Foreign Investment(CCFI).

10.11 TIED AND UNTIED AID

Foreign investment in India may be either tied or untied one. An untied aid is a general purpose aid which is also known as non-project or programme aid. This kind of assistance is meant for meeting the overall needs of the development plans of the country rather than those of a particular project. For instance, India receives non-project aid from IMF, the UK and the Federal Republic of Germany in the form of balance of payments assistance. It could be used for the import of raw materials, components and spares. Generally, such aid is preferred by the developing countries as they are free to utilize the aid in accordance with their development programmes. Besides, such untied aid also reduces the real costs as the recipient country can buy its requirements at competitive rates from the world market without any inter bureaucratic frictions. Conversely, when the aid is tied-up to a project or source or both it is known as "tied aid". Aid tying is followed by the U.S., Britain and the Federal Republic of Germany. This type of aid tends to increase the costs of the projects by more than 30% to the recipient countries. Double tying by source also limits the choice of technology and will force the adoption of a highly capital intensive technique which may be inappropriate to a labour surplus economy like India. Often, excessive aid-tying to projects leads to the under-utilisations of domestic resources as it creates a bias towards import based projects.

10.12 GOVERNMENT POLICY ON FOREIGN CAPITAL

The Industrial Policy Resolution of 1948 and 1956 as well as the late Prime Minister Mr. Nehru's statement (April 1949) constitute the basis of the Government policy on foreign capital. These statements show that the following three important assurances were given to foreign investors :

1. India will not make any discrimination between foreign and local undertakings.
2. Subject to favourable foreign exchange position, reasonable facilities would be given to foreign investors for remittance of profits and repatriation of capital, and
3. In case of nationalization of the undertaking fair and equitable compensation would be paid to foreign investors.

The Government of India has recognized foreign capital as an important supplementary input to domestic investment in the development of the country/ The Government extended a number of tax concessions favouring foreign enterprises and simplified industrial licensing procedures to avoid delays in approving foreign collaborations. In 1961 the Indian Investment Centre was set up to bring Indian and foreign entrepreneurs together for identifying the areas of collaboration. In 1970 the Government of India allowed those industrial houses and subsidiaries of foreign companies to expand and diversify their production, which undertake specific export commitments. These relaxations created an atmosphere of suspicion in investment circles.

Therefore, during February 1972, the Government put forward a precise formula setting out the limits of participation by Indians in foreign subsidiary companies if they undertook plans of output expansion. Thus, companies with foreign holdings exceeding 75% would have to raise 40% of the estimated cost of expansion by the issue of additional equity to Indians. The corresponding proportion for companies with 60-70 percent under foreign ownership would be 33% and for those with 51-60 percent under foreign ownership 25%. Thus, the Government has to follow a policy of Indianisation of foreign subsidiary companies or to boost up exports through the agency of foreign firms. The latter course will lead to the expansion of the influence of foreign concerns which may prove dangerous. While liberalizing the conditions for foreign private investment, the Government should in no case allow subsusdiary companies which are neither willing to make a firm commitment to export promotion nor are prepared to accept the scheme of gradual Indianisation.

The Janata Government in 1977 laid down the following guidelines regarding foreign collaboration:

1. There should not be foreign collaboration in areas where adequate Indian skills and capital were available

2. Whenever the need for foreign collaboration is felt in areas of high priority, emphasis should be on the outright purchasing of technical know-how, technological skills and machinery. Further, it was emphasized that the provisions of FERA (Foreign Exchange Regulation Act) must be rigorously enforced in the consumer goods industries. The Government also felt it necessary that the production capacities of the foreign firms should also be frozen at the existing levels.

In July 1991, the Government has declared that opportunities for promoting foreign investment in India should be fully exploited. The Government has felt that the relationship between domestic and foreign industry needs to be much more dynamic than it has been in the past in terms of both technology and investment. In view of changing global industrial scenario the Government said that it would welcome foreign investment in India in the interest of country and industrial development.

In order to invite foreign investment in high priority industries, requiring large capital and advanced technology, it has been decided to provide approval for direct foreign investment upto 51% foreign equity in such industries.

The Government admits that the required marketing skills for the promotion of exports of Indian products is very much lacking. Highly professional marketing activities are very much in shortage in our country. Hence Government will encourage foreign trading companies to assist us in our export activities.

For this purpose it invites interaction and investment from the large international manufacturing and marketing firms.

To inject the desired lend of technological dynamism in Indian industry, Government will provide automatic approval for technology agreements to high priority industries within specified parameters. Similar facilities will be available for other industries as well if such agreements do not require foreign exchange. The Indian companies are free to negotiate the terms of technology transfer with their foreign counterparts.

The above discussion amply explain the liberal approach of the Government with regard to foreign investment and technology transfer. This policy is considerably different from the earlier foreign investment policy which was relatively restrictive and regulatory in nature.

10.13 GUIDELINES

You will appreciate the Government policy on foreign investment presently in force when you acquaint yourselves with the earlier rules (1975) and the present guidelines (1991) governing the foreign capital investment. Hence a brief outline of the guidelines since 1975 is given below.

(A) In April 1975 the Government of India issued the following guidelines with regard to the foreign investment:

1. Branches of foreign companies would be required to convert themselves into Indian companies as per the policy of the Government

2. Branches and companies engaged in manufacturing activities and which are predominantly export-oriented will be allowed to continue on the basis of existing approvals subject to Indian participation being not less than 26% of the equity of the company

3. Companies engaged in trading activities in India will be required to bring down their foreign share holding to the level of 40%. Therefore, it is obligatory for all branches of foreign companies operating in India and Indian Companies with 40% and above of foreign holding to obtain the permission of the RBI for continuing their business.

4. Companies carrying on activities given in Appendix-I of the Industrial Licensing Policy 1973 together with activities requiring sophisticated technology and exports accounting for not less than 75% of the total annual turnover will be allowed to continue their activities but they will have to increase Indian participation within a specified period to not less than 26% of the equity capital of the company.

5. If the exports of the companies mentioned above account for not less than 60% of the total annual turnover, it shall have Indian participation of not less than 49% of the equity of the company.

6. If the exports of a company account for more than 40% of the total annual turnover, it will be allowed to continue its activities subject to the condition that it will increase, within a specified period, Indian participation to not less than 49% of the equity of the company.

7. Companies coming with proposals for substantial exports could be considered on merits for higher level of foreign equity participation provided that such participation is in the overall interests of the economy.

B) The following are the foreign investment norms laid down by the Government of India in August-September 1991.

i) Direct foreign investment upto 51% will be allowed automatically in new industrial enterprises

ii) Higher equity on case by case basis will be allowed without any conditions. In power sector 100% equity investment will be permitted.

iii) Only 18 industries like coal, petroleum, Sugar, motor cars, drugs and pharmaceuticals are restricted from foreign investment.

iv) Automatic approval will be accorded to industrial units where costs of capital goods imports covered by equity is less than 25% of plant and machinery upto a ceiling of Rs.2crs.

v) Restrictions on FERA companies are lifted by repealing many of the provisions of FERA 1974. After going through the above guidelines, you can clearly understand that the Government is very much liberal in inviting foreign capital into India.

10.14 FOREIGN INVESTMENTS PROMOTION BOARD (FIPB)

Consequent upon the spirit of liberalization and deregulation of trade and foreign capital, the Union government has constituted a special empowered board to promote foreign investment, by negotiating with the interested large international firms to approve direct foreign investments in selected areas.

The objective of this Board is to invite and for investments in India by international companies in projects which are considered to be beneficial for the economy. The functions of the board include expeditious clearance of proposals , establishment of contact by inviting selected international companies to invest in India in appropriate ventures and to periodically review the implementation of the projects cleared by it.

The programme of investments includes a variety of activities such as ; manufacturing , marketing , designing and export promotion, energy conservation, technological upgradation and modernization, infrastructure development; better utilization of raw-materials and natural resources and substantial increase in employment.

The board is headed by principal secretary to the prime Minister. Other members of the board include the Finance secretary , commerce secretary and secretary, Industrial development. This board is expected to cause an improvement in the foreign investment.

10.15 IMPACT OF FOREIGN INVESTMENT ON ECONOMIC DEVELOPMENT

As pointed out earlier the foreign aid is meant to (a) supplement domestic savings, (b) make available additional supplies of foreign exchange and (c) facilitate transfer of technology from advanced countries.

The extend to which foreign aid can contribute to the development of the productive capacity of the country depends on the judicious use of foreign aid, the efforts and the total disposable resources of the recipient country. Foreign aid created growth potential far beyond the original capacity of the recipient country. Foreign aid will have its impact on various aspects of the economy. For example, the import of capital goods from foreign countries may release non-aid resources for increasing the current consumption and aid in respect of consumer goods, and may help release domestic resources for capital formation. Therefore, it is difficult to assess the impact of aid precisely. However, a brief idea about the impact of foreign investment is present for your comprehension.

The rate of investment in India has substantially increased over the years on account of increased foreign capital. Of the total aid authorized and utilized, a little less than half represents in kind or commodity. A major part of the imported resources has been utilized to stabilize the food grain prices.

External assistance has contributed to the expansion of the productive capacity of agriculture in a big way by enlarging the irrigation potential of the country. In the fields of dairy and fishery, foreign aid has helped to modernize the technique of production. Foreign aid helped to enlarge the power potential of the country.

A small portion of foreign investment was used in the development of transport including railways. In the earlier period, foreign aid played a vital role in rehabilitating the railways which was over used during the second World War.

In the setting up of the steel industry, the foreign aid from the UK, the USSR and West Germany was significant. The production of steel has increased substantially because of huge foreign investment. It is to be noted that steel is a basic input for rapid industrialization. Apart from what is mentioned above the foreign investment in India has improved the country's technical resource base. Technical know-how, development of native personnel and increase educational and research facilities have contributed to the development of technical skills in the country.

The outstanding foreign investment policy aims at achieving equilibrium in foreign exchange reserves, promotion of consumer industries, increasing foreign trade and marketing activities.

10.16 SUMMING UP

Almost all developed countries have at one stage or other depended on foreign capital and technology for rapid industrialization. Foreign capital may mean the investment made by a foreign country in another country which is not under its control. Foreign capital may be in the form of equity capital, loan grant etc. Foreign collaboration means facilities provided by the foreign partner as technical services, licences, franchise etc. The need for foreign capital arise on account of savings gap, trade gap and technology gap.

Role of foreign capital economic development is to attain higher rate of economic growth without losing the present rate of consumption. Foreign investment may be either in the form of I) private foreign capital or ii) public foreign capital iii) foreign collaboration and iv) grants.

It is to be noted that foreign capital and foreign collaboration, though inter-dependent, are not one and the same. Although there are many advantages of foreign capital, it causes a surrender of ones' sovereignity and economic independence. The role and quantum of foreign capital increased much from 1923 with the adoption of policy of protection.

The sources of foreign capital in the context India are capitalist, socialist and international institutions, foreign collaboration, NRI investment and multinational companies, India has also availed tied up and untied aids from various countries. Government policy on foreign investment was selective, restrictive and choosy in the earlier years of independence but since 1991, there has been much change in the attitude of the Union Government with regard to foreign investment. The Government has relaxed the rules and committed to the policy of attracting foreign capital into India.

The Union Government has setup Foreign Investment Promotion Board to pursue the liberal policy and to keep a constant contact with foreign governments and entrepreneurs for capital investment. This Board helps in the promotion of foreign investment, technology transfer and marketing of Indian products in foreign countries.

10.17 CHECK YOUR PROGRESS : MODEL ANSWERS

1. (i) Foreign capital is the investment made by a foreign country in another country which is not under the political control of aid giving country.

2 (i) Private capital investment
Public capital investments
Collaborations
Grants.

(ii) Export and import of goods between two countries is called foreign trade.

10.18 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in about 30 lines each.

1. What are the different types of foreign capital? Explain.
2. Why is foreign capital essential for foreign trade?
3. What is the necessity of foreign capital in less developed countries?
4. What are the various sources of foreign capital for India? Explain.
5. Explain the Government policy towards foreign capital in India.
6. What is the impact of foreign capital on economic development of India? Explain.

II. Answer the following questions in about 15 lines each.

7. Distinguish between direct and indirect foreign investment.
8. Explain the difference between tied and untied loans.
9. Explain the concept of "bilateral agreement".
10. What is the role of foreign capital in economic development?
11. Explain the disadvantages of foreign capital.
12. Explain the need for foreign capital in under-developed countries like India.
13. Explain the essential aspects of the foreign investment policy of 1991.
14. What are the recent guidelines given by the Government for foreign investment in India?
15. What is the role of foreign capital in the planned economic development of India ?

10.19 RECOMMENDED BOOKS

Eugene F. Brigham : **Fundamentals of Financial Management,** The Dryden Press, 383 Madison Avenue New York.

mes C. Van Horne : **Fundamentals of Financial Management,** Prentice Hall of India Pvt. Ltd. New Delhi.

10.20 GLOSSARY

Bilateral loans : The loans which are given by the foreign government directly to the government of the aid receiving country.

Foreign capital : The investment made by a foreign company in another country which is not under its political governance.

Foreign collaboration : The participation of foreign capital with domestic capital in the establishment of industrial and business organizations is known as foreign collaboration.

Indianization : The process of diluting foreign capital.

Multilateral loans : The contributions of foreign Governments to international agencies for assisting the under-developed countries.

Rentier investment : It is the indirect foreign investment which is a form of private foreign capital.

Tied aid : The aid given for a particular project.

Untied aid : The aid given for general purpose, which is also known as non-project or programme aid.

BLOCK – III

FINANCIAL INSTITUTIONS

liberated underdeveloped countries in Asia, Africa and Latin America took steps to solve their chronic problems of squalor and poverty. In one such step was to step up the tempo of industrialisation by establishing special financial institutions to supply the basic ingredients of development, viz., capital, knowledge, and entrepreneurship. These special financial institutions are called Development Banks.

William Diamond defines Development Bank as "an institution concerned primarily with long-term loan capital and a development corporation which is concerned primarily with equity capital and with fostering and managing specific companies as well as providing financial support".

The concept of Development bank is based on the assumption that mere provision of finance will not help to bring about entrepreneurial development. Successful entrepreneurial banking should include the indentification of promising investment projects, undertaking the preparation of project report, provision of technical advice and management services, and finally assisting the management of industrial units. Thus, Development banks are the financial agencies engaged in providing medium and long-term assistance to business undertakings in the form of loans, underwriting and investment. In doing so, they serve as catalistic agents in promoting a balanced and viable process of development and may on occasions establish and manage industrial units.

11.2 NEED FOR ESTABLISHMENT OF DEVELOPMENT BANKS

The following are the reasons for establishment of Development Banks:

I. **Lack of Capital**: Most of the underdeveloped and developing economies have been unable to mobilise enough financial resources for the development of their industrial enterprises. The private enterprises requiring periods of long gestation and or big investments trade Development Corporations above would be able to supply the requisite financial assistance and so are indispensable for the economic advancement of these countries.

II. **Low Capital Formation**: In developing countries, the rate of capital formation is low, and in Consequence the rate of savings is also low. The development corporations help the economy by finding the gap between savings and investment.

III. **Ill-Organised Capital Market**: The capital markets in most of these countries are inactive and ill-organised. Apart from financing business enterprises the development corporations activise the capital market by facilitating the marketing of corporate securities either by underwriting the various issues or by creating a constant demand for them.

IV. **Planned Economy**: After the Second World War, almost all countries have opted for planned development of their economics for the proper utilisation of the scarce resources, for achieving the balanced regional development, etc. The special financial corporations play an important role in the planned development of a country. They divert resources to the projects of national importance and utilise scarce financial resources of the country in a planned way.

V. **Development of Small-scale Industries:** The small-scale industries play an important role in the economic development of a country. The problems relating to the financing of small business are of a special character which can be tackled satisfactorily only by institutions organised specially for this purpose. Most of the developed and developing countries have in the recent past established special financial corporations for financin small-scale industries exclusively.

VI. **Provision of Long-term Finance:** The commercial banks which have been an important source of industrial finance in many countries have not been helpful in providing long-term finance. The special financial corporations have been established mainly to provide medium and long-term finance to the industries.

CHECK YOUR PROGRESS - 1

1. List out the reasons for establishment of development banks.

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11.3 OBJECTIVES OF DEVELOPMENT BANKS

The principal objective of development banks is to act as a catalyst for industrial development in a country. In underdeveloped and developing economies which are hadicaped by not only scarcity of capital but also dearth of entrepreneurial talent. The development banks do not restrict their activities to the conventional function of providing term-capital to entrepreneurs. They even assume a promotional role by undertaking industrial surveys, identifying growth projects, and the preparing of feasibility studies, conducting industrial performance, etc.

The development banks have to adapt their lending and investment strategy and activities towards the realisation of the national objectives. They have to define their objectives within the scope of their statute in such a manner as to serve national objectives. The following are some of the objectives of the development banks:

(i) providing finance to medium and large industries
(ii) financing small-scale industries
(iii) achieving balanced regional development
(iv) promoting export and import substitution
(v) providing technical know-how; and
(vi) monitoring sick industrial units

11.4 FUNCTIONS OF DEVELOPMENT BANKS

The following are the functions of development banks.

I. **Sanction of Loans:** The most important function of the development banks is to provide long-term and medium-term loans to industrial concerns. Loans are provided by certain development banks in both local and foreign currencies.

II. **Underwriting:** Another important function of development banks is to underwrite the issue of shares, bonds or debentures by industrial concerns. Almost all such institutions undertake the function of underwriting.

III. **Guarantee of Loans:** Most of the development banks assist industrial concerns by providing guarantees of various types, e.g., guarantees on behalf of the industrial concerns in respect of (a) the loans raised by them in the open market or from local/foreign financial institutions, (b) the deferred payments due from such concerns arising out of the domestic purchase or import of capital goods, (c) the issue of clients, securities etc.

IV. **Subscribing to the shares and debentures:** In addition to underwriting, the development banks also directly invest by subscribing to the shares and debentures of industrial concerns.

V. **Developmental Functions:** The other type of functions of development banks are called developmental functions. These functions include the promotion of new industries, provision of technical, managerial and administrative advice and the conducting of techno-economic, market and investment surveys.

CHECK YOUR PROGRESS - 2

What are the functions of Development Banks?

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11.5 MANAGERIAL PATTERN

The Managerial pattern of the development banks normally depends upon the role of different agencies in their formation, financing and operation. The development banks on the basis of ownership can be classified into three types, viz., wholly State-owned, wholly private-owned, partly State-Owned and partly private-owned. The Government, the Central Bank and the local and foreign shareholders all nominate their representatives to serve on the Board of Directors of the Development Banks.

With increasing globalisation and blurring of the distinction between different segments of financial intermediaries, FIs and banks are developing sound and prudent financial practices for financial stability. The Committee on Banking Sector Reforms, popularly known as the Narasimham Committee-II, made a number of recommendations to streamline and strengthen Indian banking system. The Committee also recommended that Development Financial Institutions (DFIs), over a period of time, should convert themselves into banks and be subjected to the same discipline of regulatory and prudential norms as applicable to the commercial banks. Envisaging that there will be only two types of financial intermediaries in future, viz., commercial banks and non-banking finance companies, the Committee suggested that those DFIs, which do not become banks, would be categorised as NBFCs. The Committee further recommended mergers between banks and DFIs based on synergies, locational and business specific complements. The RBI has issued guidelines for DFIs to become commercial banks and these guidelines are same as for commercial banks under Banking Regulation Act. Presently, quite a few financial players which are in various businesses, qualify for universal banking. But due to regulatory restrictions, they followed the subsidiary route to provide all services. ICICI has announced to become a universal commercial bank by proposing a reverse merger with its subsidiary ICICI Bank. IDBI is actively considering different options to transform itself into universal banking. These developments are set to change the face of development banking as practiced in the past.

11.6 GROWTH OF DEVELOPMENT BANKING IN INDIA

The need for development banks was very strongly felt in the country immediately after independence to meet the inadequate of the capital market, which was ill-equipped to meet the needs of long-term finance. The commercial banks in India, patterned on the British model of banking, have traditionally confined themselves to the provision of short-term financial requirements of trade and industry. The managing agency houses which served as ar important adjunct is the capital market were found insufficient to cope with the requirements of the planned industrial development. There was also dearth of issue houses, and underwriting firms which sponsor security issues in the market. On the other hand, there was a manifold increase in the demand for long-term capital for their reconstruction, modernization, expansion and diversification requirements. The establishment of new industrial projects on gigantic scale called for the provisions of crores of rupees on a long-term credit basis.

Establishment of Industrial Finance Corporation of India: The first step towards the building up of a structure of development finance was taken with the establishment of Industrial Financial Corporation of India (IFCI) in 1948 for providing medium and long-term credit to the units in the corporate sector and industrial co-operatives. Soon after, it was felt necessary to supplement the effects of the IFCI with those of a set of regional development banks called the State Financial Corporations' (SFCs) primarily meant for meeting the term-loan requirements of the small and medium scale industry. So far 18 SFCs have been established in different states.

Another type of state level institution, viz., the State Industrial Development Corporations (SIDCs) were established in most of the states in the sixties for promoting the medium scale industrial units. The SIDCs which are owned by the state Governments have promoted a number of projects in the joint sector and 'assisted' sector and also set up some industrial units as fully-owned subsidiaries. The State Small Industries Development Corporations (SSIDCs) were established for catering to the requirements of the small industry at the state level by setting up and managing industrial estates, providing supply of raw materials, running of common service facilities and supplying machinery on hire purchase.

The Industrial Credit and Investment Corporation of India Limited (ICICI) was established in 1955 as a public limited company primarily to finance the foreign exchange components of industrial projects. The world Bank played an important role in its establishment. At the same time, the National Small Industries Corporation Limited (NSIC) was established to assist small-scale industry through promotional, marketing, financing and other support activities. Its major activity now is to supply machinery to small-scale units on hire-purchase basis. Consequent to the notionalisation of the life insurance business, the Life Insurance Corporation (LIC) was created in 1956 and it was also assigned, as part of its business, role of providing industrial finance through the underwriting, and direct purchase of industrial shares, bonds and debentures.

Establishment of Industrial Development Bank of India: The Industrial Development Bank (IDBI) was established on the 1st of July, 1964, as part of reorganised and integrated structure of industrial financing institutions in the country. The main object was to set up an apex institution to co-ordinate the activities of other financial institutions including banks, and to provide term-finance to industry as well direct financial assistance to industrial units to bridge the gap between the supply of and demand for medium and long-term finance.

As a development agency, the IDBI was also required to undertake market and investment research and surveys as also 'techno-economic studies in connection with development industry, provide technical and administrative assistance for promotion and management of expansion of industry, and plan, promote and develop industries to fill vital gaps in the industrial structure.

Other Financial Institutions: The Unit Trust of India (UTI) was established in 1964, Life Insurance Corporation (LIC) in 1956 and General Insurance Corporation of India (GIC) in 1973. These special financial institutions work closely with other all-India financial institutions to meet the financial requirement of the industrial sector. In 1971, the Industrial Reconstruction Corporation of India Limited (IRCI) was set up for the rehabilitation of sick units. In January 1982, it was converted into the Industrial Reconstruction Bank of India. In January 1982, the Export-Import Bank of India (Exim Bank) was set up and the export finance operations of IDBI were transferred to that bank with effect from March 1, 1982. It provides financial assistance to exporters and importers and functions as the principal financial institution for co-ordinating the working of the institutions/banks engaged in financing exports and imports.

Further, with a view to strengthening the institutional network catering to the credit needs of the agricultural and rural sectors, the National Bank for Agriculture and Rural Development (NABARD) was set up in July 1982. NABARD is responsible for short-term, medium-term and long-term financing of agricultural and allied activities and overseeing the rural credit system.

11.7 WORKING OF DEVELOPMENT BANKS IN INDIA

During the last three decades, the term lending institutions operating at the national and regional levels have emerged as a significant source of long-term finance in India. The aggregate sanctions and disbursements made by the development banks in India can be seen from Table 1. It can be seen from the Table that the aggregate assistance sanctioned by these development banks has shown a steady increase over the years. During 1980-81, the total sanctions stood at Rs.29,269 million. The same have increased to Rs.12,93,377 million by 2000-01, whereas disbursements have grown from Rs.18,479 million to Rs.810,470 million during the same period.

ASSISTANCE SANCTIONED AND DISBURSED BY ALL FINANCIAL INSTITUTIONS (AFIs)

(Rs. million)

Year	Sanctions	Growth rate (%)	Disbursements	Growth rate (%)
1980-81	29269.0		18479.0	
1981-82	32774.0	12.0	23520.0	27.3
1982-83	33585.0	2.5	24684.0	4.9
1983-84	41664.0	24.1	31384.0	27.1
1984-85	55487.0	33.2	36177.0	15.3
1985-86	65291.0	17.7	49400.0	36.6
1986-87	81184.0	24.3	57091.0	15.6
1987-88	95545.0	17.7	70610.0	23.7
1988-89	112867.0	18.1	77008.0	9.1
1989-90	144593.0	28.1	96397.0	25.2
1990-91	191961.0	32.8	128101.0	32.9
1991-92	223148.0	16.2	162729.0	27.0
1992-93	331933.0	48.8	231525.0	42.3
1993-94	409870.0	23.5	266243.0	15.0
1994-95	578324.0	41.1	335772.0	26.1
1995-96	599363.6	3.6	386979.7	15.3
1996-97	520336.2	-13.2	450205.8	16.3
1997-98	764273.3	46.9	558651.3	24.1
1998-99	859095.5	12.4	612629.4	9.7
1999-2000	1086881.2	26.5	729416.7	19.1
2000-01	1293377.9	19.0	810470.3	11.1
Cumulative Total upto end of March 2001	7729037.1		5434527.5	

11.8 CO-ORDINATION AMONG DEVELOPMENT BANKS

At present, the country is served by over 60 development financing institutions in the field of industrial finance. The IDBI co-ordinates the activities of these institutions at the national and state levels. At the national level, the IDBI maintains close working relationships with other financial institutions in all matters relating to policy formulation, procedural improvements, project appraisal and follow-up. Such co-ordination is ensured primarily through the forum of Inter-Institutional Meetings (IIMs) and Senior Executive Meetings (SEMs). IIMs are held once a month where the chief executives of all-India institutions discuss common policy matters and other issues of mutual concern and also issues concerning specific projects. At SEMs which are normally held twice a month, senior executives of all-India institutions appoint 'lead' institutions for processing the proposals and consider issues concerning policy matters and specific projects.

Similar to these, the State Level Institutions are evolving a common application form, common appraisal procedures, and the concept of lead institution wherever more than one institution is involved. The IDBI, which extends refinance to the SFCs, and SIDCs has representation on the Board of Directors of these institutions. The IDBI also arranges special training courses for the officers of these institutions.

11.9 FUTURE OF DEVELOPMENT BANKING IN INDIA

Over the years, the Development Banks have come to occupy a place of importance in the planning and promotion of industries in the country. Responding to the emerging requirements of industrial and economic growth, they have not only continuously increased the flow of assistance, but also developed a co-ordinated approach towards industrial financing. Within a span of 35 years or so, a wide network of Development Banks have been established some of which have specialised in specific areas of development finance, at the same time, all these institutions have introduced important organisational changes including decentralisation and delegation of powers to their branch offices. Lending procedures have undergone changes in response to emerging requirements. As a result, the process of appraisal of project finance proposals as also the sanctioning and disbursal of assistance has become considerably simpler and quicker. Simultaneously, consistant with their role as a catalyst in economic development, the financial institutions have been continuously enlarging the scope of their operations from providing financial assistance to identification of industrial opportunities, training of entrepreneurs provision of techno-economic consultency facilities, industrial research and other promotional activities.

The participation and involvement of these banks in the process of economic development can be expected to grow with in years to come as they intensify their efforts at the development of entrepreneurs, backward areas, small industries and export-oriented units as also the upgrading of technology in traditional sectors. The tasks ahead are varied and challenging. Newer demands may not only call for a substantial increase in resource mobilisation efforts to keep pace with the growth of the volume of financial assistance but also the re-orienting of the policies and priorities for allocation of assistance. Equally important will be the demand for the multifarious promotional and developmental activities.

11.10 INDUSTRIAL FINANCE CORPORATION OF INDIA (IFCI)

With the end of the Second World War, the urge to speed up industrial expansion was great. At the same time, the need for modernisation and replacement of obsolete machinery in ready established industries was keenly felt. The agencies existing at that time were unable provide the long-term finance required by the industries. Hence, the Government of India came forward and set up the IFCI in July, 1948 through a special Act of the Parliament. With a view to impart greater operational flexibility as also to enhance its ability to respond to the needs of the changing financial system, IFCI was incorporated as a company in May 1993. Thus it became IFCI Ltd., now.

Objective: The main object of establishing this corporation is to provide medium and long-term credit to large industrial concerns in India. The financing operations of IFCI include project financing, financial services and corporate advisory services. The financial assistance is provided by way of rupee and foreign currency loans, underwriting/direct subscription to shares and debentures, guarantees, equipment finance, equipment leasing, suppliers'/buyers' credit, finance to leasing and hire-purchase companies, corporate loans, short-term loans and working capital loans. Over the years, IFCI has set up several subsidiaries/associate companies in the financial sector offering custodial and investor services, rating and venture capital services.

Resources: The authorised capital of the IFCI is Rs.500 million which may be raised to a maximum of Rs.1000 million or any other amount as fixed by the Government of India from time to time. By the end of March 31, 2001, the paid-up share capital of the IFCI stood at Rs.198,795 million and Reserves to the extent of Rs.5051.4 million. Apart from the paid-up capital, reserves built-up out of profits constitute an important source of funds. The major source of rupee funds of the IFCI's operations has been market borrowings by way of bond issues which carry the Government of India's guarantee with regard to their repayment and payment of interest thereon. The borrowings from RBI and other agencies stood at Rs.199,668 million.

Management and Organisation: The general supervision and direction of the affairs and business of the IFCI are vested in a Board of Directors consisting of a Chairman and Managing Directors appointed by the Government of India in consultation with the IDBI, and 12 Directors. Four of the 12 directors are appointed by IDBI, 2 by the Government of India, and 2 each elected by commercial banks, co-operative banks and other shareholders.

Functions: The functions of the IFCI may be divided into: (i) provision of financial assistance, and (ii) promotional activities.

i) **Provision of Financial Assistance:** The corporation has been authorised to carry on and transact the following kinds of business:

   a) Sanction of rupee Loans;

   b) Sanction of sub-loans; in foreign currencies out of the foreign exchange lines of credit made available to it;

   c) Underwriting of and/or Direct subscription to the shares and debentures of public limited companies; and

   d) Guaranteeing of:-

      a) deferred payment for machinery imported from abroad or purchased within the country;

      b) foreign currency loans raised by industrial concerns from foreign institutions; and

      c) rupee loans raised by industrial concerns from Scheduled Banks or State Co-operative Banks or the public market.

ii) **Promotional Activities:** The IFCI has been undertaking various promotional activities financed out of its benevolent Reserve Fund and allocations of Interest Differential Funds received from the Government. The corporation has been emphasizing of small and medium scale industrial entrepreneurs by providing them with the needed guidance through its recently set up specialised agencies engaged in product identification, formulation implementation, development of ancillary and small-scale industries, an encouraging the adoption of indigenous technology etc.

Working of the Corporation: The IFCI completed 54 years by 2002. During this period, the corporation as a pioneer in the field of long-term industrial financing played an effective role. The loans sanctioned and the disbursements made during this period set forth in Table 2. By the end of March 2001, the cumulative sanctions and disbursements aggregated to Rs. 4,35,670 million and Rs.4,12,840 million respectively. Assistance outstanding amounted to Rs.2,23,386 million.

The assistance given by the IFCI in the early years after its establishment was conferred to traditional industries Sugar, Textiles, Jute etc. But subsequently in pursuance of the national priorities and objectives, the IFCI has extended considerable assistance in recent years to non-traditional industries like basic metals, fertilisers, chemicals, and a wide range of engineering industries. As a matter of policy, the IFCI has been paying particular attention to projects promoted by new entrepreneurs/ technician entrepreneurs with a view to enlarging the entrepreneurial base of the country.

Amendments to the IFCI Act, 1948: The IFCI Act was amended by the enactment of 'Industrial Finance Corporation (Amendment) Act of 1982 has considerably enlarged the scope and coverage of IFCI's operations with a view to meeting the rapidly growing requirements of the industry. The IFCI by virtue of the amendment has also been authorised for carrying out certain incidental activities such as:

a) The undertaking of research and surveys for evaluating or dealing with marketing or investment and techno-economic studies in connection with the development industry;

b) To providing of technical and administrative assistance to any industrial concern for the promotion, management or expansion of any industry; and

c) The undertaking of Merchant Banking operations.

The Amendment Act of 1982 has increased the authorised capital of the IFCI from Rs.200 million to an amount not exceeding Rs.1000 million or as may be fixed by the Central Government from time to time. The Act has also removed limitations on the borrowing of the IFCI. The enlarged scope and extension of activities also enable the IFCI to participate in most of the activities which IDBI, as an apex institution, is authorised to undertake.

ASSISTANCE SANCTIONED AND DISBURSED BY I.F.C.I.

(Rs. million)

Year	Sanctions	Disbursements	Disbursements as % of sanctions
1964-65	30.36	28.27	93.1
1965-66	33.98	44.28	130.3
1966-67	23.11	40.35	174.6
1967-68	18.40	32.14	174.7
1968-69	21.00	21.25	101.2
1969-70	17.03	18.06	106.0
1970-71	323.0	174.0	53.8
1971-72	287.0	233.0	81.2
1972-73	457.0	280.0	61.3
1973-74	419.0	319.0	76.1
1974-75	292.0	370.0	126.7
1975-76	513.0	347.0	67.6
1976-77	766.0	549.0	71.7
1977-78	1134.0	575.0	50.7
1978-79	1385.0	735.0	53.0
1979-80	1379.0	910.0	65.9
1980-81	2066.0	1089.0	52.7
1981-82	2181.0	1694.0	77.6
1982-83	2302.0	1961.0	85.2
1983-84	3219.0	2245.0	69.7
1984-85	4154.0	2729.0	65.7
1985-86	4992.0	4039.0	80.9
1986-87	7981.0	4516.0	56.6
1987-88	9226.0	6571.0	71.2
1988-89	16355.0	9975.0	60.9
1989-90	18170.0	11218.0	61.2
1990-91	24298.0	15743.0	64.5
1991-92	24212.0	16044.0	66.3
1992-93	23479.0	17334.0	73.8
1993-94	37459.0	21631.0	57.7
1994-95	43270.0	28387.0	65.6
1995-96	65797.1	45865.2	69.7
1996-97	39522.3	51755.3	130.9
1997-98	57215.3	56531.7	98.8
1998-99	38721.1	48935.1	126.4
1999-2000	21392.0	33312.7	155.7
2000-01	18664.1	21289.0	114.1
Cumulative upto end-March 2001	435669.8	412839.8	94.7

11.11 INDUSTRIAL CREDIT AND INVESTMENT CORPORATION OF INDIA (ICICI)

The Industrial Credit and Investment Corporation of India (ICICI) was set up in 1955 to encourage and assist industrial development and investment in India. This is a privately owned and operated corporation. The World Bank played an important role in its formation. ICICI continues to play a facilitating role in the ongoing phase of consolidation in various sectors of the Indian economy, by funding mergers and acquisitions. ICICI expanded the scope of its corporate finance business by introducing long-term financing for captive/sole suppliers of large companies, where the financing was made contract-centric rather than client-centric. Channel financing was significantly broadened to tap the vendor segment as well. ICICI also executed securitisation deals in respect of new asset classes, including student fees receivables, road toll receivables, employee loans and license fee receivables.

Objectives: The objectives of the Corporation are:

i) to provide assistance for the creation, expansion and modernisation of industrial enterprises;

ii) to encourage and promote the participation of private capital both internal and external, in such enterprises; and

iii) to encourage and promote industrial investment and the expansion of investment markets.

Resources: The authorised capital of ICICI is Rs.500 million of which Rs.50 million in ordinary shares was originally issued and paid up. It augmented its issued capital of ICICI as at December 31, 1983 was Rs.270 million, in which the foreign shareholding is about 13%. The paid-up capital of the corporation now stands at Rs.11,348 million.

Borrowings constitute a major source from which the ICICI raised its funds. Its borrowings included those from the Government of India, the World Bank, the Development Loan Fund (now merged with the agency for International Development) Kreditanstaltfur-Wiederaufbau (an agency of the Government and of Federal Republic of Germany), the British Government and Industrial Development Bank of India. The total borrowings came to Rs.530,171 million by March 31, 2001.

Types of Financial Assistance: The following are the various types of financial assistance available from ICICI.

a) The underwriting of public and private issues and offers of sale of industrial securities-ordinary shares, preference shares, bonds and debentures stock;

b) Direct subscription to such securities;

c) The securing of loans in rupees repayable over periods extending to 15 years;

d) Provision of similar loans in foreign currencies for payment of imported capital equipment and technical services;

e) The guaranteeing of payments for credits made by others; and

f) Provision of credit facilities to manufacturers for promoting the sale of industrial equipment on deferred payment terms.

Working of the Corporation: The corporation has completed 47 years by 2002. The ICICI is the only institution of its kind which specialises in securing assistance for Indian securities from foreign countries. The sanctions and disbursements of the ICICI have been progressively increasing. The corporation has been helping in a significant way the setting up of industries in the private sector.

Table-3 presents the data relating to the sanctions and disbursements of loans of the ICICI. It can be seen from the table that the assistance sanctioned and disbursed by ICICI during 2000-01 increased by 28.9% and 23.7% to Rs.5,60,920 million and rs.3,19,646 million, respectively as against the growth rates in sanctions and disbursements of 34.5% and 34.4% in 1999-2000. Upto end-March 2001, ICICI sanctioned and disbursed Rs.24,75,585 million and Rs.14,61,672 million, respectively. Assistance outstanding, amounting to Rs.6,37,869 million as on march 31, 2001, grew by 16.9% as compared to a growth of 15.9% in 1999-2000.

The analysis of the sector-wise assistance of the corporation shows that the private sector received 86% of the assistance as against 9% to the joint sector, 3% to co-operative sector and 2% to the public sector. The industry-wise classification of assistance shows that machinery, textiles, chemicals and cement industries received a relatively larger share of the ICICI's assistance. The region-wise classification shows that the corporation sanctioned and disbursed nearly 70% of loans of assistance to the Western and Southern regions in India.

11.12 INDUSTRIAL DEVELOPMENT BANK OF INDIA (IDBI)

The IDBI was established on 1 July, 1964 under the IDBI Act, 1964, as a wholly-owned subsidiary of the Reserve Bank of India. The ownership of the IDBI has been transferred to the Central Government with effect from February 6, 1976. In pursuance to the amendment in the IDBI Act in 1994 enabling the Bank to raise equity from the public, the Government's holding was reduced to 72.14% in 1995 with IDBI having made its first public offering of equity. During 2000-01, under a capital-restructuring plan aiming at enhancing the shareholders' value, the Government's stake has further been reduced to 58.47%.

Objectives: The main objective of the IDBI is to bring into existance an apex institution to co-ordinate the activities of other financial institutions including banks, to provide term-finance to industry as well as direct financial assistance to industrial units to bridge the gap between the supply and demand for medium and long-term finance. The Bank has been assigned a special role in the matter of planning, promoting and

ASSISTANCE SANCTIONED & DISBURSED BY I.C.I.C.I.

(Rs. million)

Year	Sanctions	Growth rate %	Disbursements	Growth rate %
1970-71	439.0	--	289.0	--
1971-72	397.0	-9.6	303.0	4.8
1972-73	494.0	24.4	397.0	31.0
1973-74	611.0	23.7	435.0	9.6
1974-75	629.0	2.9	454.0	4.4
1975-76	786.0	25.0	611.0	34.6
1976-77	987.0	25.6	673.0	10.1
1977-78	1083.0	9.7	916.0	36.1
1978-79	1828.0	68.8	1092.0	19.2
1979-80	2043.0	11.8	1358.0	24.4
1980-81	3141.0	53.7	1853.0	36.5
1981-82	3024.0	-3.7	2647.0	42.8
1982-83	3921.0	29.7	2822.0	6.6
1983-84	5076.0	29.5	3342.0	18.4
1984-85	6207.0	22.3	3927.0	17.5
1985-86	7082.0	14.1	4822.0	22.8
1986-87	11183.0	57.9	6955.0	44.2

1987-88	12317.0	10.1	7712.0	10.9
1988-89	19781.0	60.6	10856.0	40.8
1989-90	28506.0	44.1	13571.0	25.0
1990-91	37440.0	31.3	19675.0	45.0
1991-92	40949.0	9.4	23513.0	19.5
1992-93	57718.0	41.0	33152.0	41.0
1993-94	84914.0	47.1	44133.0	33.1
1994-95	145279.0	71.1	68793.0	55.9
1995-96	145948.5	0.5	71204.0	3.5
1996-97	140837.6	-3.5	111808.0	57.0
1997-98	247174.7	75.5	158069.2	41.4
1998-99	323705.8	31.0	192250.6	21.6
1999-2000	435227.8	34.5	258357.3	34.4
2000-01	560920.4	28.9	319645.5	23.7
Cumulative upto end-March 2001	2475584.5	--	1461672.3	--

developing industries and undertaking market and investment research and surveys. The bank is also expected to co-ordinate guide and monitor the entire range of credit facilities offered by the other financial institutions for the small and cottage sectors. Besides, until recently the Bank has functioned as the Export-Import bank of the country.

Resources: The authorised capital of the Bank is Rs.4000 million. At the end of March 2001, the paid-up capital come to be Rs.6,528 million. During 2000-01, IDBI mobilised Rs.88,419 million (Rs.91,870 million) by way of rupee and FC borrowings. Rupee resources aggregating Rs.78,168 million comprised Omni Bonds-on tap (Rs.31,220 million), Omni-private placement (Rs. 11,978 million), certificate of deposit (Rs.15,417 million), flexi bonds series 9 and 10 (Rs. 11,610 million), fixed deposits (Rs.1,473 million), capital gains bonds (Rs.1,035 million), term money bonds (Rs.136 million) and ICDs (Rs.5,299 million). Rupee resources raised during 2000-01 were less by 8% as compared to previous year (Rs.85,000 million). The incremental cost of rupee borrowings declined from 12.14% in 1999-2000 to 11.21% in 2000-01 due to declining interest rate regime as also the lower maturity profile of funds raised. IDBI borrowed in the short-term segment through ICDs to take advantage of softer interest rates and to maintain a more balanced asset liability portfolio. FC borrowings including drawals under existing Lines of Credit aggregated Rs.10,250 million (Rs. 6,870 million). During 2000-01, IDBI contracted FC borrowings through Floating Rate Note and syndicated loan with Standard Chartered Bank, Tokyo, Mitsubishi International Ltd., and Sumitomo Bank, Japan.

Management and Organisation: The management of the IDBI is vested in a Board of Directors consisting of 22 persons including a fulltime Chairman-cum-Managing Director appointed by the Central Government. The other Board members comprise a representative of the Reserve Bank of India, 2 officials of the Central Government, a representative each of the all-India financial institutions, 3 representatives each of the public sector banks and SFCs and 5 persons with special knowledge and professional experience of industry. The Board has constituted an Executive Committee consisting of ten directors including the Chairman and Managing Director. The Board of Directors deals with the overall policy matters and the Executive Committee with proposals for the sanctions of financial assistance and other matters.

Functions: The following are the functions of IDBI:

1. **Direct Assistances to Industries:** The IDBI gives direct assistance by way of term-loans, subscriptions to or underwriting of issues of shares or debentures and guarantees.

2. **Refinance of Industrial Loans Scheme**: The Bank refinances the term-loans sanctioned by special financial institutions, viz., IFCI, SFCs, SIDCs etc.

3. **Soft-Loans Scheme**: Under this scheme, the IDBI extends soft-loans to units in selected industry groups, to enable them to overcome the backlog in modernisation, replacement and renovation of plant and machinery. The loans under this scheme are given on concessional terms.

4. **Bills Rediscounting Scheme**: The IDBI rediscounts bills or promissory notes arising out of sales of indigenous machinery on deferred payment basis.

5. **Other Scheme**: The other schemes of the IDBI include the Technical Development Funds Scheme, the Seed-Capital Assistance Scheme, the Technical Assistance Fund, etc.

6. **Promotional Activities**: In addition to these activities mentioned above, the IDBI also undertakes promotional activities. It has completed industrial potential surveys of 19 states, sponsored 8 Technical Consultancy Organisations (TCOs) and established separate wings for the financing and development of small, and village industries.

WORKING OF IDBI

Loans Sanctioned: The IDBI completed 38 years by 2002. The trends in assistance sanctioned and disbursed during 1964-81 can be observed from Table 4. The cumulative sanctions at the end of March 2001, stood at 2,231,343 million, while the cumulative disbursements during the same period amounted to Rs.1,523,921 million. Sanctions under direct finance, constituting 95.1% of overall sanctions, increased by 9.2% to Rs.2,73,035 million as compared to a growth of 19.2% in 1999-2000. While sanctions under project finance, constituting 45.9% of total sanctions, declined marginally by 0.3% to Rs.1,31,919 million, sanctions under non-project finance, constituting 49.25 of total sanctions, grew by 19.9% to Rs.1,41,116 million. Sanctions of rupee loans under project finance declined by 1.1% to Rs.81,265 million, whereas sanctions of foreign currency (FC) loans declined significantly by 52.3% to Rs.15,535 million. The volatility in the Rupee-Dollar exchange rate in the first half of the year, followed by softening of rupee interest rate in the second half, adversely affected the demand for FC loans. Underwriting & direct subscription to equity/debt instruments increased by 96.6% to Rs.11,533 million during 2000-01 from Rs.5,867 million in the previous year. The increase is attributable to investments made in electricity generation and telecom industry. Assistance by way of guarantees nearly doubled to Rs.23,586 million during 2000-01 from Rs.11,763 million sanctioned in 1999-2000.

Sector-wise Assistance: Sector-wise assistance sanctioned to private sector projects accounted for well over three-fourths of the cumulative sanctions. During 2000-01, private sector accounted for 67% of the total sanctions, followed by public sector (30.7%) and joint sector (1.9%). Sanctions to co-operative sector recorded manifold increase as compared to a decline of 99.1% in the previous year, followed by public sector (44.6%). While sanctions to private sector declined marginally by 0.1% as against a growth of 5.3% in 1999-2000, joint sector recorded a decline of 57.6% over a decline of 1.3% in the previous year.

The IDBI has been extending concessional assistance to new units set up in specified backward districts/areas. The assistance to units in backward areas expanded rapidly during the last 19 years of IDBI's operations. The IDBI also extends assistance to the small-scale sector on a priority basis comprising small-scale industries and small road

ASSISTANCE SANCTIONED & DISBURSED BY I.D.B.I.

(Rs. million)

Year	Sanctions	Growth rate %	Disbursements	Growth rate %
1964-65	3473.0	--	3015.4	--
1970-75	9170.2	--	6553.0	--
1975-80	41404.1	--	29196.7	--
1980-81	16915.6	--	12586.0	--
1981-82	17789.4	5.2	15043.1	19.5
1982-83	19259.6	8.3	15950.1	6.0
1983-84	23942.7	24.3	19763.1	23.9
1984-85	33712.0	40.8	21887.5	10.7
1985-86	36603.9	8.6	27978.6	27.8
1986-87	45875.5	25.3	32590.4	16.5
1987-88	53024.9	15.6	40043.4	22.9
1988-89	44084.1	-16.9	33824.0	-15.5
1989-90	73248.2	66.2	51241.9	51.5
1990-91	62778.5	-14.3	44985.4	-12.2
1991-92	65699.4	4.7	57796.2	28.5
1992-93	93451.7	42.2	67373.7	16.6
1993-94	122148.8	30.7	81140.6	20.4
1994-95	183945.3	50.6	106808.3	31.6
1995-96	159846.8	-13.1	107207.6	0.4
1996-97	139934.6	-12.5	114831.0	7.1
1997-98	220827.9	57.8	151699.3	32.1
1998-99	218289.3	-1.1	144700.7	-4.6
1999-2000	269664.5	23.5	170594.3	17.9
2000-01	287111.0	6.5	174983.1	2.6
Cumulative upto end-March 2001	2231343.3	--	1523920.7	--

transport operators. Such assistance is granted mainly through the scheme of refinance of industrial loans, and, to some extent, through the bills rediscounting scheme.

11.13 INDUSTRIAL INVESTMENT BANK OF INDIA (IIBI)

Industrial Investment Bank of India Ltd. (erstwhile Industrial Reconstruction Bank of India) was set up in 1985 under the IRBI Act, 1984 as the principal credit and reconstruction agency for aiding rehabilitation of sick and closed industrial units. With a view to converting the institution into a full-fledged all purpose development financial institution, IRBI was incorporated as Industrial Investment Bank of India Ltd., (IIBI) under the Companies' Act, 1956 on March 17, 1997, providing it with adequate operational flexibility and financial autonomy.

Since its reconstitution in 1997, IIBI's business strategy focusses on improvement in asset quality and generation of profit. To create and maintain high quality assets, IIBI placed emphasis on redeployment of manpower and installation of modern, objective risk assessment and monitoring systems. Asset acquisition policy has been re-oriented by giving more importance to investment in rated debt instruments in the primary and secondary markets. The other programmes aimed at strategic re-orientation of IIBI include assessment of asset risk through formal risk scoring models, modernisation and documentation of processes and systems, organisational restructuring, enhanced role of internal audit pursuing on-the-spot compliances, proactive, and timely loan workouts/ restructuring/one-time settlements, continuous and focused monitoring of cost of funds and income, emphasis on spreading new skills and team-based approach to decision making with accountability.

Objective: The new bank will function as the principal credit and reconstruction agency for industrial revival and will co-ordinate the work of other institutions engaged in the revival of industries. It will also assist and promote industrial development and rehabilitation of industrial concerns. IIBI provides, besides project finance, short duration non-project asset-backed financing and working capital/other short-term loans to companies. During 2000-01, IIBI made efforts towards diversifying into investment in rated debentures/bonds. Out of total fresh acquisition of financial assets during the year, 38% (Rs.6,440 million) was through loans and 62% (Rs.10,660 million) was through investments. As a result of this strategy, the percentage share of loans in the outstanding portfolio declined from 82% as on March 31, 2000 to 66.4% as on March 31, 2001. Sovereign/state government guaranteed debt papers and corporate papers rated A+ and above, accounted for 58.4% of the investment assets portfolio as on March 31, 2001.

Resources: The Bank will have an authorised capital of Rs.2,000 million and an initial paid-up capital of Rs.500 million. The paid-up would be made up of the existing paid-up capital or Rs.200 million of the IRCI and the conversion of Central Government loans to IRCI into capital to the extent of Rs.20 crores and Rs.10 crores direct subscription by the Central Government. The Bank looks forward to receiving interest-free Central Government loans ranging from Rs.400 million to Rs.800 million every year, depending upon the magnitude of its operations. It would also raise foreign loans guarantee by the Government of India. In addition, the 'Reconstruction Assistance Fund' was set up within the Bank, for the purposes of financing any loan or advance or entering into any arrangements.

ASSISTANCE SANCTIONED & DISBURSED BY I.I.B.I.

(Rs. million)

Year	Sanctions	Growth rate %	Disbursements	Growth rate %
1971-72	66.0	--	11.0	--
1972-73	61.0	-7.6	35.0	218.2
1973-74	72.0	18.0	52.0	48.6
1974-75	76.0	5.6	80.0	53.8
1975-76	53.0	-30.3	47.0	-41.3
1976-77	100.0	88.7	108.0	129.8
1977-78	109.0	9.0	91.0	-15.7
1978-79	107.0	-1.8	126.0	38.5
1979-80	152.0	42.1	125.0	-0.8
1980-81	194.0	27.6	169.0	35.2
1981-82	504.0	159.8	284.0	68.0
1982-83	623.0	23.6	379.0	33.5
1983-84	695.0	11.6	414.0	9.2
1984-85	1108.0	59.4	548.0	32.4
1985-86	752.0	-32.1	678.0	23.7
1986-87	1489.0	98.0	947.0	39.7
1987-88	1865.0	25.3	1019.0	7.6
1988-89	2088.0	12.0	1165.0	14.3
1989-90	1466.0	-29.8	1411.0	21.1
1990-91	2347.0	60.1	1539.0	9.1

1991-92	2777.0	18.3	1852.0	20.3
1992-93	2943.0	6.0	1839.0	-0.7
1993-94	4258.0	44.7	1886.0	2.6
1994-95	7778.8	82.7	3975.9	110.8
1995-96	8972.6	15.3	5285.9	32.9
1996-97	8160.1	-9.1	5496.0	4.0
1997-98	20610.4	152.6	11531.8	109.8
1998-99	21751.6	5.5	16884.8	46.4
1999-2000	23380.8	7.5	14395.8	-14.7
2000-01	21022.6	-10.1	17097.5	18.8
Cumulative upto end-March 2001	95915.1	--	89586.7	--

Functions: The Bank will have powers to take over the management of assisted sick industrial units, lease them out or sell them as running concerns of prepare schemes for reconstruction by scaling down the liabilities with the approval of the Government of India.

A novel aspect of the functions of the new bank is that it will also assist and promote industrial development by providing or securing assistance and operating schemes for them as also granting loans and advance to any industrial concern or subscribing to or purchasing or underwriting the issue of stocks, shares, bonds and debentures. By the end of March 2001, the paid-up capital stood at Rs.57.2 million.

Operations: Table 5 presents information on assistance sanctioned and disbursed by IIBI. During 2000-01, while IIBI's sanctions declined by 10.1% to Rs.21,023 million, disbursements increased by 18.8% to Rs.17,098 million. Upto end-March 2001, IIBI's sanctions and disbursements aggregated Rs.95,915 million and Rs.89,587 million, respectively. As at end-March 2001,outstanding assistance amounted to Rs.44,734 million.

Sanctions under direct finance, constituting 73.2% of overall sanctions, declined by 32.1% to Rs.15,390 million in 2000-01. Project finance, constituting 42.9% of the total sanctions, declined by 14.7% to Rs.9,020 million during 2000-01. While rupee loans declined by 53.4%, sanctions by way of underwriting & direct subscriptions recorded an increase of 103.8%. Non-project finance at Rs.6,370 million, constituting 30.3% of the total sanctions, declined by 47.3% due to decline in sanctions of asset credit scheme/equipment finance/corporate loans and working capital/short term loans by 61.7% and 32.4% respectively.

11.14 EXPORT-IMPORT BANK OF INDIA (EXIM BANK)

In order to strengthen the institutional framework for encouraging the export of non-traditional products, particularly in the context of increasing competition in the international market for export credit, the Export-Import Bank of India (Exim Bank) was established on January 1, 1982. As a public financial institution co-ordinating the working of institutions engaged in financing exports and imports, it is entrusted with the responsibility of financing, facilitating and following foreign trade of India. The other objectives include the following: 1. to finance the export of consultancy and related sources, 2. to assist Indian joint ventures in third countries, 3. to conduct export studies, 4. to finance export-oriented industries, and 5. to provide international merchant banking services.

Resources: The authorised capital of the bank is Rs.2000 million which can be increased to Rs.5000 million. During 2000-01, the Bank raised Rs.300 million by way of private placement of bonds for 5 years and as a part of short term liquidity management, Rs.500 million was raised through commercial paper and Rs.2,400 million through certificate of

deposit. During 2000-01, the Bank undertook ready forward transactions (repos) aggregating Rs.212 million as against Rs.2,200 million last year.
During 2000-01, the Bank concluded a Guarantee Facility of US $ 100 million with Export-Import Bank of the United States (Exim USA). Under the facility, the Bank can extend term loans in Indian rupees or in US dollars to Indian companies to finance up to 85% of the value of imports of capital goods and services imported from USA. Exim USA will provide 100% guarantee for the loans extended by the Bank.

Management: The general superintendence, direction and management of the affairs of Exim Bank are vested in Board comprising Chairman and Managing Director and 15 other directors including representatives of various sections of society having a state in India's international trade. Besides the Chairman and Managing Director there are an Executive Director and two General Managers in managing the affairs of the Bank and in policy formulation in respect of the different functional areas of operations such as project finance, trade finance, overseas investment finance, planning, co-ordination and administration.

Functions: The following are the functions of Exim Bank of India.

The financing of exports from and imports into not only India but also Third world countries of goods and services;

1. The financing of Joint Ventures in foreign countries;
2. The financing of export and import of machinery and equipment on lease basis;
3. Provision of loans to an Indian party so as to enable it to contribute tot he share capital of a joint venture in a foreign country;
4. To undertake limited merchant banking functions such as underwriting of stocks, shares, bonds or debentures of companies;
5. To undertake of the developing and financing of export-oriented industries;

It is also proposed to entrust the Bank with the task of undertaking transactions involving a combination of Government-to-Government and commercial credit for the purpose of export or import.

The Bank would also give lines of credit to foreign governments and foreign financial institutions and seek collaboration with similar institutions in developing countries through participation in the share capital of such institutions.

Operations: During 2000-01, fund based assistance sanctioned by the Exim Bank under various lending programmes declined by 23.2% to Rs.21,743 million as compared to the growth of 54.1% in 1999-2000. Disbursements, however, increased by 9.6% to Rs.18,964 million as compared to the growth of 36.1% in 1999-2000. Upto end-March 2001, the Exim Bank sanctioned and disbursed fund based assistance aggregating Rs.2,42,497 million and Rs.1,93,171 million, respectively. Loans outstanding as at end-March 2001 were Rs.56,443 million, registering an increase of 11% over the previous year.

11.15 SUMMING UP

In this unit, we examined the role of development baking and discussed the functioning of the leading development banking institutions in India. We could come to know of the role of each institution in the promotion of industrial development in the country.

11.16 CHECK YOUR PROGRESS : MODEL ANSWERS

1. The reasons for establishment of Development Banks are:
   1. Lack of Capital
   2. Low capital formation
   3. Ill-organised capital markets
   4. Planned economy
   5. Development of small-scale industries
   6. Provision of Long-term finance.

2. The functions of Development Bank are:

   a) Sanction of loans (b) Underwriting (c) Guarantee of loans (d) Subscribing to the shares and debentures and (e) Developmental functions.

11.17 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in about 30 lines each.

1. What are the functions of Development Banks?
2. Discuss the role of Industrial Development Bank of India in the provision of industrial finance.
3. Evaluate the significance of ICICI Ltd., to the Indian economy.

II. Answer the following questions in about 15 lines each.

4. What is the future of Development Banking in India?
5. What are the objectives of the Industrial Credit and Investment Corporationof India?
6. What are the functions of Export-Import Bank of India?
7. Explain the working of IIBI.

11.18 RECOMMENDED BOOKS

1. Kuchhal, S.C. : **Corporation Finance**, Chaitanya Publishing House, Allahabad.
2. Kulkarni, P.V. : **Financial Management**, Himalaya Publishing House, Bombay.
3. Pandey, I.M. : **Financial Management**, Prentice Hall of India Pvt.Ltd., New Delhi.
4. Prasanna Chandra : **Financing Management** – Theory & Practice, Tata McGraw-Hill Publishing Company Limited, New Delhi.
5. IDBI : **Report on Development Banking in India**, 2000-01.

11.19 GLOSSARY

Development Banks	:	Financial agencies engaged for the purpose of providing medium and long term assistance to business undertakings in the form of loan, underwriting and investment.
Developmental Functions	:	They include the promotion of new industries, provision of technical, managerial and administrative advice, conducting of Techno-economic market and investment surveys.

UNIT – 12 : MAJOR INVESTMENT INSTITUTIONS

Contents

12.0 AIMS AND OBJECTIVES

This unit aims at discussing the objectives, functions and the role of major investment institutions in India in the provision of industrial finance.

After completing this unit, you should be able to:

- know the establishment, objectives and the working of the Life Insurance Corporation of India and its role in industrial development of India;
- explain the establishment, functions, investment policy and the working of the Unit Trust of India; and
- understand the objectives for setting up of General Insurance Corporation of India and its role in the provision of industrial finance.

12.1 INTRODUCTION

The main objective behind the establishment of investment institutions is to pool the savings of the small investors and channelise them for priority sectors of the economy. Generally, it is not possible for small investors to invest their meagre savings in industrial concerns directly. Due to lack of background and existence of high risks, certain times, they may even lose their savings. To solve these problems many investment institutions like Unit Trust of India, Life Insurance Corporation of India and General Insurance Corporation of India were set up.

12.2 LIFE INSURANCE CORPORATION OF INDIA

Establishment of the Corporation

The nationalisation of insurance business in the country resulted in the establishment of Life Insurance Corporation of India (LIC) in 1956 as a wholly owned corporation of the Government of India. To emerge as a major multinational life insurance organisation, LIC has set forth for itself certain corporate objectives. These include, spreading life insurance much more widely and in particular to the rural areas and to the socially and economically backward lasses, providing assistance/service to the underprivileged sections of society through social urity schemes, maximising mobilisation of people's savings by making insurance-linked ng schemes adequately attractive in tune with national priorities, acting as trustees of the insured public in their individual and collective capacities and meeting the various life insurance needs of the society that would arise in the changing social and economic environment.

LIC has been one of the pioneering organisations in India, which ushered in the use of information technology in their business on a very large scale to deliver more value and satisfaction to the policy holders. LIC has fully computerised most of its branches all over India. Metropolitan Area Network (MAN) has enabled policy holders to pay premiums or to get their status report, surrender value quotation and loan quotation online. The Zonal Offices and MAN centres are connected through a Wide Area Network (WAN). Interactive Voice Response Systems have been made functional in a number of centres all over the country. LIC is also planning to set up Interactive Touch screen based Multimedia kiosks in prime locations of metros and some major cities for disseminating information to general public on various products and services. These kiosks will provide policy details and accept premium payments.

Resources

When the LIC was established, an initial capital of Rs.500 million was provided by the Government of India. Premiums paid by the policy holders are the principal source of funds of the LIC, besides, LIC receives interest, dividends, repayments and redemptions which add upto its investible resources. The LIC's investible funds comprising Controlled Fund, Group Gratuity Fund and Group Superannuation Fund have grown at an average annual rate of around 19.5% from Rs.54,000 million as at end-March 1979 to Rs.1,754,910 million as at the end of March 2001.

Management

The LIC is managed by a Board of Directors consisting of not more than 15 directors who are appointed by the Government of India. The Chief Executive, designated as Chairman is also appointed by the Government of India. The Chief Executive is generally assisted by the directors or whole-time executives of the LIC. For the purpose of general superintendence and direction of affairs and business, the Board appoints an Executive Committee. For advising it in the matter of investment of funds, it appoints an Investment Committee.

Investment Policy

The Corporation is essentially an investment institution. Its investment policy has been designed taking into account, the cardinal principles of safety and yield. As such, the Corporation is expected to diversify its investment in terms of types of securities, number and types of enterprises, maturities and regions. The Corporation is guided by the consideration of the interest of its policy-holders unless it be in the larger interests of the country.

Besides investing in Government and other approved securities in the form of shares, bonds and debentures, LIC extends assistance for development of socially-oriented sectors and infrastructure facilities like housing, rural electrification, water supply and sewerage. It also provides finance to industrial concerns by way of term loans and underwriting/direct subscriptions to shares and debentures. For this purpose, the LIC has set up three subsidiaries viz., LIC Mutual Fund, LIC International and the LIC Housing Finance.

According to the Investment policy of the LIC, out of accretions to the Controlled Fund, not less than 75% has to be invested in the Central Government and State Government securities, including the Government-guaranteed marketable securities and in the socially-oriented sectors, including the public and Co-operative sectors. As for the balance of 25% of the Fund, the Government of India has indicated that (a) about 8% would be required for loans against policies within the limit of their surrender values, (b) about 2% may be in immovable properties, and (c) about 10% may be invested in the private sector.

The remaining 5% of the Controlled Fund being in pipeline are not usually available for investment. For granting loans to companies in the private sector, the LIC considers proposals only from public limited companies, new and existing. Investments are made by the LIC on the advise of the Investment Committee which meets at least once a month.

Overall Sanctions and Disbursements

Assistance sanctioned and disbursed by LIC to corporate sector during 2000-01 increased by 59.2% and 26% to Rs.108,672 million and Rs.70,950 million, respectively, as against the growth rates in sanctions and disbursements of 40.9% and 16.4% in 1999-2000. Upto end-March 2001, LIC's sanctions and disbursements aggregated Rs.439,017 million and Rs.368,343 million. As at end-March 31, 2001, assistance outstanding amounted to Rs.389,048 million (Table 1).

During 2000-01, project finance forming 33.8% of total sanctions, grew by 328.1% as compared to 62.2% in 1999-2000. The entire assistance under project finance was by way of rupee loans. Assistance sanctioned under non-project finance grew by 20.6% as compared to 38.3% in the previous year. Disbursements under project finance declined by 1.2% over a decline of 18.8% in 1999-2000, whereas disbursements under non-project finance grew by 27.5% in 2000-01.

Industry-wise Assistance

During 2000-01, LIC's sanctions witnessed growth in respect of industries such as refineries & oil exploration, paper & paper products, infrastructure, machinery, cement, services and chemicals & chemicals products. Sanctions declined sharply in respect of basic metals (-81.6%) and textiles (-43.5%). Sanctions to electrical machinery, fertilisers and transport equipment amounted to Rs.300 million, Rs.720 million and Rs.3,580 million, respectively in 2000-01 as against nil sanctions in 1999-2000. Industries accounting for a substantial portion of LIC's sanctions during the year included infrastructure (33.1%), services (23.1%), refineries & oil exploration (7.3%), chemicals & chemical products (5.2%) and transport equipment (3.3%).

Disbursements grew in respect of refineries & oil exploration (manifold), followed by infrastructure (72%), cement (68.8%), services (67.6%) and chemicals & chemical products (12.3%). Within infrastructure, disbursements to electricity generation grew by 43.7%. Disbursements to roads/ports/bridges and telecommunications amounted to Rs.2,080 million and Rs.145 million, respectively, as against nil disbursements during 1999-2000. Industries that recorded decline in disbursements included food products, textiles and basic metals.

State-wise Assistance

States that witnessed manifold rise in sanctions were Haryana, Punjab and Uttar Pradesh, followed by Andhra Pradesh (67.6%), Maharashtra (27.4%), Karnataka (25.4%) and Gujarat (15.7%). States that recorded decline in sanctions in 2000-01 over growth in 1999-20000 included Assam, Delhi, Madhya Pradesh, Goa and West Bengal.

Sector-wise Assistance

Public sector (73.2%) accounted for the bulk of LIC's sanctions, followed by private sector (25.5%). Also, sanctions to public sector at Rs.79,477 million grew at 75.3% in 2000-01 as compared to a growth rate of 32.7% in 1999-2000. Sanctions to private sector grew at much lower rate of 21.4% as compared to 62.4% growth in the previous year.

Purpose-wise Assistance

While the share of others (comprising loans to insurers policies, investments in foreign countries, special deposits and contribution to initial capital of UTI, LIC, Housing Finance, LIC International and LIC Mutual Fund) in LIC's sanctions to corporate sector declined to 59.5% in 2000-01 from 86.6% in 1999-2000, the share of new projects and expansion/diversification increased from 7.1% and 6.3% in 1999-2000 to 15.6% and 24.9% respectively in 2000-01. New projects and expansion/diversification projects recorded growth in sanctions in 2000-01. Purpose-wise disbursements, however, indicate somewhat different trend. Disbursements to new projects increased by 26.5% (29.2%) whereas expansion/diversification projects recorded a decline of 50.3% in 2000-01 over a decline of 16.6% in the previous year. Disbursement to others, however, registered a growth of 33.9% over a growth of 18% in the previous year.

ASSISTANCE SANCTIONED AND DISBURSED TO CORPORATE SECTOR BY L.I.C.

(Rs. million)

Year	Sanctions	Growth rate %	Disbursements	Growth rate %
1970-71	180.0	--	80.0	--
1971-72	230.0	27.8	50.0	-37.5
1972-73	200.0	-13.0	140.0	180.0
1973-74	260.0	30.0	200.0	42.9
1974-75	440.0	69.2	540.0	170.0
1975-76	610.0	38.6	280.0	-48.1
1976-77	570.0	-6.6	390.0	39.3
1977-78	530.0	-7.0	430.0	10.3
1978-79	660.0	24.5	320.0	-25.6
1979-80	800.0	21.2	710.0	121.9
1980-81	700.0	-12.5	660.0	-7.0
1981-82	1660.0	137.1	1360.0	106.1
1982-83	1370.0	-17.5	870.0	-36.0
1983-84	1670.0	21.9	1410.0	62.1
1984-85	2200.0	31.7	1620.0	14.9
1985-86	3840.0	74.5	2620.0	61.7
1986-87	3640.0	-5.2	3900.0	48.9
1987-88	3630.0	-0.3	3420.0	-12.3
1988-89	6600.0	81.8	4420.0	29.2
1989-90	5780.0	-12.4	4550.0	2.9
1990-91	6880.0	19.0	4270.0	-6.2
1991-92	15150.0	120.2	10220.0	139.3
1992-93	17400.0	14.9	13950.0	36.5
1993-94	16640.0	-4.4	7940.0	-43.1
1994-95	17899.5	7.6	13433.4	69.2
1995-96	23419.0	30.8	25296.7	88.3
1996-97	28208.2	20.5	29606.2	17.0
1997-98	35631.0	26.3	39714.4	34.1
1998-99	48456.0	36.0	48369.5	21.8
1999-2000	68255.3	40.9	56294.4	16.4
2000-01	108672.3	59.2	70950.1	26.0
Cumulative upto end-March 2001	439017.4	--	368343.4	--

Criticism on the Investment Policy

The investment policy of the Corporation has been the subject of controversy. Its investment policy has to satisfy both yield and safety considerations of the shareholders. The procedure followed by the LIC is not very helpful because the Corporation invests on the basis of offers from brokers. The brokers will market investment to suit their interests. To remove this defect, the Corporation in 1960 had setup an investment research section in the Investment Department to analyse systematically the Balance Sheets of all the companies, whose shares were quoted on the Stock-Exchanges. This Research Bureau is responsible for the continuous evaluation of the share and the performance of the joint stock companies and also is required to provide the necessary data to the Investment Committee on the basis of which assistance can be given to any industry.

It is said that LIC's contribution to the new industrial ventures is very limited. The funds at the disposal of the Corporation are the hard-earned savings of the common man. So the Corporation is not in a position to take the risk of investing its funds in new industrial ventures. But the LIC can help them by forming underwriting consortiums with other credit institutions and by purchasing liberally the securities, shares and debentures of other financial institutions.

It is seen that the LIC has not played any significant role in social development projects like housing, drainage, water supply and other basic amenities. The Corporation might have been slow in the initial years in discharging its social responsibilities, but had stepped up in recent years. Several measures have been taken by the LIC to streamline its organisation and to improve its functioning.

Thus, the LIC occupies a unique position among the various financial institutions that constitute the Indian capital market. Because it handles huge funds, the decisions of the Life Insurance Corporation exercise a decisive influence on the capital market, whether they relate to Government bonds, industrial securities, or real estate.

The insurance industry in our country is on the threshold of a new era of rapid expansion. A more competitive environment is expected to emerge with new private participants being allowed to enter the insurance industry. The need for private sector participation in this sector is justified on the basis of enhancing the efficiency of operations, achieving a greater diversity and penetration of life insurance in the country and for a greater mobilisation of long-term savings for long gestation infrastructure projects. In the wake of emerging competition, LIC, with its more than four decades of experience and wide reach, is equipped to face the challenges emanating from the entry of new players.

CHECK YOUR PROGRESS - I

i) What are the objectives of the establishment of investment institutions?

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ii) List out three investment institutions at present working in India?

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iii) What are the main objectives of establishment of LIC.

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12.3 UNIT TRUST OF INDIA

The Unit Trust of India (UTI) was established in 1964 to offer alternative investment opportunities to the investing public in the country. The UTI was set up to perform a dual function-to mobilise savings of the people and channelise them into productive investments thereby offering the investors, particularly the small investors, a sound means of investment.

Objectives

The basic objectives of the UTI are:

(a) to stimulate and pool together the savings of the people belonging to middle and low-income groups; and

(b) to enable the investors to share the benefits of investment in the ever-growing number of business and industrial concerns in the country.

Mode of Operations

The UTI sells units to the public. The units are of a low denomination. Each unit confers on the buyer an equal share in the assets of the UTI which mainly comprise shares and debentures. the funds collected from the sale of units are invested by the UTI in the shares and debentures of carefully selected companies spread over a number of securities. The UTI is a flexible trust in that it can vary its investments keeping in view the possibility of a higher return on capital appreciation. The income from the investments, after deducting the expenses of the UTI, is distributed among the unit-holders by way of dividend.

Resources

The UTI was set up with an initial capital of Rs.5 crores contributed as given below:

The Reserve Bank of India	Rs. 25 million
The Life Insurance Corporation	Rs. 7.5 million
The State Bank of India	Rs. 7.5 million
Scheduled Banks and other financial institutions	Rs. 10 million

Besides, the UTI also sells units to raise funds under various unit schemes.

Management

The general supervision, direction and management of the affairs of the UTI is vested in the Board of Trustees. The Board consists of the Chairman appointed by the Central Government in consultation with the IDBI, four trustees appointed by the IDBI, one trustee each nominated by the RBI, the LIC and the SBI and two trustees elected by the other institutions who contributed to the initial capital of the UTI.

Investment Policy

As per the UTI Act, the Unit Trust can:

1. Sell and purchase the units issued by it;
2. Invest in, acquire, hold, or dispose of securities;
3. Keep money on deposit with the scheduled banks; and
4. Undertake related functions incidental or consequential thereto.

The Trust has, so far, introduced 12 schemes tailor-made to suit the investors' preferences. It has savings schemes which cater to the needs of all members of family such as children, the earning as well as retired, besides providing life and accident insurance plan. The trust has 1.7 million unit-holders spread throughout the country.

The trust will invest its funds having regard to considerations of safety and profitability. The investment portfolio will consist of Government securities, company debentures and equity shares. Thus some of its securities yield fixed income, while others provide variable income. In other words, it seeks to balance its investment between investment in securities yielding fixed income and securities yielding variable income. according to its investment policy, the investments of the Trust in any one company shall not exceed 5% of the investible funds or 15% of the securities issued and outstanding of such companies, whichever is lower.

Working of the Trust

During 2000-01, sanctions and disbursements by UTI declined by 12.7% and 10.9% to Rs.59,723 million and Rs.45,999 million, respectively, as compared to the growth of 71.5% and 47.6% in 1999-2000. Upto end-March 2001, sanctions and disbursements by UTI aggregated Rs.6,83,623 million and Rs.5,22,698 million, respectively.

Sanctions under project finance declined by 11.5% to rs.59,643 million as against a growth of 72.8% in 1999-2000. Direct subscription declined by 48% to Rs.35,051 million in 2000-01, while deferred payment guarantees, having nil sanctions during 1999-2000, stood at Rs.24,592 million. Non-project finance, comprising unsecured/secured term notes and special deposits with industrial concerns and constituting only 0.1% of total sanctions, declined by 92.6%. Disbursements under project and non-project finance declined by 9.4% and 91.3% to Rs.45,919 million and Rs.80 million, respectively, as against a growth of 47.6% and 48% during 1999-2000.

Sales, Repurchase and Outstanding of Units

During 2000-01, the aggregate sales (face value) of units under various schemes declined sharply by 41.2% to Rs.79,097 million from Rs.1,34,584 million during 1999-2000. US-64 accounted for the largest share in sales (24.5%), followed by Money market Fund-97 (12.3%), Monthly Income Plan – 20001 (8.2%), Monthly Income Plan – 2000 III (8.1%), UTI Bond Fund-98 (7.9%) and Children's College & Career Fund Unit Plan-93 (CCCF) (5.7%). Aggregate repurchases at Rs.1,04,912 million (face value) grew by 24.1% as against a decline of 28.7% in 1999-2000. As at end-June 2001, outstanding unit capital under various schemes stood at Rs.5,81,308 million.

Advantages of the Units

The following are the advantages of investment in the units of the UTI:

1. **Safety:** Money invested in the units is quite safe. This is because the funds are invested over a wide range of securities.

2. **Steady return**: Of the net total income on unit capital of the UTI, at least 90% is distributed among the unit holders. This means that the unit-holders are assured of a steady and reasonable rate of return on their investment.

3. **Tax exemption**: Income arising from units is eligible for exemption under the Income-Tax and Wealth-Tax Acts. Thus, income from units together with that from other specified investments, are exempted from wealth tax up to the limit of Rs.1.5 lakh.
4. **Liquidity**: The units are easily saleable and easily convertible into cash. The units can be sold back to the Trust at the prices fixed by it. These can also be transferred to third parties.

Criticism

Though the UTI has shown remarkable progress in a few years its existence, it suffers from several drawbacks. The functioning of the UTI is criticised for the following:

i) **Urban bias**: It is concentrating its activities in urban areas so that people living in rural areas are denied the advantages accruing from the holding of the units. More than 60% of the units have been sold only in a few big towns.

ii) **Centralised control**: As it is, the centralised set-up of the Trust makes it difficult to formulate an efficient and effective policy as regards investment decisions.

iii) **Conservation**: The Trust follows a conservative policy in deciding investment matters. More than half of its investments are in fixed income bearing securities which offer little scope for capital appreciation.

iv) **High cost of maintenance**: The trust spends a great deal to maintain itself. The expenditure is well over 10% of its income. Assuming that the Trust distributes 90% of its income among unit-holders, there is only a little amount left for investment or for adding to its financial soundness.

Recent Developments

In May 2001, there was a scam unearthed in the UTI. The same resulted in the debacle of UTI as a Mutual Fund. There was considerable depreciation in the NAV of the units of several schemes. The government interfered in the matter, but could not set right the things. A committee was appointed to enquire into the scam and make recommendations for its revival. The committee suggested bifurcation of UTI into UTI-I and UTI-II. The Government has announced its decision for bifurcation of the UTI into the units.

12.4 GENERAL INSURANCE CORPORATION OF INDIA

The General Insurance Corporation of India (GIC) was established in 1973, after nationalization of General Insurance Companies in the country. The following are the subsidiaries of GIC.

a) National Insurance Company Limited;

b) New India Assurance Company Limited;

c) Oriental Fire and General Insurance Company Limited; and

d) United India Insurance Company Limited.

Investment Policy

All the four subsidiary companies are undertaking a number of insurance schemes to cater to the diverse needs of the society. According to Insurance Act, 1938, the GIC is required to channelise 70% of annual accretions of its investiable funds to socially-oriented sectors of the economy. GIC also participates in consortium financing of industrial projects. It extends assistance by way of term loans, underwriting and direct subscriptions to the shares and debentures of new and existing industrial undertakings.

Investment pattern

The investment pattern of GIC and its subsidiaries can be seen from Table-3. It can be observed from the table that the GIC and its subsidiaries invested mainly in Government and other approved securities. However, in the recent past, the GIC increased its assistance to industry.

INVESTMENT OF GIC AND ITS SUBSIDIARIES

(Rs. million)

Investment	**As at end December**	**As at end March**		
	1987	**1989**	**1990**	**2001**
Government and other approved securities special deposits with Govt. of India etc.	17,722	21,099	24,271	92,480
Shares and debentures deposits with and term loans to companies	9,596	11,154	13,497	95,690
Bills rediscounting scheme	481	1,236	1,302	13,430
Others	1,354	601	649	29,520
Total	**29,153**	**34,090**	**39,719**	**231,120**

Direct Assistance to Industry

Assistance sanctioned and disbursed by GIC to the corporate sector during 2000-01 declined by 22.3% and 19.7% to Rs.23,182 million and Rs.22,565 million, respectively, as against the growth rates of 126.9% and 102.6% in sanctions and disbursements in 1999-2000. Upto end-March 2001, GIC's sanctions and disbursements aggregated Rs.1,40,956 million and Rs.1,17,672 million (Table 4).

The industry-wise analysis reveals that the GIC's assistance during 1989-90 was more to the machinery industry followed by basic metals, textiles, and chemicals and chemical products. The assistance sanctioned to backward areas in 1989-90 almost registered a three fold increase to Rs.6.2 crores from Rs.2.2 crores in 1988-89.

CHECK YOUR PROGRESS - 2

i) What are the functions of UTI?

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ii) Mention the investment policy of the GIC.

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ASSISTANCE SANCTIONED AND DISBURSED TO CORPORATE SECTOR BY G.I.C.

(Rs. million)

Year	Sanctions	Growth rate %	Disbursements	Growth rate %
1981-82	501.0	--	337.0	--
1982-83	927.0	85.0	447.0	32.6
1983-84	1085.0	17.0	845.0	89.0
1984-85	1441.0	32.8	1105.0	30.8
1985-86	1530.0	6.2	1073.0	-2.9
1986-87	1533.0	0.2	1316.0	22.6
1987-88	983.0	-35.9	1035.0	-21.4
1988-89	1226.0	24.7	1154.0	11.5
1989-90	2112.0	72.3	1796.0	55.6
1990-91	3368.0	59.5	1703.0	-5.2
1991-92	6955.0	106.5	2801.0	64.5
1992-93	5593.0	-19.6	5360.0	91.4
1993-94	8240.0	47.3	4703.0	-12.3
1994-95	6885.0	-16.4	3792.0	-19.4
1995-96	8345.8	21.2	5878.5	55.0
1996-97	12733.4	52.6	9253.8	57.4
1997-98	11727.9	-7.9	11437.7	23.6
1998-99	13146.9	12.1	13861.5	21.2
1999-2000	29828.8	126.9	28088.0	102.6
2000-01	23182.4	-22.3	22564.6	-19.7
Cumulative upto end-March 2001	140956.1	--	117672.1	--

12.5 SUMMING UP

In order to pool the savings of the small investors and channelise them for priority sectors of the economy, the Government of India established three major investment institutions. They are: The Life Insurance Corporation of India, Unit Trust of India and General Insurance Corporation of India.

Since their establishment, these institutions came out with many schemes suitable to the individual investors from time to time. They mobilized and channelised huge sums of savings to various socially-oriented sectors in addition to investing heavily in the corporate sector. The individuals also got many advantages by investing in these institutions. Recently, the Government has also been permitting the banking and private institutions to raise money through various schemes. Hence, the future of these investment institutions depends upon their competitive capacity in mobilising funds.

12.6 CHECK YOUR PROGRESS: MODEL ANSWERS

1. i) The main objective behind the establishment of investment institutions to pool the savings of the small investors and channelise them for the priority sectors of the economy.

   ii) The Life Insurance Corporation of India, the Unit Trust of India and the General Insurance Corporation of India are the three important investment institutions in India.

   iii) The main objective of establishment of LIC is to carry on the business of life insurance to the best advantage of the community and channelise the funds into investment in accordance with Five Year Plans.

2. The following are the functions of UTI:

2. i) (a) Sell and purchase the units issued by it;

   (b) Investment in, acquire, hold, or dispose of securities;

   (c) Keep money on deposit with the scheduled banks; and

   (d) Undertake related functions incidental or consequential thereto.

   ii) According to the Insurance Act, 1938, the GIC is required to channelise 70% of annual accretion of its investible funds to socially oriented sectors of the economy.

12.7 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in about 30 lines each.

1. Critically examine the performance of Life Insurance Corporation of India in the provision of industrial finance.
2. Briefly state the working of the Unit Trust of India.
3. Discuss the role of the General Insurance Corporation of India in the provision of industrial finance.

II. Answer the following questions in about 15 lines each.

4. What is the main objective of establishment of LIC?
5. State the management structure of LIC.
6. What are the objectives of UTI?
7. What are the advantages of Units of UTI?
8. What are the subsidiaries of the General Insurance Corporation of India?

12.8 RECOMMENDED BOOKS

1. IDBI : **Report on Development Banking in India**

2. Saxena, R.M. : **"Development Banking in India"**, Vora and Company, Bombay.

3. Srivatsava, R.M. : **"Management of Indian Financial Institutions"**, Himalaya Publications, Bombay.

4. Bhole, L.M. : **Financial Institutions and Markets**, Tata McGraw Hill, New Delhi.

12.9 GLOSSARY

Backward Area : An area notified by the Government as backward on the basis of certain specified criteria.

Investment Trust : An institution which mobilizes the small savings of the people and channelise them to various sectors of the economy according to its investment policy.

Priority Sectors : The sectors for which more preference is to be given in the allocation of resources.

UNIT – 13 : STATE FINANCIAL DEVELOPMENT CORPORATIONS

Contents

13.0 AIMS AND OBJECTIVES

This Unit aims at discussing the objectives, functions and the role of State Financial Corporations (SFCs) and State Industrial Development Corporations (SIDCS) in the field of industrial finance. The working of Andhra Pradesh State Financial Corporation (APSFC), Andhra Pradesh Industrial Development Corporation (APIIC) is also covered in this unit.

After studying through this unit, you should be able to:

- know the establishment, objectives, resources and the management of SFCs and SIDCs;
- understand the various types of assistance given by SFCs and SIDCs; and
- explain the working of SFCs and SIDCs with special reference to APSFC, APIDC and APIIC.

13.1 INTRODUCTION

The Industrial Finance Corporation of India (IFCI) was established in July 1948 to provide finance to large-scale industrial undertakings. The small and medium-size industries were excluded from its purview. Hence, the Government felt the need for establishing development banks on a regional basis in each State for financing the long-term needs of these industries in their respective areas. Later, two of such institutions viz., the State Financial Corporations (SFCs) and State Industrial Development Corporations (SIDCs) were established in each state. The State Financial Corporations were established for the provision of long-term loans to the small and medium scale industries. While the State Industrial Development Corporations were established to accelerate the industrial development in their respective states.

13.2 STATE FINANCIAL CORPORATIONS

The State Financial Corporations (SFCs) are the State-level development banks set up under the SFCs Act, 1951 for the development of small and medium scale industries in their respective states. SFCs aim at bringing about balanced regional development by wider dispersal of industries, catalysing greater investment and generating larger employment opportunities.

SFCs, numbering 18 at present, provide financial assistance to industries by way of term loans, direct subscriptions to equity/debentures, discounting of bills of exchange and guarantees. Most of the Industries Development Banking India's schemes for assistance to small and medium sectors are operated through SFCs. These include composite loan scheme, schemes for women entrepreneurs, modernisation scheme, equipment finance scheme, scheme for hospitals and nursing homes, scheme for ex-servicemen, single window scheme. During the year, SFCs commenced operations under two new IDBI schemes viz., Mahila Udyam Nidhi Scheme and scheme for financing tourism and related activities.

The SFCs (Amendment Act 2000) which became effective in September 2000, provide greater flexibility to the SFCs to cope with the challenges posed by the deregulated financial system. The Government of India has also set up a Committee headed by Shri G.P. Gupta, the then Chairman and Managing Director, Industrial Development Bank of India for looking into the functioning of SFCs and main recommendations for their restructuring and revitalisation. The Committee, in its report submitted to the Government of India in January 2001, indicated that the future business canvas of SFCs is likely to be affected by stiff competition emerging in the financial system. In the wake of WTO provisions becoming effective, SSI sector would face new challenges. The Committee also felt that, there would be a new role for financial institutions specialising in and dedicated to financing and development of SSI sector. The SFCs, therefore, would continue to be significant players particularly in financing of SSI sector in India. The Committee recommendations for restructuring and recapitalisation of SFCs are under consideration of the Central Government.

Working of the SFCs

During fifties and sixties, the SFCs operation was only moderate. During the seventies, however, there was a rapid increase in their activities mainly due to the emphasis laid down by the Government on the promotion of small scale industries, new entrepreneurs and development of backward areas. During 1965-66, the SFCs sanctioned and disbursed Rs.253 million and Rs.10 million respectively. The sanctions and disbursements of SFCs were below Rs.2,650 million and Rs.150 million respectively upto 1979-80. Later the operations of SFCs increased rapidly by 2000-01, they were able to sanction around Rs.27,900 million. (see Table 13.1)

TABLE – 13.1
ASSISTANCE SANCTIONED AND DISBURSED BY SFCs

(Rs. million)

Year	Sanctions	Growth rate (%)	Disbursements	Growth rate (%)
1965-66	253.0	--	180.0	--
1970-71	496.0	--	335.0	--
1971-72	641.0	29.2	396.0	18.2
1972-73	787.0	22.8	447.0	12.9
1973-74	1031.0	31.0	546.01	22.1
1974-75	1418.0	37.5	796.0	45.8
1975-76	1555.0	9.7	988.0	24.1

1976-77	1633.0	5.0	1052.0	6.5
1977-78	1661.0	1.7	1074.0	2.1
1978-79	2007.0	20.8	1350.0	25.7
1979-80	2638.0	31.4	1848.0	36.9
1980-81	3705.0	40.4	2480.0	34.2
1981-82	5096.0	37.5	3177.0	28.1
1982-83	6116.0	20.0	4040.0	27.2
1983-84	6449.0	5.4	4355.0	7.8
1984-85	7431.0	15.2	4977.0	14.3
1985-86	10091.0	35.8	6085.0	22.3
1986-87	12108.0	20.0	7919.0	30.1
1987-88	13050.0	7.8	9425.0	19.0
1988-89	13911.0	6.6	10552.0	12.0
1989-90	15142.0	8.8	11565.0	9.6
1990-91	18639.0	23.1	12708.0	9.9
1991-92	21903.0	17.5	15368.0	20.9
1992-93	20153.0	-8.0	15574.0	1.3
1993-94	19088.0	-5.3	15634.0	0.4
1994-95	27024.0	41.6	1809.0	20.3
1995-96	41885.0	55.0	29611.0	57.4
1996-97	35448.0	-15.4	27827.0	-6.0
1997-98	26261.0	-25.9	21102.0	-24.2
1998-99	1641.8	-29.0	16246.5	-23.0
1999-2000	22377.8	20.0	18250.9	12.3
2000-01	27899.7	24.7	20050.6	9.9
Cumulative upto end-March 2001	358886.7	--	29242.5	--

The sanctions and disbursements of the SFCs increased from Rs.375.5 crores and Rs.248 crores respectively during 1980-81 to Rs.1,543.6 and Rs.1,190.2 crores respectively during 1989-90. On the whole, the cumulative sanctions and disbursements of SFCs upto end of March, 1990 stood at Rs.10,074 crores and Rs.7,550 crores respectively.

Problems

The SFCs have been playing an important role in meeting the financial needs of small and medium-scale concerns. They have been helping their respective States in their industrial development. However, the SFCs at present are facing certain limitations and difficulties. They include: 1) non-recovery of loans, 2) procedural problems in the recovery of loans; 3) increasing sickness among industrial units; 4) dominance of the personal factor in small business units; and 5) lack of adequate resources for the Corporations.

13.3 ANDHRA PRADESH STATE FINANCIAL CORPORATION

The Andhra Pradesh State Financial Corporation (APSFC) was established in 1956 mainly for the purpose of financing small and medium scale industries in the State.

Functions: The following are the functions of APSFC

1. Granting of long-term loans to industries for purchasing land, buildings and machinery.

2. Guaranteeing payment on behalf of the entrepreneur for purchasing machinery on deferred payments from suppliers within India.

3. Underwriting issue of shares, bonds and debentures of industrial concerns.

4. Guaranteeing loans raised by industrial concerns through 'Floating' in the public market, for a period of not exceeding 20 years.

5. Guaranteeing loans raised by industries from commercial banks or co-operative banks for acquiring fixed assets.

6. Subscribing to debentures of industrial units.

7. Provision of foreign exchange loans to industries under the World Bank Line of Credit.

8. Special capital assistance upto Rs.2 Lakhs.

9. Loans to industries in collaboration with the central financial institutions like the IDBI, the IFCI; and the ICICI and joint financing of projects along with APIDC and the commercial banks.

10. Acting as an agent of the State or Central Government or any other financial institution notified in this behalf by the Central Government.

Eligibility

Industrial concerns under any form of ownership viz., a proprietary concern, Joint Hindu Family, registered co-operative society, private or public limited company engaged in or proposed to engage in one or more of the following activities are eligible for financial assistance from the State Financial Corporation.

a) Manufacture of goods;
b) Preservation of goods;
c) Processing of goods;
d) Mining;
e) Hotel Industry;
f) Development of any continuous area of land as an industrial estate;
g) Generation and distribution of electricity or any other form of power;
h) Transport Industry;
i) Assembling, repairing or packing any article with the aid of machinery or power
j) Fishing or providing shore facilities for fishing or maintenance thereof; and
k) Providing special or technical knowledge or other services for the promotion of industrial growth.

Working of the Corporation

The APSFC has undoubtedly made tremendous progress in the last decade. The number of pending applications have considerably decreased in the recent years. The Corporation had soared to newer heights in recent years in respect of sanctions, disbursals and the financing of new units. (see Table 13.2) Further, the cumulative sanctions to small industry and small road transport operators stood at Rs.19,561.5 million and Rs.2,336.4 million respectively by the end of March 2001.

TABLE – 13.2
ASSISTANCE SANCTIONED AND DISBURSED BY A.P.S.F.C.
(Rs. in million)

Year	Sanctions	Disbursements
1985-86	1,095.1	677.2
1986-87	1,353.4	810.1
1987-88	1,120.5	990.9
1988-89	1,679.3	1,140.1
1989-90	1,933.2	1,283.4
1999-2000	3,351.9	2,641.8
2000-2001	3,919.1	2,828.0
Cumulative upto end March, 2001	2,929.1	24,405.2

CHECK YOUR PROGRESS - 1

i) What are the reasons for the establishment of SFCs?

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ii) What is the financial assistance given by APSFC?

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13.4 STATE INDUSTRIAL DEVELOPMENT CORPORATIONS

Since 1960, many States and Union Territories have established State Industrial Development Corporations (SIDCs) or State Industrial Investment Corporations (SIICs). They were set up as wholly owned State Government undertakings for promotion and development of medium and large industries. At present there are 28 SIDCs in the country. Those in the Andaman & Nicobar, Arunachal Pradesh, Daman & Diu and Dadra & Nagar Haveli, Goa, Manipur, Meghalaya, Mizoram, Nagaland, Tripura, Pondicherry and Sikkim also act as SFCs to provide assistance to small and medium enterprises and act as promotional agencies for this sector.

Objectives

The main objective of SIDCs is to act as catalytic agents for industrial development in their respective states. SIDCs provide financial assistance to industrial units by way of term loans, underwriting and direct subscriptions to shares/debentures and guarantees. They also undertake a variety of promotional activities like preparation of feasibility reports, industrial potential surveys, entrepreneurship development programmes and developing industrial estates/areas. SIDCs are also engaged in setting up of medium and large industrial projects in joint sector in collaboration with private entrepreneurs or as wholly-owned subsidiaries. Some

SIDCs also administer the incentive scheme of Central/State Governments and participate in risk capital.

Resources

In addition to the paid-up capital and loans from the State Governments, borrowings from the market by way of bonds and debentures and refinancing from the IDBI are the important sources of funds for the SIDCs. With the fast expansion of their financial commitments, the SIDCs have been increasingly relying on borrowing from the State Governments, IDBI, banks and other institutions.

Management

The SIDCs function under the overall guidance of the respective State Governments. Except for the nominee of the IDBI, all the other members of the Boards of Directors of SIDCs are nominated by the State Governments. The Boards constitute special committees, whenever necessary to advise them in conducting the business. The Managing Director, who acts as the Chief Executive of the SIDC looks after the day-to-day management.

Functions

There are some differences in the functions of different SIDCs. They differ depending mainly on the degree of industrialisation and the kind of institutional network developed in the State concerned. The functions of SIDCs cover:

a) Industrial promotion activities such as project identification, preparation of feasibility reports, identifying the entrepreneurs and the offering of assistance to them in project implementation;

b) The setting up of industrial projects in the medium and large sectors in partnership with private entrepreneurs (Joint Sector) or as sole owners (Public Sector).

c) Provision of infrastructural facilities and market intelligence services;

d) The granting of financial assistance by way of term loan/bridge loans and underwriting of or subscription to equity/preference shares; and

e) Acting as an agent of the State/Central Government in respect of grant of subsidies, incentives etc., as also of IDBI for provision of seed capital assistance.

Promotional Activities

Some SIDCs have on their own or in association with other State-level agencies, been conducting techno-economic surveys of industrially backward areas for ascertaining their industrial potential as also identification of potential entrepreneurs and specific project areas. In some states, the SIDCs have set up industrial escort divisions to provide guidance to industrial units. Some SIDCs also provide a variety of ancillary services like assistances in project identification, supply of project profits, etc. These services are made available to entrepreneurs at nominal cost and in some cases, without any charge.

Operations

During 2000-01, financial assistance sanctioned and disbursed by SIDCs increased by 29.9 and 3.1% to Rs.20,801 million and Rs.16,644 million, respectively, as against a declin sanctions and disbursements of 29.8% and 25.8% in 1999-2000, respectively. Upto end-M 2001, aggregate sanctions and disbursements amounted to Rs.223,309 million and Rs.1 million, respectively. (see Table 13.3)

TABLE – 13.3

ASSISTANCE SANCTIONED AND DISBURSED BY SIDCs

(Rs. million)

Year	Sanctions	Growth rate (%)	Disbursements	Growth rate (%)
1971-72	236.0	--	144.0	--
1972-73	235.0	-0.4	166.0	15.3
1973-74	279.0	1.7	2006.0	24.1
1974-75	335.0	20.1	267.0	29.6
1975-76	375.0	11.9	264.0	-1.1
1976-77	718.0	91.5	350.0	32.6
1977-78	879.0	22.4	44.0	28.0
1978-79	983.0	11.8	601.0	34.2
1979-80	1577.0	60.4	853.0	41.9
1980-81	2164.0	37.2	1246.0	46.1
1981-82	2996.0	3.4	1911.0	53.4
1982-83	2966.0	-1.0	2080.0	8.8
1983-84	3646.0	22.9	2365.0	13.7
1984-85	4779.0	31.1	2976.0	25.8
1985-86	5270.0	10.3	3640.0	22.3
1986-87	5703.0	8.2	4255.0	16.9
1987-88	6415.0	12.5	4486.0	5.4
1988-89	7221.0	12.6	4721.0	5.2
1989-90	6910.0	-4.3	5452.0	15.5
1990-91	8237.0	19.2	5983.0	9.7
1991-92	10090.0	22.5	6787.0	13.4
1992-93	9731.0	-3.6	6947.0	2.4
1993-94	9179.0	-5.7	7008.0	0.9
1994-95	15886.0	73.1	10510.0	50.0
1995-96	19512.0	22.8	11887.0	13.1
1996-97	18111.0	-7.2	15018.0	26.3
1997-98	17951.0	-0.9	14162.0	-5.7
1998-99	22805.6	27.0	21763.4	53.7
1999-2000	16014.2	-29.8	16147.1	-25.8
2000-01	20800.5	29.9	16643.7	3.1
Cumulative upto end-March 2001	223308.5	--	176478.6	--

During 2000-01, direct finance constituting 66.6% (83.1%) of overall sanctions, increased by 4.1% to Rs.13,849 million as against a decline of 41.6% in 1999-2000. Of the project finance, rupee loans declined by 2.3% over a decline of 49% in the previous year. Underwriting & direct subscriptions, however, registered a growth of 315.4% (-92.5%). Non-project finance constituting 15.7% of the total sanctions, declined by 6.4% during 2000-01. Of the non-project finance, assistance under asset credit scheme/equipment finance/corporate loans increased by 48.3%, while working capital/short-term loans declined by 41.5%. Sanctions under bills finance, accounting for 31.8% of the total sanctions, grew by 144.7% to Rs.6,604 million during 2000-01.

During 2000-01, disbursements under direct finance were lower by 4% (-52.5%), constituting 59.6% of overall disbursements. Disbursements under project finance grew by 1.3% to Rs.7,533 million, accounting for 45.3% of the total disbursements. Of the project finance, rupee loans declined by 12.7%, while underwriting & direct subscriptions increased by

341.1%. Non-project finance accounting for 14.4% of total disbursements, declined by 17.4%. Disbursements under asset credit scheme/equipment finance/ corporate loans and working capital/short-term loans were lower by 17.6% and 25.9% respectively, during 2000-01. Disbursements under bills finance accounting for 38.4% of total disbursements, grew by 9.9%.

Of the 28 SIDCs, 16 registered increase in sanctions during 2000-01. Of these, the SIDC in West Bengal recorded the maximum increase (235.6%), followed by SIDCs in Maharashtra (51.6%), Karnataka (45.3%), Haryana (17.5%), Gujarat (17.2%) and Rajasthan (6.8%). The other SIDCs that recorded increase included Tripura, Jammu & Kashmir, Uttar Pradesh, Andhra Pradesh, Sikkim, Arunachal Pradesh, Nagaland, Himachal Pradesh, Pondicherry and Orissa. States in which SIDCs recorded decline in sanctions in 2000-01 over growth in 1999-2000 were Goa (-63.7%), Mizoram (-35.3%), Kerala (-33.2%) and Meghalaya (-28.1%). In terms of absolute sanctions, SIDC in Maharashtra (52.2%) ranked first, followed by Karnataka (11.92%), West Bengal (7.9%), Haryana (6.1%), Rajasthan (4.8%) and Gujarat (4.3%).

The SIDCs have contributed significantly to the structural transformation in industry. In fact, three-fifths of the total sanctions by the SIDCs were in respect of units in non-traditional industries such as chemicals, basic metals and metals products, machinery including electrical machinery etc. The Corporation's assistance for the acceleration of industrial development in backward regions has been growing. The concept of 'Joint Sector' was developed as a promotional tool to attract private sector investment and their managerial abilities the promotion of projects in different states. The SIDCs have been able to promote a number of projects in the joint sector in association with private co-promoters. About three-fourths of the cumulative sanctions by the SIDCs were in favour of the projects in the private sector, the share of the joint sector being 11.9%.

Tasks and Challenges for the SIDCs

Despite organisational and operational limitations and limited resources, these Corporations have been playing a significant role in the industrialisation process. The Corporation's role in training new entrepreneurs and offering them assistance for launching new industrial ventures is well-known. The role of the SIDCs in promoting and financing industries, particularly in backward areas has been widening. As State Government promotional agencies, the SIDCs are able to act as an effective link between the industrial development planning efforts of the Government and the activities of the entrepreneurs and industrialists.

13.5 ANDHRA PRADESH INDUSTRIAL DEVELOPMENT CORPORATION

The Andhra Pradesh Industrial Development Corporation (APIDC) was established on the 16th of December, 1960 as a fully owned undertaking of the Government of Andhra Pradesh for promoting medium and large industries in the state. The main efforts of the Corporation are directed towards industrial development of the State, rational transfer of resources for reducing the regional imbalances, the development of a self-sustaining entrepreneurial within the state and the creation of additional employment opportunities.

Objectives

The main objectives of the Corporation are:

1. To promote medium and large industries as to bring about planned industrial development in the state;

2. To develop backward areas so as to bring about a balanced dispersal of industries.

3. To develop and foster a wide and competent entrepreneurial base.

4. To offer opportunities for the exploitation of the State's national resources through industrial applications; and

5. To bring about the upgrading technology on the industrial front

Functions

The Corporation undertakes a wide range of activities and services. Following are the activities of the Corporation:

1. Participation in venture capital of industrial projects including underwriting of equity;
2. Extending of term loans under IDBI Refinance Schemes
3. Extending of seed capital to first generation professional entrepreneurs
4. Identifying of new projects and scope for higher technologies; and
5. Nursing of sick and undermanaged units;

Services

The APIDC helps the entrepreneurs by providing various services. The services of the Corporation include the following:

1. monitoring of industrial projects;
2. helping entrepreneurs in obtaining all necessary clearances;
3. advising entrepreneurs in technical and financial aspects of projects; and
4. developing project reports and profiles

Working of the Corporation

The total sanctions and disbursements of APIDC during 1996-97 to 2000-01 can be seen from Table given below. As it can be observed from the table that total sanctions and disbursement of the corporation remained constant at around Rs. 278 million and Rs. 227 million respectively. In fact, the sanctions and disbursements of the Corporation declined drastically during the recent years. However, the Corporation sanctioned more than 70 per cent of its assistance to the Units located in backward areas.

TABLE – 13.4
APIDC – SANCTIONS AND DISBURSEMENTS

(Rs. in million)

Year	Sanctions	Disbursements
1996-97	168.0	239.0
1997-98	214.0	177.0
1998-99	251.6	173.9
1999-2000	164.1	215.7
2000-2001	278.0	227.4
Cumulative upto March 2001	5,360.0	4,695.6

13.6 ANDHRA PRADESH INDUSTRIAL INFRASTRUCTURE CORPORATION

The Andhra Pradesh Industrial Infrastructure Corporation was Registered in September, 1973 with an Authorised Capital of Rs.10.00 crores and its paid up capital is Rs.5.80 crores. It has acquired or alienated 15,650 acres of land has under the control of 121 Industrial Estates (IEs) Industrial Development Areas (IDAs).

Objectives

The main objectives of the Corporation are as follows:

- to identify potential growth centres in the State
- to acquire land for IDAs and IES
- to establish IEs and IDAs equipped with roads, water, power supply and also to build work sheds and develop plots.
- to arrange Voluntary Loan Contributions to Andhra Pradesh State Electricity Board on behalf of entrepreneurs.
- to provide social infrastructure like industrial housing near work place.
- to establish Ancillary Industrial Estates for large parent units like BHEL and benefit both the ancillary and the parent unit.
- to establish Autonagars to serve the transport industry. This helps in reducing traffic congestion and at the same time offers a single umbrella, multi-facility kereel to transport operators, tradesmen and technicians
- to construct Commercial Complexes to help small traders, businessmen, banks and other institutions with accommodation for their operations.

Concessions

a) Entrepreneurs belonging to SC/ST categories are given a reduction of 10% of the cost for the allotment of land/shed.

b) Entrepreneurs commissioning their projects (regular production) within one year of taking possession of land are given 10% rebate on the land cost.

Activities of the Corporation

APIIC identifies growth centres and establishes fully equipped industrial estates and industrial development areas so that entrepreneurs can literally walk into his new, ready made premises. The Corporation proposes to develop land to an extent of 8,383 plots, construct 912 industrial sheds and acquire land to an extent of 7,155 acres by the end of the seventh five-year plan. The activities of the APIIC are expected to create direct employment to 92,950 persons. Till the end of March, 1987, the APIIC has developed 10,943 plots and 2,516 sheds and constructed 4,455 houses all over the state.

On the basis of the report of the infrastructure committee constituted by the State development board, the APIIC proposes to develop an action plan for a total expenditure of Rs.160 crores in the development of industrial townships, ungradation and establishment of new industrial estates all over the states. The money would be raised with the assistance from the commercial banks and the IDBI with the contributions by the State Government confined to the margin money only. The Corporation has constructed 3,999 houses with the assistance of HUDCO.

Thus the APIIC is doing a tremendous service to the enthusiastic entrepreneurs in the small scale sector for setting up their industries in the State.

CHECK YOUR PROGRESS – 2

i) What are the main objectives of SIDC?

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ii) What are the main services undertaken by APIDC?

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iii) What are the main activities of APIIC?

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13.7 SUMMING UP

The State level development banks viz., the SFCs and SIDCs have been playing an important role in the industrial development of their respective states. The sanctions and disbursements of these Corporations, particularly to the small scale industries and the units located in the backward areas, increased substantially in the recent years. However these corporations are facing certain problems. They include: the non-recovery of loans inadequate resources and increasing industrial sickness. The future of these Corporations depends mainly upon their efficiency in the management of their resources.

13.8 CHECK YOUR PROGRESS: MODEL ANSWERS

1) i) SFCs are established for the development of small and medium industries in their respective states. They aim at bringing about balanced regional development by wider dispersal of industries, catalysing greater investment and generating larger employment opportunities.

ii) In the case of proprietary and partnership concerns, the maximum assistance for which they are eligible is Rs.30 lakhs and in the case of limited companies and co-operative societies, the maximum limit is Rs.60 lakhs.

2. i) The main objective of SIDCs is to act as catalytic agents for industrial development in their respective states. SIDCs provide financial assistance to industrial units by way of term loans underwriting and direct subscriptions to shares/debentures and guarantees.

ii) The APIDC provides the following services to the entrepreneurs:

1. monitoring of industrial projects;
2. helping entrepreneurs in obtaining all necessary clearances;
3. advising entrepreneurs in technical and financial aspects of projects; and
4. developing project report and profiles.

iii) APIIC identifies growth centres and establish fully equipped industrial estates and industrial developmental areas, so that the entrepreneurs can occupy readymade premises.

13.9 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in about 30 lines each.

1. Critically examine the working of APSFC.
2. How far the APIDC achieved its objectives? Discuss the problems and the future of the Corporation?

II. Answer the following questions in about 15 lines each.

i. What are the reasons for setting up of SFCs? Discuss their functions.

ii. Explain the management structure of SIDCs.

iii. What are the functions of SIDCs?

iv. What are the various promotional activities of SIDCs?

v. What are the functions of APIIC?

13.10 RECOMMENDED BOOKS

1. Saxena, R.M. : **'Development Banking in India'**, Vora & Co., Bombay.

2. Srivastava, R.M. : **'Management of Indian Financial Institutions'**, Himalaya Publishing House, Bombay.

UNIT -14 : ROLE OF COMMERICIAL BANKS IN INDUSTRIAL FINANCE

Contents

14.0 AIMS AND OBJECTIVES

This Unit discuss the role, progress, performance and bank services and facilities to various sectors of India economy, and the role of commercial banks in providing industrial finance.

By the end of this unit, you should be able to understand:

- the role of commercial banks in the development of Indian economy;
- the functions of commercial banks;
- the financial assistance extended by commercial banks to various sectors of the company; and
- the role of commercial banks in providing industrial finance.

14.1 INTRODUCTION

Commercial Banks in India have come to play an important role in the promotion of country's economic growth. They accept deposits and finance trade, commerce and industry in meeting their short-term needs. Since the launching of five year plans, commercial banks have progressively adopted innovative approaches for the mobilization of deposits, promotion of savings and provision of funds for growth oriented purpose. They have been able to meet the demands of the complex and expanding economic activities. There has been a phenomenal increase in the number of branches of banks all over the country.

14.2 GROWTH AND DIVERSITY

ubstantial proportion of branch expansion covered the rural areas which were for long d banking facilities. This has resulted in the promotion of banking habits among the public. The number of account holders increased enormously. About 55 percent of bank offices are estimated to be operating in rural areas. One of the results of mass banking has been a sharp increase in the number of small deposit accounts, particularly in the rural and semi-urban categories. There has been a significant increase in the number of borrowers belonging to the weaker sections. A substantial proportion of bank lending is done in the priority sectors of the economy including agriculture and small business. Over 50 per cent of the savings of the house hold sector of the economy is held in the form of bank deposits.

Enactment of Banking Regulation Act of 1949, and nationalization of Reserve Bank of India in the same year brought about significant change in the outlook of commercial banks and their willingness to meet the growth needs of the country. In the year 1955 the State Bank of India was set up in the Public Sector with a view to extending banking facilities, on a large scale, more particularly, in the rural and semi-urban areas. Along with its seven subsidiaries which were later set up, the State Bank of India did considerable innovative and pioneering work in the development of banking habit and in providing resource to the hitherto neglected but growth oriented sectors of the economy.

However, criticism persisted that many commercial banks, particularly in the Private Sector, were helping in creating industrial monopolies and concentration of economic power in the hands of a few. There were accusations that these banks favoured a preferred few with substantial advances, thus encouraging hoarding and speculation. Small businessmen, artisans and other self-employed persons did not receive adequate attention with a view to correcting this, a scheme of social control was introduced in 1968. Its aim was to ensure that banks developed into more effective instruments of economic progress by widening their base of bank credit, and diverting a sizable flow of resources to the priority sectors.

In order to give a further thrust to the speedy achievement of social purposes and to meet the legitimate requirements of the weaker sections of the community, 14 major scheduled commercial banks were nationlised in 1969. This has called for drastic changes in the attitudes and operations of banks. Loans to clients were no longer to be related to security and credit worthiness of the borrowers. In the case of large borrowers, the advances were to be confined to the legitimate needs for productive use and grant of credit for speculative or unproductive purpose was to be avoided. The nationalised banks had the responsibility to provide assistance for productive efforts of a wide range of borrowers, irrespective of size and social \status, and to help in the economic development of backward areas. They have to take particular interest in helping farmers, small traders and small industries and self-employed professional groups, especially, those in the semi-urban and rural areas. Through a process of coordinated branch expansion, they are required to mobilize savings and raise deposits from all parts of the country and from all sections of the people.

Over the years, the advances portfolio of banks have become broad-based and diversified. The end-use and viability are the criteria for bank loans now as against the erstwhile undue emphasis on security and credit worthiness. Banks have actively participated in promoting balanced regional development of the country. Banks are also providing medium term advances for deserving schemes of national priority. Banks also invest in government securities. Thus they are directly participating in the efforts of national development. Through active and large scale mobilisation of savings and through judicious allocation of credit to the various segments of the economy, the banks have facilitated the economic growth and helped in creating employment opportunities.

There are 28 public sector banks which account for over 90 per cent of the deposits and about 87 per cent of the total branches of banks. Their dominant position and involvement in the national development effort and achievement of social justice is thus evident. Besides expanding banking facilities, these banks extend credit facilities liberally and at concessiona rates to priority sector and the weaker sections of society. These banks are closely associated with the government planning and development activities.

The bank credit is increasingly tied up with the planning system of the country. The banks prepare quarterly credit budgets identifying the needs and the links for balanced development. They held discussions with the borrowers from various sectors to ensure proper utilization of the resources provided. As lead banks, banks take the initiative in the formulation and implementation of credit plans for given areas or districts and thus are actively involved in the country's economic planning and growth efforts.

14.3 NATIONALISATION – RATIONALE AND OUTCOME

With a view to ensuring social justice and equality, the Government of India nationalized 14 major banks in 1969. The most vehement argument in favour of nationalization is that government ownership of banks is an essential precondition for the fulfillment of social obligations. If banks are privately owned, the allocation of scarce resources will be influenced by market factors and the preferences may not match the national priorities. In order to deploy funds for productive purposes or otherwise socially justifiable schemes, for the neglected sectors and weaker sections of the society, at concessional rates, resource mobilizing agencies should be owned by the government. Covering of these funds by a powerful small group of monopolists firms and the attendant undue concentration of economic power and corrupt practices can be checked only if the ownership and control of these funds are assumed by the Government. Extension of banking facilities to remote and interior areas will be possible only at the initiative of the Government as private banks consider this evenue uneconomical.

In India, the nationalised banks have done a remarkable job of extending banking facilities on a very wide scale to rural and semi-urban areas and to regions which have hither to been poorly served. However, inadequate banking facilities and regional imbalances still persist and there are several needy segments of the economy, the deserving claims of which are to be promptly met.

14.4 ROLE OF COMMERCIAL BANKS

Commercial banks play as important role in the economic development of a country. Without the existence of these banks, the underdeveloped countries cannot join the ranks of advanced countries. More specially, the importance of commercial banks can be very clear from the following points:

i) **Banks help trade and industry :** Without the introduction of bank cheques and drafts, it would be impossible to transact large-scale trade within the country and also between the countries. Today bank cheques, drafts, and bills of exchange constitute an important source of money. Without these sources of money internal trade and international trade could not have developed and without such trade, specialization and industrial development is not possible.

ii) **Banks encourage right type of industries :** Banks provide funds in the shape of loans and advances to right type of industries. This is done in accordance with the national priorities. These funds help the entrepreneurs to acquire materials, labour and other factors of production. However, banks provide funds to only those entrepreneurs whose products are in great demand. Besides, banks loans help the manufactures to increase their productive capacity also.

iii) **Banks help in distribution of funds between regions :** Through a wide network of branches, the banks help the development of backward regions. This is possible as the banks transfer the surplus funds of one place to the other places. Thus funds can be utilized more effectively and efficiently in those places where they are really needed. This encourages production and enhances national income.

iv) **Banks Create Credit and help in business expansion :** Expansion of bank credit provides more funds to entrepreneurs. This encourages production and creates employment opportunities. Further, the increased bank credit certainly contributes to the increased economic development.

v) **Banks promote Capital formation :** Banks encourage habits of thrift among the people. Thus, they mobilize the idle and dormant capital of the community and make it available for productive purposes. Thus there is a possibility of diverting economic resources from consumption to capital formation. A higher rate of savings and investments, is therefore, what constitutes the real capital formation.

Thus, banks occupy an important place in the socio-economic development of a nation.

14.5 FUNCTIONS OF COMMERCIAL BANKS

Commercial banks play an important role in the socio-economic development of a countr The importance of these can be understood through the functions they perform. The functi of commercial banks can be classified as below:

I. Primary Functions

a) Acceptance of Deposits
b) Granting loans and advances

II. Subsidiary Functions

a) Agency services
b) General public utility functions
c) Overseas trading functions
d) Information and other services

I. Primary Functions

a) Acceptance of Deposits : Banks accept deposits from the public. They provide safe custody of deposits and facilitate the transfer of money of customers through cheques. The deposits accepted by commercial banks can be of three types. They are :(i) Demand deposits; (ii) Savings deposits: and (iii) Fixed deposits. Demand deposits are also called current accounts on which banks do not pay any interest. But these account holders are permitted to deposit and withdraw any amount at any time.

Customers can deposit their small savings in savings deposits on which banks pay certain amount of interest. But banks impose certain limitations on the withdrawals of money from these accounts.

Fixed deposits are accepted for a fixed period of time and withdrawals are not permitted before the due date. Interest is paid on these deposits depending on the period of deposit. However, customers can obtain loans from the banks against these deposits. Further, before the due date, subject to certain limitations they can cancel their deposits and get back their money.

b) Granting of loans and advances : With a view to increasing the wealth of the nation, banks grant loans and advances to business men, and investors out of the money mobilized from the pubic. Banks grant different types loans by accepting the discounting of bills, granting cash credit, and providing overdraft facility. In order to get back these amounts banks grant the loans against the personal security, gold, silver and other fixed and variable securities. Usually, the rate of interest charged by the banks on the loans and advances is higher than the rate of interest offered on the deposits.

c) Credit Creating: The origin of this function is the mobilization of deposits and granting of loans and advances. The amount of loans granted by the banks can be more than the amount of deposits they mobilize. That is why, Sayer opined that "banks are not merely purveyors of money but in an important sense, manufactures of money.

In a country, the total quantum of money in circulation includes the legal tender money issued by the banker. Bank deposits are also known as bank money. While granting the loans, instead of paying the amount in cash to the loanee, banks credit the amount to the accounts of the customers. Many of the customers use cheques and drafts for making payments to different parties. Thus, additional deposits are also created on which banks get interest.

II. Subsidiary Functions

In addition to the primary functions, banks also render different kinds of services to the customers. These services are called subsidiary services. Banks collect nominal rate of interest on these services. Subsidiary functions can be classified as below:

i) Reprehensive functions
ii) General public utility functions
iii) Functions relating to international trade
iv) Information and other functions.

i) Representative functions: The transactions performed by the banks on behalf of their customers are known as representative functions. Commercial banks perform the following representative functions.

a) On request from the customers, banks collect dividend, and interest on behalf of the customers and credit such amount to their accounts.

b) On behalf of the customers, banks make payments towards insurance premium, subscriptions, rent, cheques, bills, promissory notes etc., and debit such amounts to their accounts.

c) Advising the customers regarding the purchase of shares, debentures and bonds and purchasing them on behalf of the customers.

d) Transferring the amount of the customers from one place to the other as per the instructions of the customers.

e) Acting as agents, correspondents, representatives, executors and trustees of customers.

f) Acting as an administrator of the deceased account holder if he dies without administering.

g) Presenting the tax-returns, helping in assessing the tax liability of customers and collecting the excess tax paid by the customers.

ii) General Public utility functions: Commercial banks render the following services to the customers.

a) Issue of credit cards, traveler cheques and gift cheques.

b) Providing safe deposit lockers for the safe custody of gold and silver ornaments, ownership title deeds, agreement papers and other valuables.

c) Providing leather wallets for the safe custody of money of the business persons after the bank working hours.

d) Acting as referees of the customers.

iii) Functions relating to International Trade: To facilitate the smooth functioning of international trade, banks render the following services to the customers:

a) Discounting the bills drawn by the exporters on the importers of foreign countries and paying Indian currency to the customers.

b) Agreeing to pay the amount towards the bills drawn by the foreign exporters on Indian importers.

c) Issuing letters of credit to importers and helping them in importing the goods and services.

iv) Information and Other Services: Banks provide information regarding the trade potential and foreign trade to the customers. In this regard, they offer the following services:

a) Publication of bulletins containing information regarding trade, commerce and general economic conditions of the country.

b) Preparation of special reports containing information regarding the marketability of goods and services within the country and also in other countries.

c) Issue of letters of introduction to the customers who visit foreign countries and sending the details of the customers to the bankers of the places where the customers visit.

d) Collecting secret information regarding the financial position of the persons, institutions and companies of other countries on behalf of the customers. This type of information helps the customers in taking correct decisions regarding their investment.

e) Provision of information to the customers intending to set up branches in other countries regarding the general economic conditions, rules and regulations of companies, foreign exchange, insurance, local bank facilities, etc.

Thus, in the modern world, banks are rendering invaluable services to the customer. They are working as nerves a human body which carry blood to the entire body. In this connection, Walter Leaf opined that "banker is an intermediary who is acceptable to all in the world economy"

CHECK YOUR PROGRESS - 1

1) Describe the role of commercial banks in the development of Indian economy.

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2) Explain the functions of commercial banks.

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14.6 FINANCING VARIOUS SECTORS OF THE ECONOMY

Commercial banks provide financial assistance to various sectors of economy such as, agriculture, industry, commerce and trade. A brief description of bank financing to these sectors is as follows:

i) Financing of Agricultural Activities

Till 1967 commercial banks provided meager assistance to agricultural activities. Cooperative credit societies also received some assistance. Thus, very little was available for agricultural production. Banking at that time had a predominantly urban orientation and was mainly concerned with trade, commerce and industry. Since 1967, the situation changed in view of the Governments determination to harness the commercial banking sector for rural finance. With the nationalisation of banks the commitment became all the more urgent and significant and the banking system began to evolve a variety of schemes for the direct financing of agriculture. A number of schemes for promoting agriculture related activities such as distribution of fertilizers, pesticides, implements, energisation of irrigation wells, construction of godowns were also introduced.

ii) Financing Commerce and Trade

Initially, Commercial banks largely invested in financing domestic trade, wholesale and retail. Later, when it was found that big traders were cornering funds from banks for anti-social purposes such as hoarding and speculating. The Reserve Bank of India introduced appropriate measures of credit control. The small traders and retail business, have from the beginning received little assistance.

Credit facilities to exporters are provided by authorized banks dealing in foreign exchange. The Reserve Bank of India refinances short term export credit and the Industrial Development Bank of India refinances medium term export credit. The efforts of commercial banks to expand export credit have also been substantially supported by the guarantee facilities provided to commercial banks by the Export Credit Guarantee Corporation by underwriting a major portion of the losses or risks arising from advances to exports.

iii) Financing of Neglected Sectors

The Commercial banks now provide assistance for the furtherance of higher education. They extend credit facilities to professional and self-employed persons. The government and the Reserve Bank of India have introduced a number of supporting schemes to enable commercial banks to provide assistance to the neglected sectors of the economy.

iv) Financing the Investment Activities of the Government

Commercial banks support public programmes of development by investing their deposit resources in Government securities. In the investment portfolio of Commercial banks, the government securities have a very dominant place. The readiness of banks to invest in government securities leads to the repeated success of Government's borrowing programmes and this has a stabilizing effect on the securities market.

v) Contribution of Generation of Employment

Creation of employment opportunities is part of the economic growth process of a country. The country's resources of skilled, educated and technical manpower have to be productively deployed. Commercial banks through their rapid expansion, have directly absorbed educated youths in various parts of the country. Banks have assumed the responsibility to identify and assist employment oriented schemes. Potential entrepreneurs are given assistance for launching their schemes. Self-employed people like tailors, artisans, barbers, etc., are given financial assistance besides providing financial assistance and technical advice. Banks extend guidance in assessing market prospects and aid in a variety of other ways through their Multi-Service Agencies.

14.7 COMMERCIAL BANKS AND INDUSTRIAL FINANCE

Banks provide financial assistance to industries in a variety of ways. They provide loans and advances, purchases shares and debentures. However, a bulk of the bank assistance is related to cash credit and overdraft facilities. Term finance is also provided for purchases of fixed assets.

At the very outset it may be pointed out that the part played by commercial banks in financing industries is inadequate. Especially their share in the long-term finance for fixed capital purposes is undoubtedly negligible. They generally follow the theory of commercial banks assets by confining their advances to short-term loans. In this context it is advisable for banks with large resources, with their intimate contact with the industrial units in the sphere of short-term finance and their large branch network to extend long-term loans to industrial borrowers.

Data on sectoral deployment of gross bank credit relating to select scheduled commercial banks which account for 90-95 per cent of bank credit extended by all scheduled banks are given in the following Table. The number of banks covered was 49 for March, 1990, 48 for March 1991 to March 1993, 47 for March 1994 to March 1997 and 50 for March 1998 to March 2000.

TABLE – 14.1

INDUSTRY-WISE DEPLOYMENT OF GROSS BANK CREDIT

(Rupees crore)

Industry	Outstanding as on last reporting Friday of March										
	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
1	2	3	4	5	6	7	8	9	10	11	12
Industry (Small, Medium and Large)	53,805	61,240	65,240	78,482	80,482	1,02,310	1,24,937	1,38,548	1,61,038	1,78,999	1,99,112
1. Coal	178	229	246	340	457	475	488	570	801	1,114	1,126
2. Mining	--	--	--	--	--	--	--	65	975	1,360	1,240
3. Iron and Steel	2,835	3,292	3,692	5,710	4,528	6,725	8,482	11,668	15,767	18,291	18,799
4. Other Metals and Metal Products	1,838	2,227	2,312	2,679	3,199	3,471	3,977	5,276	5,193	5,918	6,294
5. All Engineering	12,509	13,931	14,842	17,094	17,127	21,160	25,621	22,684	22,833	21,513	23,069
of which *Electronics*	1,290	1,874	2,092	2,327	2,512	3,544	5,276	4,699	4,472	4,872	5,133
6. Electricity	1,258	1,152	1,298	1,404	1,425	1,984	2,703	3,506	4,652	6,813	7,438
7. Cotton Txtiles	3,659	4,073	4,278	4,645	4,802	5,907	7,592	8,053	9,331	10,430	11,682
8. Jute Textiles	340	339	330	348	410	502	605	543	1,089	844	894
9. Other Textiles	3,297	3,761	3,970	4,653	4,916	6,590	7,802	9,685	10,651	12,000	13,003
10. Sugar	647	639	330	348	410	502	605	543	1,089	844	894
11. Tea	571	608	658	782	922	1,106	1,313	814	1,028	825	1,034
12. Food Processing	1,056	1,216	1,241	1,423	1,601	2,470	3,103	3,655	4,134	4,750	5,986
13. Vegetable Oils (including vanaspati)	700	865	898	1,017	1,075	1,219	1,565	1,[illegible]55	2,296	2,710	2,958
14. Tobacco and Tobacco Products	379	391	550	739	623	854	1,009	934	1,076	1,005	993
15. Paper and Paper Products	1,346	1,482	1,501	1,595	1,735	2,185	2,366	2,580	2,742	2,938	3,143
16. Rubber and Rubber Products	912	989	1,077	1,186	1,196	1,569	1,748	1,817	2,534	2,014	2,063
17. Chemicals, Dyes, Paints etc.	6,785	7,743	8,280	10,117	10,034	12,797	16,450	15,393	18,120	19,929	23,440
Of which:											
i) Fertilisers	1,075	1,309	1,357	1,713	1,540	1,663	2,108	2,358	2,910	3,577	4,577
ii) Petro-Chemicals	681	680	614	945	747	747	1,633	1,923	2,956	4,748	6,185
iii) Drugs and Pharmaceuticals	1,013	987	1,127	1,309	1,439	1,834	2,367	3,672	5,219	5,323	5,693
18. Cement	843	899	986	1,103	1,217	1,515	1,744	1,918	2,502	2,746	3,624
19. Leather and Leather Products	931	998	1,086	1,095	1,279	1,848	2,279	2,225	2,478	2,542	2,664
20. Gems and Jewellery	1,214	1,236	1,300	1,624	1,975	2,361	2,785	3,096	3,530	4,124	5,406
21. Construction	1,091	1,321	1,344	1,567	1,670	2,032	1,854	2,494	2,646	2,569	2,736
22. Petroleum	137	54	19	436	227	622	1,510	3,374	6,155	5,516	8,969
23. Automobiles including trucks	--	--	--	--	--	--	--	--	2,870	3,128	4,028
24. Computer Software	--	--	--	--	--	--	--	--	616	747	1,022
25. Infrastructure	--	--	--	--	--	--	--	--			
i) Power	--	--	--	--	--	--	--	--	3,163	5,941	7,243
ii) Telecommunications	--	--	--	--	--	--	--	--	697	2,109	3,289
iii) Roads and Ports	--	--	--	--	--	--	--	--	2,045	2,273	1,992
									421	1,559	1,962
26. SAFAUNS	149	87	68	46	30	10	2	--	--	--	--
27. Other Industries	11,130	14,157	14,385	17,803	18,664	21,958	26,640	33,696	30,897	35,894	36,426

Source: Handbook of Statistics on Indian Economy, Reserve Bank of India, 2000.

Before taking a close analytical look at the table which by and large portrays the data relating to the post-liberalisation period, it becomes imperative to capture the pre-liberalisation scenario.

A major part of the growth in credit to industries was extended to the engineering group (Rs. 926 crores) chemicals, dyes, paints etc., (Rs. 794 crores), cotton textiles (Rs. 335 crores), other textiles (Rs. 330 crores) and iron and steel (Rs. 309 crores) during the years 1986-88.

Credit to 'other sectors' comprising hire purchase agencies, leasing companies etc., accounted for Rs. 1,913 crores.

An analysis of industry – wise deployment of Gross Bank Credit for a 10-year period (1990-2000) reveals that total bank credit absorbed by the industry (all industries put together) has gone up from Rs. 63, 805 crores in 1990 to Rs. 1,99,112 crores in 2000. However, among the industries, the bank credit absorption by the all Engineering Industries doubled to reach Rs. 23,069 crores in the year 2000 from Rs. 12,609 crores in 1990, of which Electronics accounted for Rs. 5133 crores in 2000. The Chemicals, Dyes and Paints industries together accounted for Rs. 23,440 crores in 2000 as against to Rs. 6,785 crores in 1990. One interesting feature of the strucutre of Indian industry is the emergence of computer software industry. It garnered an amount of Rs. 616 crores in 1998, and has increased to Rs. 1,022 crores in the year 2000.

Financing Small Scale Industries

The small industries sector is a high priority sector and banks provide substantial assistance to the small scale units. The State Bank of India took the initiative in this regard. The Credit guarantee scheme which is operated by the Reserve Bank of India on behalf of the Government of India provides automatic protection to eligible leading institutions against possible losses in respect of advances to small scale enterprises. The consultancy bureaus and merchant Banking Division of banks provide comprehensive commercial, technical and managerial advisory services to the entrepreneurs of small scale units. Some of the facilities provided by the commercial banks to small scale industries are as follows:

i) Financing Working Capital needs of small scale industries: The working capital needs of an industry are met by the banks with facilities such as Cash Credit, Overdrafts, etc. Though, these short-term advances are sanctioned for a period of one year, they are normally renewed on satisfactory conduct of the units.

Cash Credit: This advance is granted against the security of raw-materials and finished goods which are stored under the lock and key in the godown approved by the banks. The keys of these godowns are held in the custody of the banks. The raw-materials which are not immediately required for processing, high value items of raw-materials which are critical in nature, finished goods which are not immediately required for sale may be kept under the bank's lock and key. Commercial banks also grant cash credit advances against the security of raw-materials and finished goods which are stored under the effective custody of the borrowing unit. The units enjoying these facilities have to maintain proper stock registers and submit stock statements once in a week. The drawing power is calculated on the basis of stocks declared in the stock statement.

ii) Trust Receipt facility: This type of facility is granted to small scale industrial units against the security of raw-materials, work-in-progress and finished goods. Under this facility, the borrower is permitted to take delivery of the goods pledged to the bank for sale or processing without payment of their value. However, the goods released for sale are adjusted either out of sale proceeds of goods or proceeds of the bills submitted and discounted. In cases where the goods are released for undertaking job work/processing the borrower has to repledge the goods, when they are received back after processing. A letter of undertaking and declaration has to be obtained from the processing firms who are doing job works for the customers financed by the banks.

iii) Packing Credit: Export packing credit is a working capital advance granted against a specific letter of credit of prime overseas bank or firms which order for purchase, processing, manufacture and packing goods for export purpose. Generally, these advances are granted for a period not exceeding 180 days.

iv) Demand Drafts Purchase Limits (DDP): This kind of facility is given to sellers of goods against the demand bills drawn on customers (buyers) who reside at different places. However, this facility is made available to the sellers who sell the goods on cash basis. Since the buyers are situated at some other places, there is a possibility of delay in the payments. As such, during such period, banks grant the advances and meets the financial needs of the small scale units.

v) Overdraft (Supply Bills): This type of facility is granted to small scale units who supply their products to Government Departments on credit basis. According to this scheme, the units have to execute a power of attorney in favour of the banks so that the banks get the power of attorney registered with the Government Departments concerned.

vi) Overdraft (Bills in course of collection): This type of facility is given to the small scale units which dispatch the goods to the buyers without receiving cash or bills. However, the bills accompanied by LR/PR, Delivery challan and invoices are submitted to the bank. On this basis, the bank gives drawing power to the seller of goods.

vii) Bank Guarantees: Bank guarantee is a contract agreed by a bank to perform the promises or discharge the liability of a third person in case of his default. In recent times, there has been substantial growth in the bank guarantee business of Commercial banks, both in dimension and in diversity. A guarantee provided by a bank constitutes part of its contingent liabilities which do not involve immediate cash outflow. However, banks have to undertake the obligation of payment in the event of default by its constituents.

Normally, bank guarantees are issued by the commercial banks in the following situations:

(a) Guarantees on behalf of SSI Units in lieu of Security/earnest money deposits for participating in tenders.

(b) Guarantees in respect of raw-materials supplied to units or in respect of advances received by such units form indenters.

(c) Guarantees to allow units to draw funds from time to time against part execution of orders from the concerned indenters.

(d) Guarantees to units to enable them to collect paddy from the Food Corporation of India for milling and due return of rice, etc.

viii) Term Loans: Financing of term loans is a part of advances portfolio of commercial banks. The Government of India set up in 1978 a Working Group (Tambe Committee) for designing arrangements to ensure adequate flow of bank finance to weavers, artisans and other SSIs who are outside the cooperative structure. Accordingly, the Working Group made recommendations for channelsing institutional credit on an increasing scale to the tiny and village industries in rural areas.

ix) Entrepreneur Scheme: Technically qualified and experienced entrepreneurs who have worthwhile projects for setting up of new industries are eligible under this scheme for financial assistance to the extent of 100 % if necessary to set up SSI units. Under this scheme, technocrats such as Degree/Diploma holders in Engineering/Technology, having limited or no resources are eligible for financial assistance. Under this scheme advances are given to units engaged in the manufacture, processing and/or preservation of goods.

14.8 SUMMING UP

Commercial banks in India have come to play an important role in the promotion of country's economic growth. They have been adopting innovative approaches to promote savings and banking habits among the people. In India, the nationalized banks have done a remarkable job of extending banking facilities on a very wide scale to rural and semi-urban areas and to regions which have hitherto been poorly served. Banks help trade and industry, and distribution of funds between regions. They encourage right type of industries and create and help business expansion. They also promote capital formation. Banks accept deposits and grant loans and advances. They also perform certain subsidiary functions like agency services, general public utility services, overseas trading functions and information and other services.

Banks extend financial assistance to various sectors of the Indian economy like agriculture, industry and trade and commerce. They help the craftsmen and technocrats. Banks finance the working capital needs of small scale industries through cash credit and overdraft facilities.

14.9 CHECK YOUR PROGRESS : MODEL ANSWERS

1. i) Banks help trade and industry
   ii) Banks encourage right type of industries
   iii) Banks help in distribution of funds between regions
   iv) Banks create credit and help in business operations; and
   v) Banks promote capital formation

2. A) Primary Functions:
      i) Accepatcne of deposits
      ii) Granting loans and advances

   B) Subsidiary Functions :
      i) Agency services
      ii) General utility functions
      iii) Overseas facilities
      iv) Information; and
      v) Other services

14.10 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in about 30 lines each.

1. What is the role of commercial banks as instruments of national economic progress?
2. Explain the functions of commercial banks.

3. Explain the financial assistance extended by commercial banks to various sectors of the economy.

II. Answer the following questions in about 15 lines each.

1. What are the primary functions of Commercials Banks?
2. What are the public utility functions performed by Commercial Banks?
3. Explain briefly the growth of Commercial Banks in India.
4. What is the rationale of the nationalization of Commercial Banks in India?

14.11 RECOMMENDED BOOKS

1. R.S Sayers : **Modern Banking**
2. Steiner and Shapiro : **Modern Banking**
3. S.C.Kuchhal : **Corporation Finance**
4. S.K.Basu : **A Survey of Contemporary Banking Trends**
5. K.P.M.Sundaram : **Money, Banking, Trade and Finance**

14.12 GLOSSARY

Fixed Deposits : Deposits accepted for a fixed period of time.

Demand Deposits : Demand deposits are those deposits on which interest is not paid.

Cash Credit : It is a facility provided by the commercial banks against raw-materials, and finished goods.

Export Packing Credit : It is a Working Capital advance granted against a specific letter of credit of prime Overseas Bank.

UNIT – 15 : FINANCIAL SERVICES

Contents

15.0 AIMS AND OBJECTIVES

The objective of this Unit is to discuss the emerging trends in the financing of the corporate sector in India.

At the end of this Unit, you should able to:

- know the various types of financial services available to the corporate sector in India;
- understand the main features of certain financial services; and
- explain the procedure to be followed to secure assistance from various financial services.

15.1 INTRODUCTION

The corporate sector in India since independence has been developing fast. The corporate sector in India earlier used to depend on shares and debentures only for financing its activities.

15.2 MERCHANT BANKING – PROJECT FINANCE

Merchant Banking is a much desired innovative step undertaken by the commercial banks in India. The need for merchant banking in India was vehemently stressed by the Banking Commission (1972). According to the Commission, merchant banking institutions are to offer services like syndication of financing, promotion of projects, investment management and advisary services to medium and small savers and to provide funds and trusts of various types. In fact, merchant banking implies a wider range of specialist services, such as:

a) Loan syndication;

b) Financial and management consultancy;

c) Project counselling;

d) Portfolio management;

e) Formulation of schemes of rehabilation;

f) Guidance on foreign trade financing; and

g) Guidance to non-resident Indians for investment in India.

Growth of Merchant Banking in India

The history of merchant banking services, as understood in the modern context, is comparatively short in India. The National Grindlays Bank was the first foreign bank which obtained a licence from the Reserve Bank of India in 1967 to do merchant banking business in India. It started its Merchant Banking Division in 1969. Subsequently more foreign banks like First National City Bank entered the area in 1970. Amongst the Indian Banks, the State Bank of India was first to set up a Merchant Banking Division in 1972. Among the non-banking financial institutions, the Industrial Credit and Investment Corporation of India (ICICI) extended merchant banking services since 1974. After that many other banks also started the service in late 70's and early 80's. These banks include: Canara Bank, Bank of Baroda, Bank of India, Indian Bank, Punjab National Bank, Allahabad Bank.

More recently many other banks like United Commercial Bank, Indian Overseas Bank, Punjab and Sind Bank, Andhra Bank, etc., have also entered the field. Amongst the foreign banks new entrants are Standard and Chartered Bank, the Bank of Credit and Commerce International United, Bank of America and American Express. In fact, the buoyancy in the investment climate in the country in the recent past has led to cultural scramble in the Indian banking to capture increasing merchant banking market. This is obvious from the entry of Bank of America and American Express – who never had merchant banking division. Big brokers and financial consultancy firms/companies have not lagged behind. Many of them like 20th Century Finance and Consultancy Pvt. Limited, M.J.P. Financial and Consultancy Private Limited, K.R. Consultants etc., have entered the field. Most of the leasing companies are also listing merchant banking services as one of their activities.

Role of a Merchant Banker

The Securities and Exchange Board of India (Merchant Bankers) Rules 1992 define merchant banks as –

"A person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities as manager, consultant, advisor or rendering coporate advisory services in relation to such issue management".

The merchant banks plays a vital role in channelising the financial surplus of the society into productive investment avenues. The Merchant Banker has a fiduciary role in relation to the investors. He has to ensure that only quality paper emanates from his firm. He is required to exercise due diligence to ensure the adequacy and appropriateness of the disclosures made in the offer document.

The Merchant Banker is the leader among all the intermediaries associated with the issue. He is required to guide and co-ordinate the activities of the Registrar to the issue, bankers to the issue, advertising agencies, printers, underwriters, brokers, etc.

The Merchant Banker has to endure the compliance of all the laws and regulations governing the securities market. He may also be called upon to assist the statutory authorizing in developing a regulatory framework for orderly growth of capital markets.

Merchant Banking Functions

The following are the functions of a merchant banking division of a bank:

1. To help in obtaining government consent for starting new industrial projects.
2. To prepare economic, technical and financial feasibility studies.
3. To manage capital issues, fixed deposits and underwriting of shares and debentures.
4. To help in securing rupee finance from financial institutions like IDBI, ICICI, IFC, SFC's etc.
5. To assist the firms in deciding the scale of operations and the technical process to be used.
6. To arrange foreign currency loans for import of machinery, etc.
7. To advise various companies in their reconstruction through amalgamation and absorption.
8. To counsel in project planning and company law matters.
9. To maintain liaison with government an semi-government bodies.
10. To suggest Research and Development.

In general, however, the merchant banking activities of the Indian banks have been largely confined to the management of public issues and loan syndications. They have yet to develop expertise in the fields of project counselling, corporate counselling, capital restructuring, portfolio management, management consultancy, tax consultancy etc. Indeed, there is a vast scope for development in the merchant banking activities in India. The fast growing capital market will provide them with ample opportunities. There is little doubt that the future of the commercial banks in Indian lies in their innovative services, which can be provided through merchant banking.

Regulation of Merchant Banking

The activities of merchant banking are regulated by the Merchant Bankers Regulation of SEBI. The regulations stipulate that any person or body proposing to engage in the business of merchant banking or presently engaged as managers, consultants or advisors to issue would need authorization by SEBI. The Merchant Banking Regulations ensure involvement of Merchant Bankers in post issue management even where those activities are handled by other intermediaries. They would be primarily responsible for ensuring timely refunds and allotment of securities to the investors and listing of the instrument on the stock exchanges. Merchant Bankers have to submit to SEBI, whatever information, documents, return and reports as may be prescribed and called for Merchant Bankers have to adhere to a code of conduct prescribed by SEBI. The authorization of merchant bankers may be suspended or cancelled for suitable duration in case of violation of the guidelines. A procedure for appeal to Govt. of India has also been prescribed against the orders of SEBI.

The registration norms with SEBI are not very stringent. The low entry barriers coupled with lucrative opportunities lured many new entrants into this industry. The market was soon flooded with competitors, and improper diligence most of the small firms had to exit from the business because of the stiff competition and the shake-out in the industry, because of lack of adequate business. Subsequently, most of the top rank Indian merchant bankers, who had strong domestic base, started entering into joint ventures with the Foreign Investment Banks. Some of the successful tie-ups are –

J.M. Finance	--	Morgan Stanley
DSP Financial Consultants	--	Merrill Lynch
Kotak Mahindra	--	Goldman Sachs
Ind. Global Fin. Trust	--	Salomon Bros
Credit Capital	--	Lazard Bros
SBI Capital Market	--	Lehman Bros

15.3 MUTUAL FUNDS

A mutual fund is a common pool of money into which investors place their contributions that are to be invested in accordance with a stated objective. The ownership of fund is thus 'joint' or 'mutual' and the fund belongs to all investors.

The recent financial service that has pooled huge volumes of savings into both capital markets and money markets is mutual funds.

A mutual find uses the money collected from investors to buy those assets which are specifically permitted by its stated investment objective. Thus, an equity fund would buy equity assets – ordinary shares, preference shares, warrants, etc. A bond fund would buy debt instruments such as debentures, bonds, or government securities. It is these assets which are owned by the investors in the same proportion as their contribution bears to the total contributions of all investors put together.

Since each owner is a part owner of a mutual fund, it is necessary to establish the value of his part. In other words, each share or unit that an investor holds needs to the assigned a value since the units held by an investor evidence the ownership of the fund's assests, the value of the total assets of the fund when divided by the total number of untis issued by the mutual fund giving the value of one unit. This is generally called the Net Asset Value (NAV) of one unit or one share.

The mutual funds industry come to India almost four decades ago. It arrived with the establishment of the Unit Trust of India, in 1964. For almost 25 years, the UTI was the sole player in the fund market. That was the period when the capital markets were still to take roots and the financial institutions were the major suppliers of long term finance. Between 1947 and 1986, where the UTI was a monopolist, the total investible funds flew from Rs. 25 crores in June 1965 to Rs. 4,564 by June 1987. In 1987, the first public sector mutual fund was established by SBI. Between 1987 and 1992, 7 mutual funds were setup, 5 by public sector banks, and 2 by the insurance corporations, viz., LIC & GIC. The investible funds which stood at Rs. 4,564 crores at the end of June 1987 grew to rs. 37,000 crores by the end of June 1992. Between 1992 and December 1995, mutual funds raised Rs. 57,530 through 113 schemes.

The number of mutual funds during this period have grown to 27 and the number of schemes increased to 196, thereby making the total assets managed under them reached to Rs. 80,600 crores level. Beginning with 1993, foreign asset management companies began to set up domestic asset management companies as joint ventures with Indian firms. By 1999, the assets under management by the mutual funds reached close to Rs. 87,000 crores and were Rs. 90,587 crores by March, 2001 –with a continuous rise, the total assets of the mutual fund industry were Rs. 1,00,594 crores by March 31, 2002.

Kinds of Mutual Funds

Mutual funds are of two kinds – open end funds and close-end funds. If the period and/or target amount of the fund is definite, it is called close-ended. If indefinite, it is called open-ended. For instance, the unit scheme of UTI is open-ended fund, both in terms of period as well as target amount.

The mutual funds may be 'income-oriented' as well as 'growth oriented'. The income oriented funds aims at distributing income periodically amongst investors. Consequently, its investment strategy conforms to the fund objective by deployment of investor's monies into fixed income yielding securities. On the other hand, the growth oriented fund meets the investor's need for appreciation high risk bearing capacity and ability to defes liquidity. As such, the investment by growth oriented funds are predominantly made in equities. The fund which partially meets the needs for income and growth are called 'balanced' or 'Income-cum-growth' fund.

However, a broad classification of mutual funds is always done as ownership securities (or) creditor ship security basis. They are-

i) Equity Funds: These are funds that primarily invest in equity stock. An illustrative list of kinds of equity funds is given below-

- Growth funds
- Maximum Growth Funds
- Income Funds
- Equity-Income Funds
- Growth & Income Funds
- Balanced Funds
- Small Company Funds

ii) Bond Funds: These funds invest exclusively in fixed income securities like government bonds, corporate debentures, money market, etc. An illustrative list of bond funds is given below-

- Corporate Bond Funds
- Convertible Securities Funds
- Government Bond Funds
- Municipal Bond Funds
- Zero-Company Bond Funds
- International Bond Funds

Future of Mutual Funds

The future of mutual funds is bright. The first trust, UTI has successfully launched a variety of schemes to meet the diverse needs of millions of investors. With a view to provide a wider choice to small investors, the government has now permitted bonus to launch mutual funds in the country. State Bank of India, Canara bank, Andhra bank and LIC have already launched their mutual funds. The entry of banks and financial institutions in this vital field will provide, in the first place, the much needed competition. This will improve customer services and widen his choice.

The basic requirements an investor looks for in an investment are safety, returns and liquidity. After observing the stock market crashes and scams, many savers are turning towards mutual funds. This is largely because, mutual fund embodies investment at its best and widely addresses the savings component of safety to suit various risk tolerances. There are a host of mutual funds run in India by both Indian and foreign players offering various schemes. Along with a facility of starting with a minimum investment, there are many attractive features like diversification, transparency, flexibility, etc. offered by mutual funds which are attracting more number of savers and investors into its fold. With the government and SEBI's move of close regulation with adequate flexibility to the mutual fund players, the industry is all set to grow in leaps and bounds.

15.4 LEASING

A lease represents a contract between lessor and the lessee. In this contract the lessor allows the lessee to use his asset on rent basis to be paid periodically. While leasing of land, buildings and animals has been known from times immemorial, the leasing of industrial equipments is a relatively recent phenomenon, particularly on the Indian scence. Lease financing represents a marginal source of long term financing in India.

Types of Lease Agreements

Lease agreements may be broadly divided into two categories:

1. Operating Lease
2. Financial Lease

Operating Lease: An operating lease, or service lease, has the following features:

1. It is a short term lease. The lease period will be generally less than the life of the equipment.
2. The lease is not fully amortised. It means, the lease rentals payable during the lease period are not sufficient to cover fully the cost of the equipment along with an acceptable return there on.
3. The lease is usually cancellable at short notice.
4. The lessor is responsible for maintenance, insurance and taxes.

Manufactures interested in leasing their own products typically use operating leases. computers, vehicles, copiers and furniture are examples of assets that are commonly leased under operating lease arrangements. The system is more popular in Western Countries, compared to India.

Financial Leases: A financial lease, or capital lease, is essentially a form of borrowing. The following are the characteristics of financial lease:

1. It is an intermediate-term to long-term non-cancellable arrangement. During the initial lease period, which is usually 3 years or 5 years or 8 years, the lease cannot be cancelled.
2. The lessee is responsible for maintenance, insurance and taxes.
3. The lease is fully amortised during the initial lease period. This means that during this period the lessor recovers, through the lease rentals, his investment in the equipment along with an acceptable rate of return.
4. The lessee usually enjoys the option of renewing the lease for further periods for very nominal lease rentals.

Characteristics of Leasing: The following are the significant characteristics of leasing:

1. Leasing eliminates the need for a down payment in a majority of cases. Cash outlay is thereby conveniently spread out, matching the inflows from operations.
2. Since lease can take the shape off-balance sheet finance, it has the effect of increasing the borrowing capacity of the company.
3. Leasing should in most cases be costlier than borrowing.
4. Where manufacturer lessors are involved, leasing serves to reduce the risk of obsolescence. In other cases, generally the rental payments are so decided as to ensure that the asset is fully paid for during the lease period. The lessee has to be careful in negotiating the lease terms and ensure that the benefits of technological developments or innovations pertaining to the leased equipment are transferred by the lessor promptly. For this purpose, the lease periods should be relatively short, say 3 years to 5 years, depending on the nature of item.
5. For instance, where funds are needed for investment in current assets the existing property or selected fixed assets of the company can be sold and leased back, thus raising the required resources.
6. Since the lease rental can be paid out of the cash generations from the operations of the company it is a self financing progress. Heavy initial cash outlay, through borrowing, is averted, and the company pays for the leased assets as it earns.
7. The lease rentals are tax deductible expenses. But lease company is not eligible to claim the benefits of depreciation or investment allowance on the leased assets.
8. Leasing involves simple and flexible procedures. Urgent non-budgedted acquisitions are facilitated and the company has also the advantage of having the assets as the current costs with the payments being made on agreed dates in future thus providing a safeguard against inflation.
9. Lease finance is not provided for setting up new projects or gross **root expansion /** diversification programmes. It covers mainly the modernisation / replacement expenditures.

Leasing in India

In late 60's and early 70's hectic efforts were made by Citi Bank to introduce leasing to Indian industry in a big way, but had to give it up as the response was poor. Computer leasing alone made some headway. The first leasing company of India (FLCI) braved the odds and got started in 1973 but had to stay dormant for a long period. Till the advent of the 1980's only a few finance companies reported occasional leasing transactions, but these were of marginal nature. These initial leasors were looking for higher returns and the intending lessees also were not adequately familiar with the process of negotiation for getting a fair deal. It took years for professional awareness of leasing to develop.

In the funds-starved environment that prevailed at the start of the 1980's the efforts of the first leasing company to forge ahead met with success. The Indian industry saw the logic in getting equipment on lease without being required in fund substantial resources for intial investment in capital assets but yet being able to obtain and use them for maintaining or expanding operations. The 20th Century Leasing Company started its operations in 1980 and found its business picking up rapidly in 1981 and more so in 1982. The Industrial Credit and Investment Corporation of India took up leasing in 1983 and by virtue of its close involvement in the promotion and growth of Indian Industry over decades, gave considerable credibility and support to the concept of leasing. Since then leasing has caught on faverishly and leasing companies have proliferated. The Industrial Reconstruction Corporation of India, the Gujarat Industrial & Investment Corporation of Maharashtra also joined in. The commercial banks have also been permitted to set up subsidiares to carry on leasing business and some of them taken the initiative in identifying opportunities. In effect, this financial innovation has been effective in widening the base of the capital market in India.

Thus, lease financing in India has been a welcome development as it has widened and deepened the capital market. There is a significant scope for this business in the coming years. However, the mushrooming growth of leasing companies have also brought to the surface some unethical and harmful practices, particularly among the smaller leasing companies. There are instances of the lessor fixing a low rental for the client and collecting the difference between the negotiated and the fair rental in cash. This cash transaction is outside the records. Or else the lessor only fix a very high rental and pay back the difference between the negotiated and the fair rental to the client in cash. Such unscrupulous activities will tranish the image of the leasing industry which has a positive role to play in the economic development of the country.

15.5 FACTORING

Factoring, a sort of suppliers credit, is understood by the services an agent renders to its principal by managing the latter's sales register, realising the book debts or bills receivables against a pre-determined commission known as "Commercial Charge". The factors' responsibility is contractual with the privity of contract with the seller. Depending upon the terms of the contract, the factor may assume risk for non-payment by the customer also. The need for the factor services is felt in view of expanding sales by the manufacturer/suppliers so as to manage the sales realisation by minimising risk for non-realisation and without waiting for realisation of book debts. The factoring firms have professional skills and use complete system to handle sales ledger for different clients in different trade for betters credit control and management.

Credit sales generate the factoring business in ordinary course of business dealings. Realisation of credit sales is the main function of factoring services. Once sales transaction is completed the factor come into picture and take course to realise the sales. Thus the factor works between the seller and the buyer and sometimes with seller's banks together.

Main terms and conditions of Factoring

Following terms and conditions are generally covered in the agreement of factoring.

a) Assignment of debt in favour of factor.

b) Setting limits and the conditions with which the factor will have no recourse to the supplier on non payment from the customer and in what circumstances the factor will turn to recourse to the supplier.

c) Setting any details of the payment to the factor for his services known as service charge or commercial charge which is usually a percentage on turnover.

d) Setting out details of the interest to be allowed to the factor on the accounts where credit has been allowed or to be allowed to the supplier. The rate of interest is to vary depending upon the money market conditions and is commonly fixed at 2 ½ to 4% p.a. above the base rate so as to give a better margin to the factor.

e) The agreement must set the limit of any overdraft of by the supplier and the rate of interest to be charged by the factor on such overdrafts.

f) The agreement should specify that the amount to be paid by the factor to the supplier should be net of the service charge.

g) The percentage of the amount of the invoice value to be received from the factor by the supplier be specified in the agreement. Usually about 80% of the invoice value of the amount is provided by the factor to the supplier.

h) Specific schedule be provided in the agreement setting out special terms for the factor to handle accounts of different customers.

TYPES OF FACTORING

A. Domestic factoring

It is sub-divided into following types:

1) **Disclosed factoring:** Under this type of factoring the name of the factor is disclosed and clearly mentioned in the invoice asking the buyer to make payment to the factor so named therein. The supplier may continue to bear the risk of non-payment by the buyer or without passing it on to the factor. In such cases the factor is said to have "recourse" to the principal. Generally, the factors assume this risk under "non-recourse" arrangements. The limit within which the factor works as non-recourse is said down in an agreement beyond which the dealings are done on recourse basis.

2) **Undisclosed factoring:** Under this type of factoring the name of the factor is not disclosed in the invoice although factor maintains the sales ledger of the supplier manufacturer. The whole realisation of the debts and receivables is done in the name of the supplier company but control of all moneys remain with the factor.

3) **Invoice Discounting:** The factor could be a bank or the supplier of funds which discounts the invoices of the supplier at a pre-agreed credit limit providing finance to the supplier against the security in the form of a charge on the book debts of the supplier on a specific cash receivables.

B. Export factoring

Under this, banks play an important role. The export company obtains finance from the bank by virtually selling the export documents to it on a reasonable basis.

If the claims are not honoured by the importers bank the exporter still repay the bank the amount so received. The factor bank usually advances 75% to 50% of the export claims of the supplier's exporter. This advance is on both recourse as well on non-recourse basis.

C. Cross border factoring

Export factoring is also known as cross border factoring when import factor at the debtor's place is engaged by export factor. Import factor has knowledge of local conditions and provides help in realisation as well as reduction of commercial risk. The export factor takes over the commercial risk from the exporter as the assurances given by import factor.

Advantage of Factoring Services

1) Factoring make through discounting the bills. The funds available to business enterprises which do not carry legal strings like loans or fixed deposits as the former one is neither a loan nor a deposit.
2) Since factoring makes available to the firm short term money the firm's needs of funds is satisfied without recourse to borrowing. Thus, factoring helps in avoiding increased debts.
3) This services are helpful for improving financial position of the concerned business and it avoids sickness due to want to realisation of debts.
4) Since the funds are made available by factors generally to the extent of 80% of the invoices, the firm can easily meet its liabilities. This enables the firm to reduce in Balance Sheet the realisations from debtors and also the elimination of current liabilities to that extent.

Advantages of Factoring

Factoring has certain advantages that make it quite attractive to many firms. One advantage is the ability it gives the firm to turn accounts receivable immediately into cash without having to worry about repayment. When a firm receives an advance, it does not have to make repayment. Once the factor collects the account or his repayment obligation is that it merely retains the money. A firm that factors its accounts knows that it will definitely receive the cash flows from the accounts by a certain date. This simplifies the firm's cash flow planning.

If factoring is undertaken on a continuous basis, so that all accounts are sold to the factor, a couple of other advantages result. One is the elimination of the firm's credit department. The factor takes over the firm's credit analysis function when it determines accounts are acceptable credit risks. Another advantage is the climination of the firm's collection department. Since the factor normally accepts all crdit risks, it must pay any collection costs. The net results of continuous factoring is the elimination of the credit function from the firm. With this function eliminated, many administrative and clerical costs may be reduced.

Disadvantages of Factoring

The disadvantages of factoring are considered to be its cost and the implication of financial weakness associated with it. The stated costs of factoring are obviously higher than unsecured borrowing cost, but in light of the cost savings resulting from the elimination of many administrative and credit outlays the net cost may not be high for the protection received. As for the belief that may damage future business if the firm's customers learn about it, it is quite difficult to determine its validity. Each factoring agreement is unique, and the advantages and disadvantages of factoring for given firms can only be evaluated in light of the terms of the specific agreements drawn up. In general, small firms that cannot afford to carry professional credit and collection employees often find factoring quite feasible.

15.6 VENTURE CAPITAL

Venture capital implies an investment of long term equity finance on high risk projects with high return opportunities. It is investment in securities made directly of new and unseasoned enterprises by way of private placements while there is risk of total loss and also expectation of higher reward. Risk is involved with such capital investment and as such it is termed as venture capital. It is also known as "risk capital".

Investors of Venture Capital have no liquidity for a period of time. Venture capitalists hope that the company they are supporting will thrive and that after three or more years it will be large and enough profitable to sell its shares in the public market. The venture capitalists hope to sell their shares fro many times what they paid for. If the unit fails the venture capitalists loses everything. The probability distribution of expected return for most venture capital investment is highly skewed to the right. The success rate is about 10 to 20 percent.

The concept of venture capital originated in USA during the nineteenth and early twentieth centuries when the European Investors along with American natives were involving in backing of construction of new industries such as rail rods, steel, oil and gas etc. This concept was formalised after world war II with the involvement of a few American Wealthy family groups who made fortunes in earlier new ventures. In USA the venture capital funds got a boost after the creation of small business investment company under the small business investments Act in 1958. The venture capital funds are privately owned and constitute the longest sources of equity capital. The venture finances were risky but carried opportunities of high return. The sources of venture capital in the USA are several, individuals make venture capital investments directly or indirectly. In direct investment individual or partnership of individuals appraises the proposal and in indirect approach the venture capitalist appraises the proposal and presents his evaluation to the investors.

Features of Venture Capital

The following are some of the features of venture capital agreements:

1. The venture capita firm is inclined to assume a high degree of risk in the expectation of earning a high rate of return.
2. The venture capital firm in addition to providing funds, takes an active interest in guiding the assisted firm.
3. The financial burden for the assisted firm tends to be negligible in the first few years.
4. The venture capital firm normally plans to liquidate its investment in the assisted firm after 3 to 5 years. Typically, the promoter of the assisted firm is given the first option to acquire the equity investment held by the venture capital firm.

Promotion of Venture Capital in India

Realising the importance of venture capital for the development of new technologies, the Union Government in its long-term fiscal policy, proposed to establish, on an experimental basis a venture capital fund with an initial capital of Rs.100 million. This fund will provide equity capital for pilot plans attempting commercial applications of indigenous technology and to adapt previously imported technologies to wider domestic applications.

A venture capitalist's management approach differs significantly from that of a conventional banker or lender or a stock market investor. In fact, the venture capitalist combining the qualities of banker, stock market investor and entrepreneur in one.

Venture capital recognises different stages of financing-development, expansion and buyout financing for the enterprises which are unable to raise funds from the normal financing channels.

Venture Capital in India

Venture capital financing includes technological development stimulating creativity and innovation and nurtures entrepreneurship. For this, concerted efforts are required by the government, financial institutions, private sector and other agencies to create a conducive environment for the growth of venture capital in India.

Venture capital as a concept was first introduced in India in the budget for 1986-87. A 5% cess was levied on all know-how import payments to create a venture fund by IDBI.

The following are the important venture capital schemes operating in India.

IDBI Scheme

The venture capital scheme of IDBI has been set up with an initial funding of Rs. 10 Crores. The salient features are

- It is designed primarily to assist projects which promote commercial applications of indigenous technologies. The technology should be new and not tested in Indian conditions.

- The assistance to a project may vary between Rs. 5 Lakhs and Rs. 250 Lakhs and covers both capital expenditure and operating expenditure during the development phase.

- The assistance provided normally covers 80% of the project cost. The balance has to be contributed by the promoters.

- The assistance may be in the form of equity and/or in the form of loan. The loan component carries an interest of 6% during the initial development phase and 14% thereafter. The loan component is repayable in 10 years, which includes a initial moratorium of 3 years.

- It, however, the project does not succeed IDBI will assist in the transfer of technology to another promoter designated by it on mutually agreeable terms.

ICICI Venture Capital

The venture capital scheme of ICICI subsequently operated by Technology Development and Investment Corporation of India (TDICI) was reorganised as ICICI venture funds management company Ltd. The salient features of ICICI venture funds are as follows

- ICICI venture fund invests in companies with attractive growth and earnings potential with a view to achieve long term capital gain ICICI venture capital is involved in seed, start-up and growth stage of companies in a wide area of industrial sectors.

- The fund seeks to assist technocrats involved in developing commercially viable technologies and products, implementing indigenously developed yet interested technologies on a commercial scale.

- The assistance to a project can go up to Rs. 2 Crores in the form of equity and for conditional loan with flexible interest rates and repayment periods.

- The equity in the project would be held for a period of 5-8 years and thereafter sold to the promoter, at a pre-determined mutually negotiated price or can be disposed off in the secondary market.

The conditional loan can carry no interest during the development phase. The interest rate would depend on the commercial viability of the project.

Other venture capital schemes

1. IFCI Venture Capital Funds Ltd., (erstwhile risk capital and - technology finance corporation)
2. SBI Capital markets
3. Indian Investment Fund of Grindley's Bank
4. Credit Capital Finance Corporation
5. Can Bank Financial Services has setup a Venture Capital Fund
6. 20th Century Finance
7. Indian Technology Venture Capital etc

CHECK YOUR PROGRESS – 1

a) What are the various types of services offered by merchant banking institutions?

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b) What is mutual fund?

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c) What is venture capital?

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15.7 CREDIT RATING

Definition

Credit Rating can be defined as an expression through use of symbols of the opinion about credit quality of the issuer of securities with reference to a particular instrument. It only indicates a representative character of a particular security which does not amount to any recommendation to purchase, sell or hold that security.

Credit rating is a measure of credit risk associated with a credit instrument. Credit rating does not indicate market risk or predict prices or yields of credit instruments.

Scope of Credit Rating

Evaluation under credit rating is limited to debt instruments only. The company which issues the debt instrument is not rated. It is the instrument which is rated by Rating Agency. It reflect upon the issuer's strength and soundness of operations, management and organisational behaviour and expresses a view on its prospective composite performance and also the organisational behaviour based on the study of the past dues. In a way risk is partially defined or indicated through credit rating and the investors are left free to consider other related aspects which might affect the company's willingness, capacity and ability to repay its debts. The scope of rating is limited to the instrument rated. Rating will differ for different instruments to be issued by the same company within the same time span.

Need for credit Rating

It become necessary in view of the growing number of cases of defaults in payment of interest and repayment of principal amount borrowed by way of fixed deposits, debentures, preference shares etc. Defaults shatter the confidence of investors in corporate instruments. Therefore, for judging creditability of the company well in advance before taking decision about investing valuable money of the investors. It become important to make rating first. In India, credit rating covers only debts instruments and not equity shares.

Benefits of Credit Rating

A) Benefits to Investors

i) **Safeguards against Bankruptcy**: Credit rating of an instrument indicates the degree of financial soundness of the issuer company. Highly rated instrument of a company gives an assurance to the investors of highly safe investments.

ii) **Recognition of risk**: Credit rating provides investors with rating symbols backed by the financial soundness of the company which is easy to understand for taking any investment decisions. Rating symbol gives them the idea about the risk involved or the expected advantages from the investment.

iii) **Credibility of Issuer**: Rating symbol assigned to a credit instrument gives a clue to the credibility of the issuer company who has been assessed impartially and judiciously and attract investors.

iv) **Easy understandability of the investment proposal**: Rating symbol can be understood by any investor who needs no analytical knowledge on his part. Investor can take quick decisions about the investment to be made in any particular rated security of a company.

v) **Saving of Resources i.e. Energy and time**: Investors relies upon credit rating. This relieves investor from the botheration of knowing about the fundamentals of a company its actual strength, financial standing.

vi) **Independence of Investment decision**: Through credit rating symbols investors shall come to know about financial strength of the company then on that basis investors can make direct investment decisions.

vii) **Choice of Investments:** Several alternative credit rated instruments are available for making investment in the capital market and the investors can make choice depending upon their own risk profile and diversification plan.

B) Benefits to company : A company which had its credit instrument or security rated by a credit rating agency is benefitted in many ways as summarised below.

i) **Lower cost of borrowing:** A company with highly rated instrument has the opportunity to reduce the cost of borrowing from the public by quoting lesser interest rate on fixed deposits or debentures or bonds as the investors with low risk preferences would come forward to invest in safe securities though yielding marginally lower rate of return.

ii) **Wider audience for borrowing**: A company with highly rated instrument can approach the investors extensivly for resource mobilisation using the press media. Investors in different strata of the society could be attracted by higher rated instruments as the investors understand the degree of certainty about timely payment of interest and principal on a debt instrument with better rating.

iii) **Rating as marketing tool:** Companies with rated instruments improve their own image and avail of the rating as a marketing tool to create better image in dealings with its customers and constituents, lenders and creditors. Even consumers feel confident in the utility products manufactured by the companies carrying higher rating for their credit instruments.

iv) **Self discipline by companies**: Rating encourages the companies to come out with more disclosures about their accounting system, financial reporting and management pattern, etc. The company gets opportunity and motivation to improve upon its existing practices to match to the competitive standard and maintain the standard of rating attained by it or make improvement upon the rating.

v) **Reduction of cost in public issues**: A company with higher rated instrument is able to attract the investors and with least efforts can raise funds. Thus, the rated company can economise and minimise cost of public issues by controlling expenses on media coverage, conferences and other publicity stunts and gimmicks.

vi) **Motivation for growth**: Rating provides motivation to the company for growth as the promoters of the company feel confident in their own efforts and are encouraged to undertake expansion of their operations or new projects. With better image created through higher credit rating the company can mobiles funds from the public and institutions or banks.

Advent of credit rating in India: Credit rating emerged in India with the birth of Credit Rating Information Services of India Ltd. (CRISIL). in January 1988. Corporate sector enterprises have depended in India for funds to finance their projects or expansion of existing projects upon the financial institutions and banks and it was the name of these institutions and banks associated with the company that enhanced the image in pubic estimation of the company and of the public issues too. The need for Credit Rating Agency has been felt much more now when the capital market is going to attain efficiency and the corporate enterprises are raising funds from the issue of securities and their dependence on the capital market is growing a move in the corporate sector from debt-age to free-market finance age has further increased the chances for more Credit Rating Agencies. This is the time for investors to measure risk as well as for the corporate units to use credit rating as a marketing tool. The growth of the capital market is discernible from the fact that there are 21 stock exchanges operating in India with over 6500 listed companies and more than 1.5crores individual investors with increasing trend of investible funds and increasing demand for funds from the industry. Investors have to rely upon rated instruments rather than following the advice of the financial intermediaries. Rating has not been made compulsory in India for companies going public. It is only for debt instrument i.e., debentures, fixed deposits or money market instruments like commercial paper or certificates of deposits for which rating is obligatory under the recent guidelines issued in this regard.

Regulators Requirements

At present debt instruments viz., Debentures/bonds, CPs, and CDs are only rated in India but not equity shares. While any and every issue of CP or CD has to be rated, the following guidelines are applicable for the issue of fully convertble debentures (FCDs), Partly Convertible Debentures (PCDs)/and Non-Convertible Debentures (NCDs):

- Compulsory credit rating is required if conversion is made for FCDs after 18 months.
- In case of NCD/PCD credit rating is compulsory where maturity exceeds 18 months.
- Before roll over of NCDs or non convertble portion of PCDs, fresh credit rating shall be obtained within a period of 6 months prior to the date of redemption and communicated to debenture holders before roll over.

The rating process of debt instruments commences at the issuers' request. Based on the tenure of the instruments, the rating agency will gather the requisite data that based upon the key parameters viz; industry evaluation, the company evaluation, technical evaluation, financial evaluation, statutory evaluation, management evaluation, regulations and competitive environment analysis and fundemental analysis of the issuer company.

Rating Process

The following steps indicate for process involved is credit rating:

1. The rating process commences when a client approaches for credit rating agents to analyse and provide a rating symbol/report to a security/individual/borrower etc.
2. The rating agency then assimilates all the necessary information required for this by meeting the management of company/borrower. The information provided for rating process will be highly confidential and will not be used for any other purposes.
3. Based on the analysis of the report, the rating will be decided.
4. The rating will then be communicated to the client along with the reasons supporting the rating. If this rating is not agreeable, the client may appeal for reviewing the rating for which additional/new information will have to be provided.
5. If the rating is accepted by the client it will then by declared to the public by the credit rating agency.

6. Since rating is not a one time process, there will be a continuous monitoring of the client's performance and its operational environment. Based on this information, the rating may be affirmed, upgraded or downgraded. Any changes will, however, be informed to the public.

The Rating Scale and Symbols

Since the rating of the agencies will be used even by lay investors, the outcome of the rating should be delivered in an understandable manner. To facilitate this, rating symbols are provided. Difference rating agencies use difference symbols and distinct symbols will be assigned for difference securities. The following are the main symbols used with a prefix. The scale of the corresponding rating is also given below.

High Investment Grades

AAA Highest Safety	Debentures rated AAA are judged to offer highest safety of timely payment of interest and principal
AA High Safety	Debt rated AA are judged to offer high safety of timely payment of interest and principal. They differ in safety from AAA issue only marginally.

Investment Grades

A Adequate Safety	Debentures rated 'A' are judged to offer adequate safety of timely payment of interest and principal; however, changes in circumstances can adversely affect such issues more than those in the higher rated categories.
BBB Modesty Safety	Debentures rated BBB are judged to offer moderate safety of timely payment of interest and principal for the present; however, changing circumstances are more likely to lead to a weakened capacity to pay interest and repay principal. Than for debentures interest higher rated categories.

Speculative Grades

BB Inadequate Safety	Debentures rated BB are judged to carry inadequate safety of timely payment of interest and principal; while they are less susceptible to default than other speculative grade debentures in the immediate future. The uncertainties that the issuer faces could lead to the inadequate capacity to make timely interest and principal payments.
B High Risk	Debentures rated B are judged to have greater susceptibilities to default; while currently interest and principal payments are met, adverse business or economic conditions would lead to lack of ability or willingness to pay interest or principal.
C Substantial Risk	Debentures rated C are judged to have factors pressure that make them vulnerable to default. Timely payment of interest ad principal is possible only if favourable circumstances continue.
D	Debentures rated are in default and in arrears of interest or e

In Default	principal payments or are expected to default on maturity. Such debentures are extremely speculative and returns from these debentures can be realized only on reorganization or liquidation.

Further, to reflect a comparative standing within a category, one or more '+' (plus) sign or one or more '–' (minus) sign will be suffixed or prefixed to the symbols given above.

Indian Credit Rating Agencies

In India the credit rating service is offered at present by four agencies. They are:

1. The Credit Rating Information Services of India Ltd. (CRISIL)
2. Credit Analysis and Research Ltd. (CARE)
3. Investment Information and Credit Rating Agencies of India Ltd. (ICRA)
4. Duff and Phelps Credit Rating India Pvt. Ltd. (DCR India)

While the first three are promoted by banks, financial institutes and investment institutions most of them being in public sector, the fourth one is a joint venture company set up by Chicago based credit rates and Alliance credit capital company of India. This company though is a late entrant has made its persence felt in the Indian industry alongside the above three agencies.

15.8 CREDIT CARDS

A credit card is a card or a mechanism that enables an individual to purchase anything, without having to pay immediately. After purchasing the card holder, instead of paying cash, presents his card at the cash counter. In short, he makes his purchase against his credit card.

Credit cards can be continued as a good substitute for cash and cheque. But these cards can be accepted only by those establishments, which have consented to entertain them. These establishments are known as merchant establishments.

Credit card has its origin in U.S.A. Mr. Frank Mc Namara leading business man, once found himself in an embarrassing situation at a holiday resort without having money to pay for the bills. His association with his friend Mr. Blooming Dey, started a credit card outfit. Franklin National Bank of Long Island, New York followed suit and it became the first to issue credit cards in 1951. The business got momentum and in 60's a number of banks entered the field in a big way. The VISA and the MASTER, the largest credit cards today, appeared in the market in 1966 These two international cards are very popular and are accepted and honoured all over the world in more than 170 countries. These two independent card companies not only placed banks all over a competitive ground but have also led to latest innovations in the credit card business.

In credit card system, the issuing bank's name and embossed code numbers are given on the card. It also bears specimen signature of the holder. The issuing bank determines the amount of credit of card-holder keeping in view his standing, means and credit worthiness. The buyer at the time of purchase presents the credit card to the trader, who enters the particulars of the purchase price, card number etc., in a bill form made out in triplicate and has to be signed by the card holder. These signatures must tally with the specimen signature given on the card. The trader then submits the bills for collection to the concerned bankers, who shall debit the amounts to the card-holders account in appropriate monthly or periodical instalments and give corresponding credit to the concerned seller. The recovery from the card-holder is so arranged as to leave a cash margin in the holder's account for his other needs.

Advantages of credit cards

The advantages of credit cards are as follows

a) Credit card is treated as a status symbol. It facilities spending by enabling the card holder to avail soft credit. It helps him in traveling without risk of carrying cash or cheques with him for his stay, dining, shopping etc.

b) System of the credit cards are also useful very much to the dealers of goods and services. Credit cards enable the businessmen to increase their sales by sharing the goodwill of card-issuing bank and enjoying guarantee of prompt payment.

c) The bank gets commission from the dealers on the turnover for providing services. It also gets interest on credit offered to the customers.

- Cash withdrawals of any of the branches of the issuer / member affiliate of the issuer.
- Making purchasing / availing of the services at any of the merchant establishments.
- Cash withdrawal facility
- Overdraft facility
- Add-on facility - by virtue of being a card holder, one spouse or children are entitled to an add-on card, on payment of extra fee which varies according to banks. This add-on card can be used by them for making purchases.
- Revolving credit facility - This facility enables a cardholder to pay only 10% of the total amount due to him. But, he is required to pay a service charge in the outstanding credit every month.
- Insurance cover to a specified extent.

Growth of Credit Cards in India

Credit cards are relatively new to India. Diners Club India (p) Limited, with a franchise from Diners club International, a member of the Citicorp group of companies, started the business in Indian in 1961. Its cards are most popular among 'elites'. With over 7,000 establishments honouring these cards, approximately 80,000 holders of Diners cards can even get cash against their cheques at the club's offices in India and Nepal. In Indian, at present, many banks are issuing credit cards to their customers and non-account holders. CENTRAL CARD is the first to be launched by Central Bank of India. It came into scene in August, 1980. United Bank of India and Vysya Bank Limited are associate members of Central Card. Andhra Bank card initiated by Andhra Bank 1981 is in real sense a credit card having linkage with VISA and Japan Credit Bureau International (JCBI) cards. Bank of Baroda launched BOBCARD in 1985. It has its linkage with VISA International and Allahabad Bank is its associate member. State Bank Card identifies the customer who has been issued a special cheque book containing prevalued cheques. CANCARD launched by Canara Bank in October, 1987 has got its tie-up with VISA International. Canara Bank has issued Gold Card and Silver Card for its valued customers and also corporate cards to serve them better. Dena Bank and a number of other banks are now offering Green cards to farmers to provide them production credit to buy agricultural inputs without repeated visits to the bank branch. Corporation bank has come out with two rural cards, one for crop loans and other consumer spending. The State Bank has also launched Green cards recently.

Indian Credit card market is with both Indian & Foreign banks, that are trying to exploit the market. Standard chartered, city bank, Hong Kong Bank, HSBC, Bank of Baroda, Canara Bank, State Bank of India, and other players are waging a price battle against each other by reducing the registration / admission / processing fee for the issuance of credit cards

The future of credit cards in India appears to be very bright. Indian is potentially the second largest market for credit cards in the world, next only to the United States. With various kinds of offers and various types of credit cards in the market, the activity is expected to grow of a faster rate in near future.

15.9 PARTICIPATING CERTIFICATES

The participation certificate is a novel scheme through which a bank, which has granted credit to its borrowers, can share with other institutions, having surplus funds, a part of the Credit. It has great potentialities as an adjunct to the new bill market scheme, particularly for reducing commercial banks reliance on refinance from the Reserve Bank.

A Participation Certificate (PC) is an instrument whereby a bank can sell to a third party (Transferee) a part or all of a loan made by the bank to its client (borrower). Legally speaking the PC is a deed of transfer. The bank transfers to the PC holder the loan it has made to its borrower against the security or hypothecation of good or book debts. After the transfer, since the loan becomes a joint loan by the bank and the PC holder, the certificate has been named as the participation certificate.

Kinds of Participation Certificates

Participation Certificates are of two types: (1) With recourse and (2) Without recourse. With recourse PC offers potential investors the security and expertise of the bank in a loan made to a borrower who has been deemed credit worthy. With recourse PC does not run until liquidation of the loan, but for a predetermined period. Without recourse PC, on the other hand, runs unitil liquidation of the participated loan. The PC scheme is not open to the public and banks are permitted to enter into participation arrangements only with other commercial banks, LIC, UTI, GCI and ICICI. The Reserve Bank has stipulated that the period of participation certificates should not be less than 30 days and not more than 180 days. Further, the rate of interest to be offered by the bank to the participating institution should not exceed the maximum of 10 percent.

The first bank which designed and issued the participation certificate was the First National City Bank. Subsequently other banks, Indian and Foreign, followed suit. At persent, 43 banks are permitted by the Reserve Bank to issue participation Certificates.

15.10 CERTIFICATES OF DEPOSITS

A more recent credit instrument available for the corporate sector in mobilizaion of funds is the negotiable certificate of deposit. Negotiable dollar certificates of deposits were first introduced in New York in 1961. The certificates of deposit are issued to attract more money without increasing the general interest rates. The certificate can be exchanged for a fixed deposit until a stated future date. It is negotiable and the purchaser can, therefore, sell it to a third party at any time or can hold it until it is redeemed at maturity.

Recently some of the banks and companies in India are trying to attract funds through certificates of deposits. The certificates of deposits are also a popular form of short-term investment for companies or institutions with temporary surplus funds.

15.11 COMMERCIAL PAPER

Commercial paper is an unsecured promissory note with a fixed maturity. Generally it is payable between 3 months and 6 months. It is issued on a discount basis. The issuer of commercial paper, generally the highly rated companies, promises to pay the buyer some fixed amount on a future date. It enable companies to raise short term debt at attractive rates of interest.

The company issuing commercial paper need not pledge any asset since it is an unsecured instrument. Commercial paper is freely transferable also. In India, highly rated companies like Bajaj Auto, Ashok Leylabd, Hindustan Lever, Tube Investments have already launched the Commercial paper. May other companies are also trying to use this method.

Important Features of Commercial Paper

The following are the important features of Commercial paper.

1. The maturity period of commercial paper mostly ranges from 3 to 270 days.
2. Commercial paper is sold at a discount from its face value and redeemed at its face value
3. Commercial paper is either directly placed with investors or sold through dealers.
4. Commercial paper is usually bought by investors who intend to hold it till its maturity. Hence, there is no well developed secondary market for commercial paper.

Companies Eligible to Issue Commercial paper

Only the Companies which satisfy the following requirements are eligible to issue commercial paper.

a) The tangible net worth of the company should not be less than Rs. 5 crores as per the latest balance sheet.

b) The Fund Based Working Capital facilities enjoyed by the company from the banking system should not be less than Rs. 15 crores.

c) Equity shares of the company should be listed in one or more stock exchanges. However, the government companies are exempted from this condition.

d) The company should obtain a credit rating from an agency approved by Reserve Bank of India for the purpose from time to time. The Credit Rating information Services of India Limited (CRISIL) has been approaved by resercve Bank of India as the agency for issuing the credit rating certificte. The minimum credit rating for issue of commercial paper shall be Pl. At the time of issue of commercial paper the rating should not be more than 2 months old.

e) The companies borrowed account should be classified under the health code I as per the Reserve Bank of India guidelines under Health Code System by the financing bank/ banks.

f) As per the latest audited balance sheet, the company should maintain a minimum current ratio of 1.33:1 based on the classification of current assets and current liabilities as per the Reserve Bank of India's guidelines, issued from time to time.

g) The aggregate amount to be raised by the issue of commercial paper should not exceed 20 per cent of the company's fund based working capital limit.

Procedure for Issue of Commercial Paper

Every company proposing to issue commercial paper shall submit in the prescribed form an application to the banking company/the banking company designated as leader of the consortium arrangement for working capital facility, together with the certificate issue by the credit rating agency.

On receipt of the application for issue of commercial paper from such company. The banking company if on verification is satisfied that the company is eligible for issuing commercial paper, shall forward the application to the Reserve Bank of India within one week of the receipt of the application together with certificate issued by the credit rating agency. The Reserve Bank of India may, after considering all the applications for issue of commercial paper received upto a specified date, allot to each eligible company such amount for issue of commercial paper as may be decided having regard to the conditions in the money market.

The Reserve Bank of India will communicate the decision of allotment of the amount of commercial paper to be issued, to the banking company in writing indicating other terms and conditions, if any, to be complied with by the banking company / the issuing company with regard to the approved issue.

Each company shall, on receipt of the approval to issue the commercial paper, make arrangements for privately placing the issue and ensure that the issue of commercial paper as approved, is complete within a period of two weeks from the date of Reserve Bank of India's approval.

Thus, commercial paper will be a very ideal and versatile tool for raising short term finance for meeting occasional out flows of companies like distribution of interim and final dividends, payment of income tax, higher seasonal requirements of many industries etc., commercial paper will contribute to the growth of money further if the rates of return on investment in commercial paper prove to be attractive. This instrument may play a vital role in the provision of short-term funds in India. This will ultimately relieve pressure on the banking sector for short term funds requirements of the corporate sector.

CHECK YOUR PROGRESS -2

1. What is a Credit Card?

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2. What is a Participation Certificate?

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3. What are the features of Commercial Paper?

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15.11 SUMMING UP

The corporate sector in India has started using various types of financial services. These financial services are very much useful not only to the corporate sector, but also to the investors and servicing institutions. Hence, efforts must be made to strengthen the quality of these services by the institutions offering these facilities.

15.12 CHECK YOUR PROGRESS : MODEL ANSWERS

I 1. A merchant banking institution generally renders specialized services like loan syndication; financial and management consultancy; project counselling; portfolio management; formulation of schemes of rehabilitation; guidance on foreign trade financing guidance to non-resident Indians for investment in India.

2. The concept of mutual fund refers to mobilization on small and medium investors funds for investing in a diversified portfolio securities so as to spread and reduce risks. In other words, a mutual fund is a form of collective investment.

3. The term Venture Capital denotes the Capital used to finance new ideas in hi-tech areas which are risky but at the same time, having profitability of high returns.

II. 1. A credit card is a card is a card given by a bank or a credit agency to a customer. The credit card enables a customer to acquire goods or services from the notified organizations without paying direct cash. He can also draw money from the branch of that bank when he goes to out station.

2. It is an instrument whereby a bank can sell to a third party (transferee) a part or all of the loan made by the bank to its client (borrower)

3. The following are the important features of a Commercial paper :

   (a) The maturity period of Commercial paper mostly ranges from 3 to 270 days.

   (b) Commercial paper is sold at a discount from its face value and redeemed at its face value.

   (c) Commercial paper is either directly placed with investors or sold through dealers.

15.13 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in about 30 lines each.

1. What are the financial services? Analyse the growth of financial services in India.
2. What are the characteristics of leasing? Discuss the future of leasing business in India
3. What is factoring? Discuss its advantages and disadvantages.
4. Explain the procedure to follow for the issue Commercial Paper.

II. Answer the following questions in about 15 lines each.

5. What are the functions of merchant banking institutions?
6. How do you classify mutual funds?
7. What is operating lease?
8. What is factoring?
9. What are the features of Venture Capital?
10. What are the advantages of credit cards?
11. What are Certificates of deposit?

15.14 RECOMMENDED BOOKS

1. Prasanna Chandra : **"Financial Management: Theory and practice"**, Tata McGraw - Hill Publishing Co. Ltd., New Delhi.
2. Lawrence J. Gitman : **"Principles of Managerial Finance"**, Harper and Row Publishers, New York.
3. Jules I Bogen (ed.) : **"Financial Handbook"**, John Wiley and Sons, New York.
4. Chhabra, T.N. and Taneja, P.L : **"Law and Practice of Banking"**, Dhanpat Rani & sons, New Delhi.
5. Kuchhal, S.C. : **"Financial Management"**, Chaitanya Publishing House, Allahabad.

15.15 GLOSSARY

Commercial Paper : An unsecured, short-term promissory note issued mainly by companies, mostly on a discount basis.

Factor : A financial institution that purchases accounts receivable, at discount, from business firms.

Financial Lease : It is one where all the risks and regards incident to ownership of an asset are substantially transferred.

Leasing	:	It is a special type of contract that requires technical knowledge, marketing efforts and skills.
Merchant Banking	:	Merchant Banking comprises many non-banking type of services rendered by banks to the industrial and business firms.
Mutual Fund	:	A mutual fund is a form of collective investment. The mutual fund basically mobilises savings of the people and invest them in corporate and Government securities.
Opening Lease	:	It is one where the risks and rewards incident to ownership of an asset remain with the lessor.
Venture Capital	:	Venture Capital represents financial investment in a highly risky proposition in the hope of earning a high rate of return.

BLOCK – IV

WORKING CAPITAL FINANCING

UNIT - 16 : NATURE AND SOURCES OF WORKING CAPITAL

Contents

16.0 AIMS AND OBJECTIVES

This unit covers the meaning, concepts and sources of financing working capital. It also discusses the bank financing for working capital along with the recommendations of various committees.

By the end of this unit, you should be able to:

- understand the meaning of working capital
- various concepts of working capital
- different sources of financing working capital
- relevance of Tandon Committee and Chore Committee norms regarding the mechanics of lending to finance working capital requirements

16.1 WHAT IS WORKING CAPITAL?

Finance is an integral part of the over-all company management. It is concerned with obtaining of funds and also the wise and optimal use of these funds. A company needs funds for financing its long-term as well as short-term operations. The amount of investment needed to finance the short term or day-to-day operations is known as Working Capital. Thus Working Capital is the proportion of the Company's total capital which is employed in short-term operations.

16.2 CONCEPTS OF WORKING CAPITAL

There are two concepts of Working Capital. They are i) "Gross Working Capital Concept" and ii) "Net Working Capital Concept". The "gross working capital", also known as "current capital" or "circulating capital" is represented by "the sum total of all current assets of the enterprise". Current assets comprise items that can be converted into cash in the short period, say, within a year, or within the normal operating cycle of the business. These items are stocks of raw-materials and supplies, finished goods, semi-processed items or components, sundry debtors, short-term investments, cash and bank balances. These items are also known as components or elements of current assets or grow working capital. On the other hand, the 'net working capital' is the difference between current assets and current liabilities. Current liabilities are those claims of outsiders which are expected to fall due in a short-period, say, within a year. They represent short-term sources of funds which include creditors, bills payable, bank overdraft or cash credit facilities and outstanding expenses of different types. These are called as components of current liabilities.

The two concepts of working capital should not be regarded as mutually exclusive. Each has its relevance in specific situations. They represent two distinct and important facets of working capital management.

The emphasis on gross working capital involves focussed attention on two aspects of current assets management. They are:

i) it has to be ensured that the investment in current assets is optimal, and
ii) it has to be ensured that the investment in current assets is obtained through the lowest cost of sources of finance.

Excessive investment in current assets should be avoided as it adversely affects the profitability. However, whenever additional investment is needed, funds should be made available promptly. For this, a good knowledge of the available avenues of investment for short periods is very essential.

The concept of 'net working capital' represents a qualitative definition and highlights the long-term sources of funds which have been obtained to finance the net working capital. The net working capital will be positive when the current assets exceed the current liabilities. If they exceed by a wide margin, the company's liquidity or solvency position is said to be sound. On the other hand, if the current liabilities exceed current assets, a situation of negative working capital arises indicating a precarious financial position. A part of the working capital has to be provided by the proprietors in the form of share capital and a part has to be obtained from external sources in the form of long-term borrowings. Internal sources such as ploughing-back of profits can also be used to finance a portion of working capital.

The finance manager has to strive hard to maintain a sound working capital position. While excessive working capital leads to unremunerative use of scarce funds, inadequate working capital interrupts the smooth functioning of the business activity and impairs profitability.

Permanent and Variable Working Capital

Since a company's production and sales activity is subject to seasonal factors of availability of raw-materials or market demand, the level of investment in current assets also fluctuates. However, there should be a bare minimum of investment in current assets which is absolutely necessary for all times. This minimum level is referred to 'Permanent or Fixed Working Capital'. The further requirements which vary with changes in the levels of production and sales activity are known as 'Variable Working Capital'. The finance manager of the company has to make long-term arrangements for financing the permanent working capital needs and should depend on flexible arrangements with the bankers for the variable working capital requirements.

Conscious management of working capital, therefore, involves constant vigilance to ensure that the right quantum and the right composition of working capital available on a continuing basis to support and promote smooth management of the activities of the company.

16.3 OPERATING CYCYLE

The process of transformation of cash into raw materials and then work-in-process and the conversion of the same into finished goods followed by credit sales and subsequent collection of debts is referred as 'Operating Cycle'. "Operating cycle is the time duration required to convert sales, after the conversion of resources into inventories into cash".

The length of time which is required to convert cash into resources, resources into the final product, the final product into receivables and receivables back into cash is known as operating cycle of an enterprise. The length of the Operating Cycle is a function of the nature of a business. It covers four distinct stages, each of which requires a level of supporting investment. The sum total of the stage-wise investment will be the total amount of working capital required.

The four stages of the Operating Cycle are:

i) The raw-materials and stores inventory stage
ii) The work-in-progress stage
iii) The finished goods inventory stage, and
iv) The book debts stage.

The stages are sequential and can also be recognised as the Cash-to-Cash in the following order:

i) Conversion of Cash into raw-material
ii) Conversion of raw-material into work-in-process
iii) Conversion of work-in-process into finished goods
iv) Conversion of finished goods into debtors and bills receivable through sale; and
v) Conversion of debtors and bills receivable into Cash.

The Operating Cycle of a manufacturing firm is shown in Fig. 1.

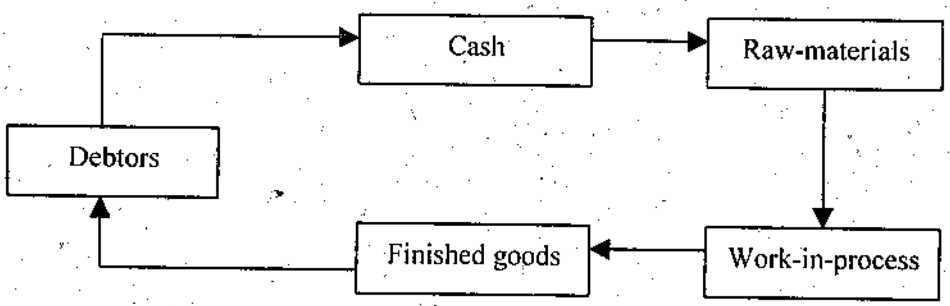

Fig. 1. Operating Cycle of a manufacturing firm

The working capital stream is a link up of 'stocks' and 'flows'. It is a sequence of storages and releases. The company needs cash initially to purchase raw-materials and pay expenses. Further, it has to hold some cash to meet future exigencies. However, it would be wasteful to hold cash for long. The idle cash does not generate any income but its value will be declined due to reduction in the purchasing power of cash based on the inflationary tendencies. The stocks of raw-material are essential for ensuring smooth production and for protecting against the risk of non-availability of materials. To meet the demands of the customers on a sustained basis and to cater to sudden spurts in demands it is necessary to carry stocks of finished goods.

In a competitive situation, the company has to extend credit facilities to customers in order to promote sales. Thus to support a smooth and uniterrupted process of production and sales, investment of funds in current assets is inescapable. But through efficient management of the current assets, it is possible to avoid excessive and un-productive investment in current assets.

CHECK YOUR PROGRESS - 1

1. What do you mean by permanent and variable working capital?

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2. Describe the Operating Cycle.

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16.4 SOURCES OF WORKING CAPITAL

While the permanent working capital requirements should be financed from the long-term sources, the variable working capital requirements of an enterprise are to be financed from the short-term sources of capital funds.

The various sources of financing working capital are as follows:

Sources of Working Capital Financing

Permanent Working Capital	Variable Working Capital
1. Share Capital	1. Commercial Banks
2. Retained Earnings	2. Indigenous Bankers
3. Debentures	3. Trade Credits
4. Public Deposits	4. Instalment Credit
5. Loans from Financial Instruction	5. Advances

A brief description of these sources of financing working capital is as follows:

Sources of Financing Permanent Working Capital

1) **Share Capital:** This is the most important source for financing the Permanent Working Capital. Share capital is raised by a company by issue of equity shares and preference shares. Preference shares carry preferential rights regarding the payment of dividend and

repayment of capital at the time of winding up of the company. However, equity shares do not enjoy these privileges. As far as possible, a company should raise the amount of permanent working capital by the issue of shares.

2) **Retained Earnings:** This source refers to the reinvestment of surplus earnings of a company in its business. As such, it is an important internal source of finance and is most suitable for an established firm for financing its expansion, modernisation and replacement programmes. This source of finance enjoys certain benefits as it does not involve dilution of control. It ensures stable divided policy.

3) **Debentures:** A Company can raise funds by issuing debentures for financing its permanent working capital requirements. A debenture is an instrument in writing given by a company acknowledging the liability for the amount it has received. Companies have to pay a fixed rate of interest on debentures. The firms issuing debentures may enjoy certain benefits like trading on equity, retention of control, tax benefits, etc.

4) **Public Deposits:** These constitute a prolific source of easy finance in the early stages of Indian industrial development at a time when modern banking facilitices were not available. The textile mills of Bombay and Ahmedabad were particularly known for their heavy dependence on this cheap source of working capital finance. Public deposits is a source of finance is simple, convenient and enjoy trading on equity and tax benefits. But this source suffers from certain dangers as it is uncertain, unsound, and inelastic. The Reserve Bank of India has laid down certain limits on public deposits. Non-banking concerns cannot borrow by way of public deposits more than 25 percent of its paid up capital and free reserves.

5) **Loans from Financial Institutions:** This source of finance is more suitable to meet the medium-term requirements of working capital. These financial institutions include Commercial Banks, Life Insurance Corporation, Industrial Finance Corporation of India, State Financial Corporations, State Industrial Development Corporations, Industrial Development Bank of India etc. On these loans, interest is paid at a fixed rate and the amount of loan is repaid in easy instalments.

Sources of Financing Variable Working Capital

1. **Commercial Banks:** Commercial banks are the most important source of variable working capital. As such, a major portion of working capital loans are provided by commercial banks. Commercial banks provide loans and advances in a number of ways as detailed below.

   a) *Loans*: Loans are granted to companies against some security. The entire amount of loan is paid to the customer either in cash or by a credit to his account. The borrower can repay the amount either in instalments or in lumpsum. Interest is calculated at quartely rates on the reduced balances. These loans are granted upto a period of one year for meeting the working capital requirements.

   b) *Cash Credit*: A Cash Credit is an arrangement by which a customer can borrow money from a bank upto a certain limit against some tangible securities or guarantees. The customer is allowed to withdraw amount from his cash credit limit and deposit any surplus amount with him. Interest is charged on the daily balance.

   c) *Overdraft*: It is arrangement with a bank by which a current account holder can withdraw more than the balance to his credit upto a certain limit. Interest is charged on daily overdrawn balances.

d) *Purchasing and Discounting of bills*: According to this, banks lend money without any collateral security. The bank purchases bills payable on demand and credits the customer's account with the amount of bill less discount. At the maturity of the bills, bank presents the bill to its acceptor for payment. In case the bill is dishonoured, the bank recovers the full amount of the bills from the bills from the customer along with expenses incurred by the bank in that connection.

2) **Indigenous Bankers:** Indigenous bankers include private money-lenders and other country bankers. Prior to the establishment of commercial banks, this source constituted a significant part of working capital financing. Indigenous bankers used to charge very high rates of interest. Even today, some of the business houses depend upon indigenous bankers for obtaining loans to meet their working capital requirements.

3) **Trade Credit:** In the modern business world trade credit plays an important role in providing short-term finance to the business houses. It is a very convenient and flexible method of finance. However, the loanees have to forego the benefit of cash discounts, which are otherwise available.

4) **Instalment Credit:** According to this method, a business person can purchase assets and take immediate possession of goods but the payment is made in instalments. Usually, interest is charged on the unpaid amount. Thus, it provides funds for a short-period as a source of short-term working capital.

5) **Advances:** These include the advances collected from customers and agents against orders. This is a short-term source of finance and useful to the firms having long production cycle. It is a very cheap source of finance.

16.5 WORKING CAPITAL AND BANK FINANCE

Banks in India have been providing finance to industry and trade on the basis of security. Where adequate security was provided, not many questions were asked about the specific uses to which the funds were applied. The banks provided assistance through cash credit accounts for the ostensible purpose of acquiring current assets.

Reacting to spells of rapid credit expansion, the Reserve Bank of India had progressively introduced since May, 1973, a number of monetary measures. These measures are aimed at containing the expansion of commercial bank credit and directing to meet only the immediate minimum needs of essential production. These measures include the following:

1) Curtailment of lendable resources of commercial banks through enhanced statutory cash reserve requirements and liquidity requirements.
2) Making bank funds more costly through suitable re-adjustment of interest rates on deposits and advances.
3) Withdrawal of most of the concessional elements in the refinance systems of the Reserve Bank.
4) Tightening of the selective credit control to check the flow of credit, particularly, to private trade against sensitive commodities.
5) Increasing the margins on most of the advances to reduce the drawing power.
6) A closer scrutiny of bigger accounts by banks to ensure justification of drawals in terms of immediate end-use; and

7) Tightening of credit (including those for priority sectors such as exports) through higher rates of interest, reduction in period of eligibility for concessionary rate of interest and the extension of Credit Authorisation Scheme to Packing Credits.

These measures caused further anxiety in industrial circles. It was in this context that the Reserve Bank of India constituted in July, 1974, a Study Group to frame guidelines for follow-up of bank credit now widely known as Tandon Committee.

As enunciated by Tandon Study Group, the new system should include the following:

i) Make a customer plan his credit needs in advance and observe a discipline in utilising it.

ii) Indicate to the banker the likely demand for credit and thus enable him to plan his own deposit-credit function.

iii) Assure finance to industry for its genuine production needs.

iv) Enable the banker on having provided finance to receive from the customer adequate information on the use of credit, but with in-built flexibility to suit the changes in certain circumstances.

16.6 THE MECHANICS OF LENDING-TANDON COMMITTEE GUIDELINES

The new role assigned to the banker by the Study Group directs him to supplement to borrower's resources in carrying a reasonable production requirement.

He has now to understand:

a) The extent of the working capital gap in borrower's business at any given time, and

b) The appropriate method of arriving at the maximum permissible level of credit for the borrower.

Three alternatives, which could also be considered to be three sequential stages were proposed for deciding on the maximum permissible level of bank credit for any borrower.

Method 1: Determine the working capital gap, i.e., reasonable level of total current assets minus non-bank current liabilities and reckon 75% of the working capital gap as the permissible level of bank finance. The balance will have to be found by the borrower from his own funds and/or from long-term borrowings.

Method 2: The borrower will have to use his own resources and/or long-term funs to finance 25% of total current assets and only then whatever is required to meet the working capital gap will be provided by the banker.

Method 3: Determine the core current assets. These have to be financed out of its own funds and/of long-term borrowings. The reasonable level of total current assets less core current assets will represent 'real current assets'; 25% of 'real current assets' will also have to be supported by borrowers' own funds and/or long-term borrowing. If the non-bank current liabilities are inadequate to cover the balance of 75 % of real current assets, the required amount will be obtained by way of bank borrowings.

Computation of 'maximum bank borrowings' permissible under the three alternative methods is shown with the help of the following illustration.

	Rs.
Total current assets required	1,00,000
Current liabilities other than bank	25,000
Core current assets	12,500

1st Method

	Rs.
Total current assets required	1,00,000
Less : current liabilities	25,000
Working capital gap	75,000
Less : 25% from long-term sources	18,750
Maximum permissible bank borrowings	56,250

2nd Method

	Rs.
Current assets required	1,00,000
Less : 25% to be provided	25,000
from long-term resources	75,000
Less : current liabilities	25,000
Maximum permissible bank borrowings	50,000

3rd Method

	Rs.
Current assets	1,00,000
Less : core current assets	12,500
	87,500
Less : 25% to be provided from long-term funds	21,875
	65,625
Less : current liabilities	25,000
Maximum permissible bank borrowings	40,625

A Critic of Tandon Report Observes:

"The Report bases itself on two premises, the first about norms for inventory holding and the second about the capital structure. At times one would wonder whether two separate types of controlling are necessary to enforce financial discipline. If the banks imposed restriction in regard to inventory holding by industry and trade, it would be superfluous to have another control on the extent of bank finance in the total working capital.

If norms are stipulated by banks for inventory holding, there should be no other restriction about the proportion of bank finance in total working capital; of if the banks think that operating on a proportion of bank finance in the total working capital is more desirable, then it superfluous to have any norms with regard to inventory holding. But unfortunately, both the things are sought to be implemented. Banks have started imposing rigid inventory norms and also restructuring capital so that it conforms to the recommendations of the study group. This is going to have a very adverse effect on the pace of industrailisation in the country".

What will be the implication of either of the two approaches advocated above? Inventory norms alone, without any guidelines on capital structure, can hardly be useful. A company may then confirm to the inventory and receivable norms, and keep bank borrowings with in permissible limits and yet have the option to contract substantial non-bank short-term liabilities, maintaining only a very slender current ratio. As already emphasised, the imposition of norms in such circumstances can only turnout to be a partial, ill-conceived approach, threatening the company's progress; simultaneous attention to a satisfactory capital structure has to be continuously supported by long-term and permanent sources of finance ; and if this is done, the current ratio will maintain a reasonable level and provide a solid framework for effective working capital management.

Method 4: Which stipulates that 25% of the reasonable level of finance, has strong merits, from the point of view of warding of a situation of a negative working capital or a slender current ratio. It provides a built-in-safety mechanism for healthy working capital management.

16.7 CHORE COMMITTEE RECOMMENDATIONS

In March, 1979, The Reserve Bank of India appointed a study group under the chairmanship of Mr. K. B. Chore to review the progress of implementation of Tandon Committee norms was slow and not satisfactory. With a view to including better discipline and planning consciousness among the borrowers, the committee made the following recommendations:

i) The banks should obtain quarterly statements in the prescribed format from all borrowers having working capital credit limits of Rs.50 lakhs and above.

ii) If a borrower fails to submit the quarterly return in time, the banks may charge penal interest of one per cent on the total amount outstanding for the period of default.

iii) The borrowers should be discouraged from approaching the banks frequently for adhoc or temporary limits in excess of sanctioned limits. Banks may charge additional one percent interest on these limits.

iv) While assessing the credit requirements, wherever it is possible, the banks should fix separate limits for the normal non-peak level and peak level credit requirements.

v) Banks should undertake a periodical review of working capital credit limits of Rs.10 lakhs and above.

16.8 EQUITY AND LONG-TERM BORROWINGS

The concept of net working capital represented by current assets minus current liabilities, lays emphasis on the extent of the financing of current assets through owners funds and long-term borrowings. In other words, it is indicative of the state of the share holders and long-term lenders in respect of the investment in current assets. The expectation is that at least 25% of current assets should be supported by share capital and long-term funds. However, in reality, this has not been attained in a large number of cases, and Chore Committee has stipulated that banker should insist on their clients falling in line with this discipline at the earliest.

Companies with a good record of performance had no difficulty in raising substantial resources through issue of shares and debentures. The capital market showed a remarkable buoyancy, and contrary to the expectation of poor response, the public savings were directly available through subscriptions to share capital and debentures. Convertible debentures, as a mode of financing working capital needs, soon became very popular. It has thus been found that successful companies will be able to mop up resources from the capital markets for genuine requirements without much difficulty.

16.9 SELECTIVE DISCRETION

The important thing to keep in mind is the spirit of the Tandon Committee's recommendations, namely, that a reasonable part of the working capital requirements should be found from long-term resources including equity capital, while bank lending should be done with discretion, on case by case basis, there must also be some general guidelines without which the bankers would be put to unhealthy pressures by the borrowers. Therefore, some norms and some guidelines become necessary and the Tandon Committee has done well to suggest them. They should be regarded as general guidelines, which have to be refined over the years in the light of experience. Therefore, there can be no question of either swearing blindly by the Tandon Group's recommendations or of rejecting them altogether. They deserve full consideration them altogether. They deserve full consideration and are subject to modifications on the basis of relevant facts.

16.10 SUMMING UP

The amount of investment needed to finance the short-term or day-to-day operations is known as working capital. There are two concepts of working capital, namely, gross working capital and net working capital. While gross working capital is represented by the sum total of all current assets, net working capital is the difference between current assets and current liabilities. Though, the level of investment in current assets fluctuates due to seasonal factors, there should be a bare minimum of investment in current assets which is known as permanent working capital. The further requirements which vary with changes in the levels of production and sales activity are known as 'Variable Working Capital'.

The length of time required to convert cash into resources, resources into final product, the final product into receivables and receivables back into cash is known as operating cycle. The sum of the stage-wise investment in operating cycle will be the total amount of working capital required.

While, the permanent working capital requirements should be financed from the fixed capital sources, the variable working capital requirements may be financed from the short-term sources of capital. The sources of permanent working capital include shares, debentures, public deposits, ploughing back of profits and loans from financial institutions; where as, the sources for Variable Working Capital include commercial banks, indigenous bankers, trade credits, instalment credit and advances.

16.11 CHECK YOUR PROGRESS: MODEL ANSWERS

1. The bare minimum of investment in current assets which is needed at all times is known as permanent working capital. On the otherhand, the further requirements which varies with changes in the levels of production and sales activity are known as "Variable Working Capital".

2. The length of time which is required to convert cash into resources, resources into the final product, the final product into receivables and receivables back into cash is known as operating cycle. It covers four distinct stages each of which requires a level of supporting investment. The sum of the stage-wise investment will be the total amount of working capital required.

16.12 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in about 30 lines each

1. Define working capital and discuss the importance of working capital management in the present day context.
2. Discuss the importance of the Operating Cycle in management of working capital.

   Mention the four stages of operating cycle and explain them with the help of a diagram.
3. Discuss the implications of Tandon Committee's and Chore Committee's recommendations on bank finance for industry.
4. Discuss the money measures adopted by the Reserve Bank of India in 1973 to contain the expansion of commercial bank credit.

II. Answer the following questions in about 15 lines each.

5. What do you mean by Gross Working Capital and Net Working Capital?
6. What are the stages in Operating Cycle?
7. What is permanent working capital and how should it be provided for?
8. Comment on significance of public deposits for financing working capital requirements.
9. What proportion of current assets are expected to be financed with long-term sources? What are the prospects of this being realised?
10. Explain the implications of negative working capital.

16.13 RECOMMENDED BOOKS

1. M.Y. Khan & P.K. Jain : **Financial Management,** Tata McGraw Hill company, New Delhi.
2. James C. Vanhorne : **Financial Management and Policy,** Prentice Hall of India, Pvt. Ltd., New Delhi.
3. I.M. Pandey : **Financial Management,** Vikas Publishing House, New Delhi.
4. Prasanna Chandra : **Financial Management,** Tata McGraw Hill Company, New Delhi.

16.14 GLOSSARY

Working Capital : The amount of investment needed to finance the short-term or day-to-day operations is known as working capital.

Gross Working Capital : The sum of money invested in all current assets of the enterprise.

Net Working Capital	:	Difference between current assets and current liabilities.
Permanent working capital	:	The bare minimum of investment in current assets which is absolutely necessary for all time.
Variable working capital	:	The further requirements which vary with changes in the levels of production and sales activity.
Operating Cycle	:	The length of time which is required to convert cash into resources, resources into final product, the final product into receivables and receivables back into cash.

UNIT-17: DETERMINANTS OF WORKING CAPITAL

Contents

17.0 AIMS AND OBJECTIVES

This unit discusses the various issues relating to planning of working capital and the factors that determine the working capital needs.

By the end of this Unit, you should be able to:

- understand the various issues involved in the planning of working capital;
- internal factors that influence the determination of working capital needs; and
- external factors that influence the determination of working capital needs.

17.1 INTRODUCTION

Though a variety of funds are available for financing working capital requirements, the ever-present prime source is the sales income which is particularly relevant to short-run management. A steady inflow of income from sales throughout the year is welcome, but some times it may fall short of cash expenses and costs for the period. As such, the company has to depend on external source, for atleast a part of its operational needs. This necessitates a careful study of the sources of financing working capital requirements.

17.2 PLANNING OF WORKING CAPITAL - SCOPE AND SETTING

The short-run objective of the company may be fulfilled through sales income but the long-run objective may not be fulfilled. There may be draining out of resources in which case the company has to seek expensive external support.

The long-run cash flow objective can be viewed as the net addition to working capital from operations. When the total sales income for the year exceeds the cash costs and expenses, the operations can be said to have generated a net working capital inflow. However, one recognised aim is to improve the shareholders networth, and for this, profits have to be generated. If the net inflow for the year exceeds the value of annual depreciation charges and non-cash charges, the surplus will approximate to the profit for the year. Accepting the premise that the portion of generated funds corresponding to the depreciation charges is to be made available for replacements and additions to equipment and facilities, the profits emerge as a potentially permanent source of working capital funds.

While, there may be no difficulty in borrowing funds for additional working capital, these loans with interest thereon, have ultimately to be repaid out of working capital. Therefore, profitable operations are all the more essential. Planning for improved profitability in operations is a positive step in the direction of attaining self-reliance in meeting working capital needs, cutting down dependence on borrowals and saving related costs. Net profits, i.e., after deductions for tax and dividends may use up the bulk of the surplus and there may be only a small addition to the working capital funds.

Occassionally, the sale of disposable fixed assets may bring funds, but this is an irregular and sporadic source. Borrowing of funds, on short or long-term basis, is a convenient method of augmenting working capital funds. This source is amenable to planning as the amount and the timing of borrowals can be determined to match the anticipated needs. Similarly, the repayments of the principal and interest have also to be planned as these have to be effected out of working capital. Issue of shares is another potentially permanent source of working capital. But if the working capital needs are seasonal, this source proves to be expensive. It is useful as a source for permanent working capital needs as there is no obligation to return the principal sum.

Intuition, experience, foresight and planning skills and will – all have to be combined in good measure in planning the sources and uses of working capital. Even with careful planning, a gap between the planned sources and planned uses is to be expected, and it is to cover this that stop gap funds of working capital balances have to be held. Planning the cash inflows involves anticipation of the quantity of the flows as also their correct timing. Effective planning and control of sources and uses will ensure that the need for unproductive stop-gap funds is the minimum.

Care has to be taken to see that the plans are carried out as envisaged. Many factors such as sales volume, price, product mix and others may move out of step in the short-run, but they can mostly be corrected and set on the right course in the long-run.

17.3 DETERMINANTS OF WORKING CAPITAL

There are no specific rules to determine the working capital requirements the firm. A wide variety of factors influence the total investment in the working capital of an enterprise. In order to determine the amount of working capital needed by a firm a number factors are to be considered by Finance Manager. These factors can be categorised into two groups, viz., internal factors and external factors.

A. INTERNAL FACTORS

1. Promotional and Formative Phase: The starting of a new project and the early years of its working constitutes the most crucial phase for planning and provision of working capital funds. In practice, however, this fact is generally overlooked and, as a result, many new ventures run into financial difficulties in their early operating years.

The general tendency is to estimate the hurdles and set back that may arise in the formative years of the company's operations. Facile assumptions are made in regard to ready availability of raw-materials, availability of operative skills, adherence to norms and manufacturing cycle, overall competence to manufacture quality products, ready marketability and prompt settlement of dues by customers. Working capital needs are computed in broad terms. When the assumptions miss the mark, and when the operational pace and efficiency lag behind expectations, the funds plans go away and severe shortage of working capital funds is experienced. And the period of operations following the commissioning of the plant is marked by avoidable struggle to find funds to match needs and repeated threats to the company's solvency.

Generally the working capital requirements for a newly established company are initially conceived in a very general and casual terms. They form the basis for funds projections in the early years of the company. The inadequacy in planning gets exposed only when succession of funds problems arise because of the wide gap between sweeping assumptions and stark realities. Any assessment of work-in-progress on the basis of the prescribed manufacturing cycle may turn out to be an underestimate as the initial technical problems and bottlenecks might extend the manufacturing period involved.

2. **Nature of Business:** The nature of business has an important bearing on its working capital needs. Working capital requirements of a firm are basically influenced by the nature of its business. For some ventures, such as, retail stores, tobacco manufacture and construction companies, the fixed assets become nominal or incidental and they require an abundance of working capital. At the other extreme, there are some public utilities such as electricity generation and supply, where the fixed assets constitute the dominant segment, the current assets playing a minor and secondary role. Most of the manufacturing organisations have to finance substantial investment in current assets to support their operations. The relative importance of current assets to total assets will indicate the required degree of planning and control efforts in working capital management area.

3. **Size of Business :** The size of the business also has an important impact on its working capital needs. Size may be measured in terms of the sale of operations. A small firm may employ additional current assets as a cushion against cash flow interruptions. Small firms having cash inflows from relatively fewer services are more affected by the defaults on the part of customers to pay in time. On the other hand, larger firms with may sources of funds may require less working capital in relation to total assets or sales.

4. **The Manufacturing Cycle :** The manufacturing cycle starts with the purchase and use of raw-materials and completes with the production of finished goods. An extended time interval between the raw-material purchase and the completioin of the manufacturing process yielding the finished product, will obviously mean a larger tie-up of funds in the form of enhanced working capital needs. Realisation of this aspect may make the managemnt attempt to reduce the intervening period and effect economy in working capital needs. Most products have alternative processes of manufacture and if working capital is considered a critical area, choice has to fall on those processes which have shorter manufacturing cycle. This is a technological choice having a bearing on working capital economy.

Having selected the process of manufacture, care has to be exercised in adhering to the normal manufacturing cycle time. This calls for effective organization and coordination at all levels of enterprise activity. Frequent changes in set-ups, waiting for materials, tools or instructions and accumulations of work-in progress have the inevitable consequence of extending the cycle time, and freezing up more funds.

Certain policy steps concerning terms of credit for raw-materials and other supplies procured can help reduce working capital requirements. Organized negotiations with suppliers for attractive credit terms, and retention of their continued confidence by the settlement of bills on agreed dates, can go a long way in releasing the financial pressure. "Trade creditors thus constitute a convenient and economical source of working capital finance for the knowledgeable manager. In fact, a part of the financial burden pertaining to the manufacturing cycle time is thus passed on the suppliers of goods and services. Some firms, manufacturing industrial products have a policy of asking for advance payments from their customers.

5. **Credit Terms to Customers :** The credit terms granted to customers influence the working capital level by determining the level of investment in book debts. Conventions and practices relating to specific industries very often dictate the nature, extent and duration of credit to customers. But in most cases, management has the discretion to decide on suitable credit rating of prospective or existing customers, in respect of both the duration of credit and the amounts involved. Slack collection procedures or permissive attitude in the matter of collection of the outstanding can also lock up funds which would other wise be available for operating needs. Hence the, the firm should follow rationalized credit policies based on the credit standing of customers and other relevant factors. The firm should evaluate the credit standing of new customers and periodically review credit worthiness of the existing customers.

6. **Production Policies :** While noting that companies which experience strong seasonal movements have special working capital problems, a strategy for maintaining a steady rate of production thought the year as against a pronounced seasonal demand for manufactured goods has to be considered. The problem is one of finding funds to support the mounting inventory levels of finished goods until they get off-loaded in the peak season. However, some companies having versatile machines and varied operative skills enjoy the advantage of resorting to diversified activities. As such the fluctuating or seasonal pattern of demand for some of its products need not necessarily lead to major working capital problems. On the other hand, some companies may have the facility of curtailing activity during lean periods by diversion of labour force to agriculture or related areas. In some cases, accumulation of inventories may create special risks and costs because of the inherent character of the products. A close cost-benefit analysis might suggest a preference for varying the production schedules in tune with the changing demands rather than maintaining steady production and enlarging inventory levels manufactured items. Production policies will have to be formulated on the basis of the individuals setting of each enterprise and the magnitude and dimensions of the working capital problem will accordingly vary.

7. **Growth and Expansion Programmes :** As business grows, additional working capital has to be found. There is no simple formula for establishing the link between growth in sales and growth in working capital. Although, there is no definite relationship between the volume of a company's business and growth in its working capital, it is usually found in actual practice that a growing firm requires additional funds to acquire additional fixed asssets so as to sustain its growing production and sales. Besides, additional current assets will be needed to support increased scale of operations. Thus, the growing firm needs funds continuously.

8. **Profit levels and dividend policy:** The magnitude of working capital in a firm is dependent upon its profit margin and dividend policy. As a matter of fact, a high net profit margin reduces the working capital requirements of the firm as it contributes towards the working capital pool. To the extent net profit has been earned in cash, it becomes a source of working capital. However, whole of the profit earned is not available for working capital purposes. The availability of net profits for working capital purposes depends upon the dividend policy pursued by the company. Distribution of larger sums of profits in the form of cash dividend results in a drain on cash resources and reduces company's working capital to that extent. If the management follows a conservative dividend policy, it can retain larger portion of net profits. As such, it can improve its working capital position to that extent.

9. **Reserve Policy:** One of the cherished goals of enterprise is to build up adequate reserves out of profits. Besides cash or funds position, the urge to retain or ploughing back of profits often acts as a major constraint on the dividend policy. In concerns that function well, the built

up reserves constitute a strong base on which the corporate growth and expansion can be sustained.

Wherever the desire to build up reserves is dominant, the working capital or funds position receives priority of consideration and dividends a residual treatment. But this policy can not be over-played to the extent of making payment of erratic dividends year after year.

10. Depreciation Policy: Depreciation policy centers around the determination of the amount to be provided as depreciation charge to make up the ultimate resource for replacement of worn out or obsolete assets. There are diversified approaches to the quantum and the mode of charging depreciation, irrespective of the stipulation of tax administration favouring diminishing balance method at prescribed rates. These variations in approach are often justified in terms of their impact on working capital position. The depreciation cahrges do not involve any cash outflow. Enhanced rates of depreciation have the effect of reducing profits correspondingly, which in turn helps in holding back distribution of dividends. By this process, cash is conserved. Thus, the effect of depreciation policy on working capital is indirect.

11. Operating Efficiency: The operating efficiency of the management is also an important determinant of the level of working capital. The management can contribute to a sound working capital position through operating efficiency. There is an obvious relationship between the operating efficiency of a company and its working capital position. Aggressive management loses no time in finding ways to off-set the adverse effects of raw-material price increases, increased labour rates and other factors outside the purview of corporate control. Waste elimination, improved coordination to cut delays, higher efficiency in operations and fuller utilisation of resources are among the measures to be taken to prevent the erosion of profits. These measures have the effect of getting more out of a given volume of working capital or obtaining the current levels of output with a reduced volume of working capital. Thus, the level of working capital is determined by wide variety of factors which are partly internal to the firm and partly external to it. Efficient working capital management requires efficient planning and constant review of the needs far an appropriate working capital.

B. EXTERNAL FACTORS

1. Business Cycles: Movements of the business cycle bring about change in working capital position. In the event of economic prosperity, the upward swing is associated with spurt in sales and increase in levels of inventories and book debts. To cope with increased demand and consequently increased production, the firm requires additional working capital. On the otherhand, if the economy is experiencing recession, there will be decline in sales. As such, production requirements decline and therefore less working capital is needed. However, the firm needs additional cash to meet operating expenses as the funds are locked in inventories. Thus, a business depression may give a misleading appearance of the financial position of the enterprise. With recovery, the cash position may decline and a shortage of working capital may develop.

2. Technological Development: Technological developments in the area of productin bring about changes in working capital requirements. If a firm switches over to new manufacturing process and instals new equipments, it may cut short the period involved in converting raw-materials into finished goods. As such, the permanent working capital requirements of the firm may decrease considerably. Further, if the new machine utilises less expensive raw-materials, the inventory needs may also be reduced.

3. Change in Demand for Products: Some manufactured products are subject to seasonal fluctuations in sales. There are obvious difficulties in ensuring that production tempo matches the ebb and flow of the seasonal demand pattern. Pressurised production in peak periods will be very expensive and relative inactivity in lean periods will be even more expensive as employment and facilities will have to be sustained without being able to obtain the corresponding output.

In the interest of full utilisation of resources, steady production will have to be maintained independent of change in demand for the finished products. This will result in progressive accumulation of finished goods inventories during the off season and their quick disposal during the peak season. The rising stock levels during the periods of production in excess of demand will require increasing amounts of working capital to be provided and these funds will remain tied up in inventories for some months. The financial planning will have to incorporate this pattern of funds requirements associated with steady production and seasonal sales.

4. Taxation: Tax liability is an inescapable element and it is to be an integral part of working capital planning. It is a short-term liability payable in cash. Advance tax may have to be remitted in instalments, the computation being based on projected profits for the year. Tax is the first appropriation out of profits and the amount of tax is determined by prevailing tax regulations. It is not left to the discretion and convenience of the enterprise management. Dividend can be curtailed or postponed but not tax commitments. Periods of high taxation impose additional strain on working capital.

The finance manager, who is well informed of tax matters, has appreciable scope for tax planning with a view to reducing the cash drain by way of tax. He can divert funds intelligently to internal operations with short as well as long-term benefits. To be able to get the best out of available tax incentives, he has to drain up the operating plans of the company in advance and steer the resources towards research and development, exports or other directions which promise tax benefits or promote the earnings of the company.

5. Price-Level Changes: The changes in price levels over the year have always created problems for the finance manager. The financial experts, all over the world, are still endeavoring to spell out right way to resolve the enigma of changing price levels.

Rapid rising prices create the need for obtaining more funds to maintain the present volume of activity. For the same levels of inventories, higher cash outlays are needed. In an inflationary set up, even operating expenses will grow for a given level of activity. Wage increases have to be financed and for current levels of services higher costs have to be incurred. Replacements of fixed assets at enhanced prices require higher cash outlay than what has been contemplated by depreciation charges. A partial savings feature, however, is that the company can seek to compensate these cost jumps by upward revision of its product prices. While some companies are in the advantageous position of being able to effect more than compensating price increases for their products, others are not placed in that fortunate position. So the implications of changing price levels on working capital position vary from company to company depending on the nature of its operations, its standing in the market and other relevant considerations.

It is also true that not all prices move at the same pace. Nor do they all move in the same direction. This diversity in price changes creates contradictions. It leaves some companies relieved of their working capital problems and, at the same time, it aggravates or intensifies the working capital problems of others.

6. Vagaries in supply of Raw-Materials: Certain raw-materials pose problems in the matter of procurement and holding. Their sources may be few and irregular. They may, therefore, be less amenable to the discipline of planned inventory management. The enterprise may feel compelled to purchase and carry large reserves of these items to sustain smooth flow of production. Inventory levels rise, as a consequence, using up more funds.

Another problem, often confronting the enterprise, pertains to the sporadic supplies of some essential raw-materials such as steel in scarcity conditions. Where controlled commodities are involved, the buyer has very limited option as to the quantum and the timing of the purchase. At a time when the company's funds position is not too happy a bulk assignment may arrive and the finance manager may have to struggle to scrap up the required money and arrange for early clearance of the goods and save mounting demurrage charges. This clement of unpredictability of the amount and the timing of these surprise arrivals of some materials unsettles the financial plans of the enterprise and causes much confusion. The cautious manager finds it necessary to carry a relatively, high level of cash and near-cash assets.

Some raw-materials may be available only in certain seasons so that these have to be obtained and stored in advance for the lean months. The working capital requirements in such circumstances may register seasonal fluctuations.

7. Competitive Conditions: A company which enjoys a dominant hold on its market feels little obliged to strain beyond a measure in satisfying customer's requirements. It can afford to restrict the variety of its products and thus reduce the aggregate levels of inventories. It can with equal facility, lighten up its credit standards and save on investments in book-debts. If conditions favour, it can dispense with the policy of extending credit facilities and obtain ready cash for its sales, or it can even raise funds in advance of sale by insisting on advance payments along with the purchase orders of customers.

A company which operates in a highly competitive market has to attempt to win and retain the customer's satisfaction on a continuing basis. This involvers extra cost and creates a variety of working capital problems. To offer the customers the benefit of choice, varied lines of products will have to be manufactured and stocked. The consequence is high levels of inventories at raw-materials, work-in-progress and finished goods stages and corresponding need for additional working capital funds. To win and retain the confidence of customers, it is necessary to extend generous credit terms in keeping with competitor's practices with very limited direction in formulating its own credit policies. The investment in book debts, thus may need additional funds. Thus, the degree of competition is an important factor that influences the working capital requirements.

8. Transport and Communication Developments: In a country, where the means of transport and communication are not well developed, industries may need additional funds to maintain large quantities of inventory of raw-materials and other accessories. On the otherhand, in a country where these facilities are well developed, the industries need not maintain large quantities of raw-materials inventory.

17.4 SUMMING UP

The inflow of income from sales throughout the year is not certain and not uniform, the company has to depend on external sources for atleast a part of its operational needs. The need for working capital arises from the operating or cash cycle of the firm. The operating cycle refers to the length of time required to convert the non-cash current assets into cash. In other words cash cycle refers to the time involved in completing the following sequence of events; conversion of cash into inventory, inventory into receivables and receivables into cash. If it were possible to complete these sequences instantaneously, there would be no need for working capital. But since the nature of these activities is each that a perfect synchronization is not possible and a certain amount of working capital is necessary.

A wide variety of factors influence the total investment in the working capital of an enterprise. They can be categorised into two groups viz, internal factors and external factors. Some of the internal factors include factors such as promotional and formative phase, nature of business, size of business, manufacturing cycle, credit terms to customers, production policies, growth and expansion programmes, profit levels and dividend policy, reserve policy, depreciation policy, and operating efficiency, on the otherhand external factors may include business cycle, technological developments, shifts in demand for products, taxation, price-level changes, vagaries in supply of raw-materials, competitive conditions and transport and communication development.

17.5 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in about 30 lines each.

1. What do you mean by planning of working capital needs? Explain the factors that should be considered while planning the working capital needs.
2. Explain the internal factors that determine the working capital needs of manufacturing firm.
3. Explain the external factors that determine the working capital needs of a manufacturing organisation.

II. Answer the following questions in about 15 lines each.

4. List out the determinants of working capital.
5. Bring out the relationship between reserve policy and dividend policy.
6. What precautions should be taken while planning the working the working capital needs?
7. What are the sources of working capital funds?

17.6 RECOMMENDED READINGS

1. S.C.Kuchhal : **Corporation Finance**
2. I.M. Pandey : **Financial Management**
3. V.E.Ramamurty : **Working Capital Management**
4. P.V.Kulkarni : **Financial Management**
5. James C. Vanhorne : **Financial Management Policy**

17.7 GLOSSARY

Manufacturing Cycle : An extended time interval between the raw-materials purchases and the completion of the manufacturing process yielding the finished product is called manufacturing cycle.

Working Capital Gap : Current assets minus non-bank short-term liabilites.

Cash Credit : Loans sanctioned by banks on mortagage of stocks through negotiations.

Gross Working Capital	:	Total investment in current assets.
Current Liabilities	:	All those liabilities for which payments are to be made within a period of one year or less.
Current Ratio	:	Current assets divided by current liabilities.
Net Working Capital	:	Difference between current assets and current liabilities.
Negative Net Working Capital	:	Excess of current liabilities over current assets.
Permanent Working Capital	:	A bare minim current assets which are to be always maintained to called working capital.
Temporary Working Capital	:	Investment required to finance the changing needs of current assets.
Working Capital	:	Investment needed to finance the day-to-day operations of a company.

UNIT – 18 : ESTIMATION OF WORKING CAPITAL REQUIREMENT

Contents

18.0 AIMS AND OBJECTIVES

This unit covers the need for estimation of working capital requirement, and different approaches to estimate the working capital.

By the end of this unit, you should be able to understand:

- the need of estimation of working capital;
- various approaches to estimate working capital; and
- procedure for estimation of working capital.

18.1 INTORDUCTION

A firm must estimate in advance the requirement of working capital for smooth operations of the business. The finance manager must consider the various factors to estimate the amount of adequate working capital. No business can be successfully run without an adequate amount of working capital. Therefore, to avoid the shortage of working capital every business firm has to estimate its working capital requirements in advance so that the arrangements can be made to procure adequate working capital. But estimation of working capital requirement is not an easy task and a large number of factors have to be taken in to account. A brief explanation about each of the factors has already been given in Unit-17. A number of methods, in addition to the operating cycle concept, may be used to determine working capital needs in practice.

18.2 APPROACHES TO ESTIMATE THE WORKING CAPITAL REQUIREMENT

The following different approaches are used to estimate the working capital requirement of a business firm:

1. Estimation on the basis of operating cycle.
2. Estimation on the basis of percentage of net sales.
3. Estimation on the basis of percentage of total assets to fixed assets.

18.3 ESTIMATION ON THE BASIS OF OPERATING CYCLE

According to this approach, the requirement of working capital depends upon the operating cycle of the business. The operating cycle begins with the acquisition of raw materials and ends with the collection of receivables. Broadly the operating stages can be classified into the following four types.

i) Raw material and stores storage stage
ii) Work-in-process stage
iii) Finished goods inventory stage
iv) Receivables collection stage

The duration of the operating cycle for the estimation of working capital requirement is equivalent to the total of the duration of each of these stages minus (-) the credit period allowed by the suppliers of the firm. After computing the period of one operating cycle, the total number of operating cycles that can be completed during a year can be computed by dividing 365 days in a cycle. The total operating expenditure in the year when divided by the number of operating cycles in a year will give the average amount of the working capital requirement.

18.4 ESTIMATION ON THE BASIS OF PERCENTAGE OF NET SALES

According to this approach the estimation of working capital requirement is based on the fact that the working capital for any firm is directly related to the sales volume of that firm. Therefore, the working capital requirement is expressed as a percentage of expected sales for a particular period. It is noted that the estimation of working capital completely depends on sales. This approach is based on the assumption that higher the sales level, the greater would be the need for working capital.

18.5 ESTIMATION ON THE BASIS OF PERCENTAGE OF TOTAL ASSETS TO FIXED ASSETS

The estimation of working capital requirement in this approach is based on the fact that the total assets of the firm are consisting of fixed assets and current assets. As per the past experience, a relationship between total current assets (Gross Working Capital) and total fixed assets or total assets of the firm is established. The firm will plan the future level of fixed assets in the capital budgeting decisions. In order to use these fixed assets in an efficient and optimal way the firm must have sufficient working capital. Therefore the working capital requirement depends upon the planned level of fixed assets.

18.6 THE INFORMATION REQUIRED FOR ESTIMATION OF WORKING CAPITAL

The following information is required for preparation of working capital forecast:

I. i. The cost incurred in material, wages and overheads.

ii. Length of time for which raw materials are to remain in storage before they are issued for production.

iii. Length of production cycle or work-in-process.

iv. Length of sales cycle denoting the period of time during which finished goods are to be kept waiting for sales.

v. The overage period of credit allowed to customers.

vi. The amount of cash required to pay day to day expenses of the business.

vii. The average amount of cash required to make advance payments.

viii. The average credit period expected to be allowed by suppliers.

ix. Time lag in payment of wage and other over heads.

The method of estimating working capital requirement based on above information is called "Cash Cost Technique" of forecasting working capital needs. According to this method, all transactions are shown in working capital forecasting on cost basis.

The amount of current assets is estimated by adding the sum of the first seven items and if the sum of the last two items i.e. the amount of current liabilities is deducted from it, the result is networking capital requirement. Further, in order to provide for contingencies, some extra amount as a fixed percentage of the working capital may be added as a margin of safety.

18.7 PROFORMA FOR ESTIMATION OF WORKING CAPITAL

Statement Showing Estimation of Working Capital Requirement

Sl.No.	Particulars	Amount Rs.	Rs.
A	Current Assets		
	i) Stock of raw materials (for No. of months consumption)		xxx
	ii) Working process (for ---- months)		xxx
	a) Raw-materials b) Direct labour c) Over heads	xxx xxx xxx	
	iii) Stock of finished goods (for ---- months)		xxx
	iv) Sundry debtors or Accounts receivables		xxx
	v) Payment in advance		xxx

	vi) Balance of cash		xxx
	vii) Others (if any)		xxx
	Total Current Assets		xxx
B	Less: Current Liabilities		
	i) Creditors (for months purchase of raw materials)	xxx	
	ii) Lag in payment of expenses/outstanding expenses (for ---- months)	xxx	
	iii) Others (if any)	xxx	
	Total Current liabilities		xxx
C	Working Capital (A-B) Add: Provision for contingencies		xxx xxx
	Net Working Capital Required		xxx

Notes

i) While estimating working capital requirement profit must be ignored because of the following reasons:

ii) Profit may or may not be used as working capital.

iii) If profit is taken into account such amount of profit is to be adjusted for amount of income tax, drawings and dividends paid etc.

iv) The calculation of work-in-progress depends upon its degree of completion as regards material, labour and over heads.

v) The estimation of the stock of finished stock and debtors mush be made at cost.

18.8 SUMMING UP

The amount needed to be invested in current assets is affected by many factors and may fluctuate over a period of time. Manufacturing cycle, production policies, credit terms, growth and expansion needs, and inventory turnover are some of the important factors influencing the determination of working capital.

A firm must estimate in advance as to how much net working capital will be required for effective and efficient operations of its business.

18.9 CHECK YOUR PROGRESS: MODEL ANSWERS

Illustration - 1

A proforma cost sheet of a company provides the following particulars:

	Amount per unit Rs.
Elements of cost:	
Raw materials	80
Direct labour	30

Overheads	60
Total cost	170
Profit	30
Selling price	200

The following further particulars are given:

Raw materials in stock, on an average - one month; Materials in process (completion stage, 50 percent), on an average, half a month; Finished goods in stock, on an average, one month.

Credit allowed by suppliers is one month; Credit allowed to debtors is two months; average time –lag in payment of wages is 1.5 weeks and one month in overhead expenses; one fourth of the output is sold against cash; cash in hand and at bank is desired to be maintained at Rs. 3,65,000.

You are required to prepare a statement showing the working capital needed to finance a level of activity of 1,04,000 units of production. You may assume that production is carried on evenly throughout the year, and wages and overheads accrue similarly.

Solution

	Statement showing Determination of Net Working Capital	
		Rs.
A.	**Current Assets**	
	i) Stock of materials for 1 month: (1,04,000 x Rs.80 x 4/52)	6,40,000
	ii) Work-in-progress for 15 days	
	a) Material (1,04,000 x Rs.80 x 2/52) x 1/2	1,60,000
	b) Labour (1,04,000 x Rs.30 x 2/52) x 1/2	60,000
	c) Overheads (1,04,000 x Rs.60 x 2/52) x 1/2	1,20,000
	iii) Finished goods for 1 month: (1,04,000 x Rs.170 x 4/52)	13,60,000
	iv) Debtors for 2 months (78,000 x Rs.170 x 8/52)	2,40,000
	v) Cash in hand and at bank	3,65,000
	Total investment in current assets	47,45,000
B.	**Current Liabilities**	
	i) Creditors, 1 month's purchase of raw materials, (i.e. 1,04,000 x Rs.80 x 4/52)	6,40,000
	ii) Average time-lag in payment of expenses	
	a) Overheads (1,04,000 x Rs.80 x 4/52)	4,80,000
	b) Labour (1,04,000 x Rs.30 x 3/104)	90,000
	Total current liabilities	12,10,000
C.	**Net working capital** = Current assets - Current liabilities (A–B)	35,35,000

Illustration - 2

Hi-tech Ltd. plans to sell 30,000 units next year. The expected cost of goods sold is as follows:

	Cost per unit Rs.
Raw material	100
Manufacturing expenses	30
Selling, administration and financial expenses	20
Selling price	200

The duration at various stages of the operating cycle is expected to be as follows:

Raw material stage	2 months
Work-in-progress stage	1 month
Finished stage	½ month
Debtor stage	1 month

Assuming the monthly sales level of 2,500 units, estimate the gross working capital requirement if the desired cash balance is 5% of the gross working capital requirement, and work-in-progress is 25% complete with respect to manufacturing expenses.

Solution

Statement of Estimation of Working Capital Requirement

	Amount (Rs.)	Amount (Rs.)
Current Assets		
Stock of raw material (2,500 x 2 x 100)		5,00,000
i) **Work-in-progress**		
Raw materials (2,500 x 100)	2,50,000	
ii) Manufacturing expenses 25% of (2,500 x 30)	18,750	2,68,750
Finished Goods		
iii) Raw material (2,500 x ½ x 100)	1,25,000	
iv) Manufacturing expenses (2,500 x ½ x 30)	37,500	1,62,500
Debtors (2,500 x 150)		3,75,000
Total Current Assets		13,06,250
Cash Balance (13,06,250 x 5/95)		68,750
Working capital requirement		13,75,000

Note: Selling, administration and financial expenses have not been included in the valuation of closing stock.

Illustration - 3

X & Y Ltd., is desirous to purchase a business and has consulted you, and one point on which you are asked to advise them, is the average amount of working capital which will be required in the first year of working.

You are given the following estimates and are instructed to add 10 per cent to your computed figure to allow for contingencies.

Particulars	Amount for the year (Rs.)
i) Average amount backed up for stocks	
a) Stocks of finished product	5,000
b) Stock of stores and materials	8,000
ii) Average credit given	
a) Inland sales: 6 week's credit	3,12,000
b) Export sales: 1.5 week's credit	78,000
iii) Average time lag in payment of wages and other outgoings	
a) Wages: 1/5 weeks	2,60,000
b) Stocks and materials: 1.5 months	48,000
c) Rent and royalties: 6 months	10,000
d) Clerical staff: 0.5 month	62,400
e) Manager: 0.5 month	4,800
f) Miscellaneous expenses: 1.5 months	48,000
iv) Payment in advance	
a) Sundry expenses (paid quarterly in advance)	8,000
b) Undrawn profits on an average throughout the year	11,000

Set up your calculations for the average amount of working capital required.

Solution

Statement Showing Determination of Net Working Capital for X & Y Ltd.

A) Current Assets	
i) Stock of stores and materials	5,000
ii) Stock of finished products	8,000
iii) Debtors:	
Inland sales (Rs.3,12,000 x 6/52)	36,000
Export sales (Rs.78,000 x 3/104)	2,250
iv) Advance payment of sundry expenses (Rs.8,000 x ¼)	2,000
Total investment in current assets	53,250
B) Current liabilities	
i) Wages (Rs.2,60,000 x 3/104)	7,500
ii) Stocks/materials (Rs.48,000 x 3/24)	6,000
iii) Rent, royalties (Rs.10,000 x 6/12)	5,000
iv) Clerical staff (Rs.62,400 x 1/24)	2,600
v) Manager (Rs.4,800 x 1/24)	200
vi) Miscellaneous expenses (Rs.48,000 x 3/24)	6,000
Total estimate of current liabilities	27,300
C) Net working capital	
i) Current assets – Current liabilities (A–B)	25,950
ii) Add 10 per cent contingency allowance	2,595
Average amount of working capital required	28,545

Assumptions

i) A time period of 52 weeks or 12 months has been assumed in year.

ii) Undrawn profit has been ignored in the working capital computation for the following reasons:

a) For the purpose of detecting working capital provided by net profit, it is necessary to adjust net profit for income tax and dividends/drawings, and so on.

b) Profit need not always be a source of financing working capital. It may be used for other purposes like purchase of fixed assets, repayment of long-term loans, and so on. Since the firm does not seem to have such uses, Rs.11,000 may be treated as source of working capital. But the WC will not change.

iii) Actual working capital requirement would be more than what is estimated here as the cash component of current assets is not known.

Illustration - 4

Grow More Ltd., is presently operating at 60% level, producing 36,000 units per annum. In view of favourable market conditions, it has been decided that from 1st January 2002, the company would operate at 90% capacity. The following information is provided:

i) Existing cost price structure per unit:

	Rs.
Raw material	4.00
Wages	2.00
Overheads (Variable)	2.00
Overheads (Fixed)	1.00
Profit	1.00
Selling Price	10.00

ii) It is expected that the cost of raw material, wages, expenses and sales per unit will remain unchanged in 2002.

iii) Raw materials remain in stores for 2 months before these are issued to production. These units remain in production process for 1 month.

iv) Finished goods remain in godown for 2 months.

v) Credit allowed to debtors is 2 months. Credit allowed by creditors is 3 months.

vi) Lag in wages and overhead payments is 1 month. It may be assumed that wages and overhead accrue evenly throughout the production cycle.

You are required to calculate the working capital requirement on an estimated basis to sustain the increased production level. Assumptions made if any, should be clearly indicated.

Solution

Statement Showing Determination at Working Capital Requirement

Particulars	Amount (Rs.)	Amount (Rs.)
A. Current Assets		
Stock of raw material (2 months x 4,500 x Rs.4)		36,000
Work-in-progress:		
Materials (1 month x 4,500 x Rs.4)	18,000	
Wages (1/2 month)	4,500	
Overheads (1/2 month)	6,000	28,500
Finished Goods (2 months)		78,000
Debtors [2 months x (4,68,000/12)]		78,000
Total Current Assets		2,20,500 (A)
B. Current Liabilities		
Sundry creditors (goods) - 3 months		54,000
Outstanding wages (1 month)		9,000
Outstanding overheads (1 month)		12,000
Total current liabilities		75,000 (B)
Working capital requirement (C = A – B)		1,45,500 (C)

Illustration - 5

Prepare an estimate of working capital requirement from the following information of a company.

i) Estimated annual sales	1,00,000 units
ii) Selling price	Rs. 8 per unit
iii) Percentage of net profit on sale	25%
iv) Average credit period allowed to customers	8 weeks
v) Average credit period allowed by suppliers	4 weeks
vi) Average stock holding in terms of sales requirement 12 weeks	
vii) Allow 10% for contingencies	

Solution

Statement Showing Determination of Working Capital Requirement

	Rs.
Current Assets	
Debtors at cost (8 weeks) : 6,00,000 x 8/52	92,308
Stock (12 weeks) : 60,00,000 x 12/52	1,38,462
Total current assets	2,30,770
Less: Current liabilities: Creditors (4 weeks): 6,00,000 x 4/52	46,154
Net working capital	1,84,616
Add : 10% for contingencies	18,462
Networking capital required	2,03,078

Working notes:

a) Sales = 1,00,000 x 8 = Rs.8,00,000

Profit = 25% of Rs.8,00,000 = Rs.2,00,000
Cost of sales = Rs. 8,00,000 – Rs. 2,00,000 = Rs. 6,00,000

b) Profits are ignored for estimation of working capital.

18.10 MODEL EXAMINATION QUESTIONS

1. Explain various methods for estimation of working capital requirement.
2. Discuss the methods for estimation of working capital requirements based on sales.
3. Explain the concept and significance of operating cycle.
4. What information is needed to estimate working capital requirement?
5. Explain the need for working capital estimation.
6. How do you treat profit for estimation of working capital?
7. Draw a proforma statement of working capital estimation.

EXERCISES

1. The cost sheet of a company provides the following data:

	Cost per unit (Rs.)
Raw material	50
Direct labour	20
Overheads (including depreciation of Rs.10)	40
Total cost	110
Profit	20
Selling price	130

Average raw material in stock is for one month. Average materials in work-in-progress is for half month. Credit allowed by suppliers; one month; credit allowed to debtors: one month. Average time lag in payment of wages: 10 days; average time lag in payment of overheads 30 days. 25% of the sales are on cash basis. Cash balance expected to be Rs.1,00,000. Finished goods lie in the warehouse for one month.

You are required to prepare a statement showing the working capital needed to finance a level of the activity of 54,000 units of output. Production is carried on evenly throughout the year and wages and overheads accure similarly. State your assumptions, if any, clearly.

(Answer: Working capital requirement is Rs.8,91,250)

2. Calculate the amount of working capital requirement for Siris Ltd., from the following information

	Cost per unit (Rs.)
Raw material	160
Direct labour	60
Overheads	120
Total cost	340
Profit	60
Selling price	400

Raw materials are held in stock on an average for one month. Materials are in process on an average for half-a-month. Finished goods are in stock on an average for one month.

Credit allowed by suppliers is one month and credit allowed to debtors is two months. Time lag in payment of wages 1½ weeks. Time lag in payment of overhead expenses is one month. One fourth of the sales are made on cash basis.

Cash in had and at the bank is expected to be Rs.50,000; expected level of production is to be 1,04,000 units for a year of 52 weeks.

You may assume that production is carried on evenly throughout the year and a time period of four weeks is equivalent to a month.

(Answer: Working capital requirement is Rs.1,45,500)

3. From the following information, prepare a statement showing estimation of working capital requirement:

i) Projected annual sales 26,000 units.

ii) Selling price unit Rs.60

iii) Analysis of selling price: material 40%; labour30%; overheads 20%; profit 10%.

iv) Time lag (on average)
Raw materials in stock 3 weeks
Production process 4 weeks.
Credit to debtors 5 weeks
Credit to suppliers 3 weeks
Lag in payment of wages and overheads 2 weeks
Finished goods are in stock 2 weeks

v) Cash in hand is expected to be Rs.32,000

(Answer: Working capital requirement is Rs.2,69,000)

4. From the following information presented by a manufacturing company, prepare a working capital requirement forecast for the year 2003: Expected monthly sales of 32,000 units @ Rs.10 per unit. The anticipated ratios of cost to selling prices are:

Raw materials	40%
Labour	30%
Budgeted overheads	Rs.16,000 per week

Overhead expenses include depreciation of Rs.4,000 per week planned stock will include raw materials of Rs.96,000 and 16,000 units of finished goods.

Materials will stay in process for 2 weeks

Credit allowed to debtors is 5 weeks

Credit allowed by creditors is 1 month

Lag in payment of overheads is 2 weeks

25% of sales may be assumed against cash and cash in hand is expected to be Rs.25,000.

Assume that production is carried on evenly throughout the year and wages and overheads accrue similarly. Assume also 4 weeks in a month.

(Answer: Working capital requirement for a weekly sales of 8,000 units is Rs.4,60,000. The overheads cost per unit is Rs.1.50 i.e. [(16,000 – 4,000)/8,000] and cost of goods sold is 85% of selling price.)

5. XYZ Ltd. sells its products on a gross profit of 20% of sales. The following information is extracted from its annual accounts for the year ending 31st Dec. 1999.

	Rs.
Sales (at 3 months credit)	40,00,000
Raw materials	12,00,000
Wages (15 days in arrears)	9,60,000
Manufacturing and general expense (one month in arrears)	12,00,000
Administration expenses (one month in arrears)	4,80,000
Sales promotion expenses (Payable half yearly in advance)	2,00,000

The company enjoys one month credit from the suppliers of raw materials and maintains 2 months stock of raw materials and 1½ months finished goods. Cash balance is maintained at Rs.1,00,000 as a precautionary measure. Assuming a 10% margin, find out the working capital requirements of XYZ ltd.

(Answer: Working capital requirement is Rs.14,52,000)

6. You are supplied with the following information in respect of ABC Ltd. For the year 2002.

Production of the year, 69,000 units

Finished goods in store 3 months

Raw material in store, 2 months consumption

Production process, 1 month

Credit allowed by creditors, 2 months

Credit given to debtors, 3 months

Selling price per unit, Rs.50

Raw material, 50 per cent of selling price

Direct wages, 10 per cent of selling price

Manufacturing and administrative overheads, 16 percent of selling price

Selling over heads, 4 percent of selling price.

There is a regular production, sales cycle and wages overheads accrue evenly. Wages are paid in the next month of accrual. Material is introduced in the beginning of the production cycle. You are required to ascertain its working capital requirement.

(Answer: Net working capital requirement is Rs.14,97,875)

UNIT – 19 : RETAINED EARNINGS

Contents

19.0 AIMS AND OBJECTIVES

The purpose of this Unit is to explain the meaning, determinants, advantages and disadvantages of Retained Earnings.

On completing this unit, you should be able to:

- explain the meaning of Retained Earnings;
- identify the determinants of Retained Earnings; and
- explain the advantages and disadvantages of Retained Earnings.

19.1 INTRODUCTION

Retained earnings constitute a very significant internal source of funds for financing the corporate growth and expansion. Many companies, notably those in the field of manufacturing, merchandise, banking and insurance, have grown mainly on account of their reinvested earnings. They act as a cushion in the capital structure of the corporation. They enable the corporation to face business fluctuations arising out of seasonal variations and business cycles. Retained earnings denote the profits reinvested in the business after paying dividends, if any. It improves the financial strength of the organization. We will explain the meaning determinants, advantages and disadvantages of retained earnings in this Unit.

19.2 MEANING OF RETAINED EARNINGS

From the corporation point of view, it is desirable that a portion of every year's profits is saved to serve as a resource of fixed and working capital finance. That portion of profits which remains undistributed and which is retained in the business, after declaring and paying the dividends; in order to meet financial requirements of the corporation is referred to as "retained earnings". Such earnings can be retained in the business either in the form of credit balance of Profit and Loss Account or kept in General Reserve Account, etc. Technically speaking, the process of accumulating corporate profits out of their annual is called **'ploughing back of profits'**. It is also known as **"retention of earnings"**, or **"internal financing"** or **"self-financing"**.

Retained earnings and the rate of dividend have an inverse relationship. A large amount of retained earnings will lower the current rate of dividend which reduces the outflow of cash that accrue to equity shareholders. Conversely, no or low retention of earnings will enable the corporation to declare a high rate of dividend resulting in a significant outflow of liquid resources. On one hand, retained earnings are desirable for the purpose of expansion of business and on the other, dividend distribution is also desirable in the interest of stabilization of market prices. These two, therefore, conflict with each other. Therefore, retention or no retention of profits depends largely on the management's policy of expansion. Substantial reinvestment of earnings by the corporation will be a better step than the distribution of the entire profits to the shareholders, because there is an "papeal of growth stocks". Guthman and Dougall state that the compounding rate of return on retained earnings at higher rate will increase the intrinsic value of shares continuously. As such, the prices of the corporation in the stock exchanges will also increase steadily.

19.3 DETERMINANTS OF RETAINED EARNINGS

The quantum of retained earnings is decided by the company by taking into consideration the following factors:

i) Earnings of the company
ii) Dividend policy of the industry
iii) Taxation policy
iv) Government policy
v) General state of economy
vi) Liquidity
vii) Ability to barrow
viii) Repayment of debt
ix) Desire of control among shareholders

i) Earnings of the company

The quantum of earnings that are to be retained in the business will depend upon the size of the total annual earnings of the company. A high growth rate of business enables the corporate to earn increasing profits. It will ultimately lead to the declaration of a high return on equity investment. If the total earnings of the corporation are more, it can naturally afford to save more, and utilize the same retentions for earning higher returns. Conversely, when there are no profits the question of retained earnings in the corporation does not arise. As a matter of fact, the volume of profits is influenced by several other factors such as timely supply of stocks and stores, demand for goods and services produced, cost of production and distribution, quality of management's attitude and political stability in the country. The stage of growth of company also determines the retained earnings. When a company is in a fast growing stage with profitable and acceptable investment opportunities promising higher rates of return than what the shareholders could earn by investing outside, the company prefers to retain a major portion of its earnings rather than declaring more dividends. In brief, the greater the future need for funds the greater is the likelihood of the company retaining the earnings.

ii) Dividend policy of the industry

No doubt, the size of corporation is one of the important determinants of retained earrings, but it is not an exclusive factor. It is also influenced by the dividend policy pursued by the industry to which the company belongs. A conservative dividend policy adopted by the industry will encourage the realization of retained earnings. The extent to which the industry should retain will depend on the following factors:

a) Provision of safeguards by the industry against business vicissitudes. These safeguards are meant to stabilize the rate of dividend;

b) The amount of sinking fund that is built up for discharging ling-term debts;

c) The amount of service created to meet expansion requirements;

d) The amount of depreciation reserves that is built up to make up for the deficiencies during the earlier period;

e) The expectations of shareholders regarding their earnings;

f) The general economic environment prevailing in the country.

iii) Taxation policy of the Government

Different taxes like income-tax, surcharge, etc., imposed by the Government on corporate profits-distributed as well as undistributed have a great influence on the amount of retained earnings. A high rate of income-tax on the corporate earnings will naturally discourage retention of earnings. Consequently, the internal capacity of to expand its business will be adversely affected. The retained earnings as a portion of total profits and the rate of taxation are inversely related.

There is a criticism that the governments of developing countries like India in their search for larger revenues from taxes to meet their Plan obligations are resorting to the imposition of heavy taxes with adverse effects on industrial growth. It appears that the Government is interested in short-term rather than long-term benefits. The sustained industrial growth attained in the long-run will steadily increase the profits as well as tax revenue. This approach of the developing countries differs from that of advanced countries. For example, in U.K. there has been a practice of imposing taxes at low rates on undistributed profits, while levying higher rates of taxes on distributed profits. The objective of such policy is to encourage corporate savings. In Japan, the tax on undistributed profits has been abolished to encourage internal financing. Apart from corporate tax, personal income-tax rates also influence the volume of retained earnings. When the tax is levied on dividends in the hands of shareholders, they may pressurise the corporation to retain a large portion of its earnings. Retention of earnings by corporations increase the intrinsic value of shares, thereby the market prices of securities. If the distribution tax is levied on the corporate dividends, the companies may retain and capitalize the earnings.

iv) Government attitude and control

Apart from the taxation policy of the Government, other aspects like the attitude, approach, ideologies and commitment of the Government to solve the socio-economic problems also influence the volume of earnings that can be retained by a company. For instance; the Compulsory Deposit Scheme which was in force from July 1965 till May 1977 affected the capital formation capacity of corporations to a large extent. The public Companies (Limitation of Dividends) Act 1949, upset the capital market and encouraged undesirable trends in the private sector. However, this Act was operative only for a short period. The dividend distribution tax imposed in the recent part on companies has led to non-declaration of dividends by many companies in India.

v) State of economy

The state of economy to a great extent affects the management's decision to retain or distribute earnings of a company. In the periods of uncertain economic conditions, the management would like to be retain the whole quantum of company's earnings to build up reserves to absorb any unsuspected shock in the future. Similarly during the portion of depression, the management may with hold payment of dividends to retain a large part of its earnings for presenting the liquidity position.

vi) Liquidity

Liquidity is also an important factor which determines the retained earrings. As payment of dividends results in the outflow of cash, the liquidity position of the company may be impaired. Though a company has sufficient profits, it may not be in a position to pay dividends as it causes depletion of cash resources. In such a situation the company would like to retain its earnings. It also serves as a cushion to safeguard against uncertainty.

vii) Ability to borrow

The abilities of the companies to borrow funds also affects the retention of profits. For instance, New and Small companies with poor financial background will find it difficult to borrow funds from capital market to finance its investment activities. Therefore, such firms tend to retain more and more of its earrings.

viii) Repayment of debt

A company with a heavy burden of indebtedness may prefer to retain a major portion of its earnings so that it can gradually unload its debts. External financing through borrowing means debt servicing. Therefore, a firm tends to use more of internal resources than the external sources. This seems justified when the available opportunities and profit potential are more within the company itself than outside.

ix) Desire of control among shareholders

The retention policy is also influenced by the desire of the shareholders to retain control lover the company. The issue of additional equity shares for procuring funds diluted the control to the determent of the existing equity shareholders. At the same time, recourse to long-term loans may entail financial risks and may prove disastrous to the interests of the shareholders in terms of financial difficulties. Therefore, companies resort to internal financing by retaining the earnings.

CHECK YOUR PROGRESS –1

List out the factors that determine the retained earnings?

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19.4 WHEN IS THE POLICY OF RETAINED EARNINGS JUSTIFIED?

The corporate management is now faced with problem of choosing between the retention of earnings for growth and the payment of the maximum cash dividend leading to an increase in market prices of the securities. In taking a decision in this regard the management should consider the following aspects:

1. New companies which will not be able to sell their securities should build up their own resources by ploughing back profits to meet their expansion requirements.
2. The corporations which enjoy good credit-worthiness may depend upon the sale of securities for raising funds rather than on the retained earnings.
3. Even the existing corporations may also prefer the ploughing back of profits to the sale of securities in the open market as a further issue of securities dilutes the power of control of the existing shareholders. Further, such a fresh issue of securities may bring down the earnings per share.
4. The corporations whose securities are popular can opt for the issuing of new securities because the company will be able to sell the securities at higher prices, which in turn will enhance the investment and earning power of the enterprise.
5. Retained earnings will help the corporation to increase its short-term borrowing power. Thus, there are possibilities of reducing the cost of borrowings.

There are instances where corporations engaged in manufacturing, merchandising, banking and insurance are benefited to a large extent by resorting to the retention of earnings. However, public utilities will be highly benefited by public financing rather than by the retention of earnings. As a matter of fact, in public utilities the quantum of profits will be just sufficient to meet depreciation and interest obligations. Thus, the retention of earnings will offer maximum benefits to the corporation only when:

i) it is difficult to sell a fresh issue of securities in the market;

ii) it creates undue risk for the equity shareholders with regard to their control over the affairs of the corporation;

iii) the earnings per share are high as compared to those of other units in the field and profits are sufficient to meet the required expansion;

iv) the additional equity shares are to be sold at prices less than the face value of shares to the present holders.

v) the tax obligation of the shareholders is going to be high on account of cash dividends;

vi) the shareholders prefer a rising market price for their shares to liberal dividend payments;

vii) the additional issue of debenture or resort to borrowing impose a heavy burden of interest payment, amortization provision and charge on the assets of company.

19.5 ADVANTAGES OF RETAINED EARNINGS

Retention of earnings has many advantages to many parties. These advantages accrue from the utilization of retained earnings. They can be considered from the points view of the following:

i) Company;

ii) Shareholders; and

iii) Society.

i) COMPANY

Companies enjoy the following benefits on account of retention of earnings:

i) **The cheapest source of finance:** Utilization of retained earnings is the easiest and cheapest way of financing the expansion programmes of the company. There would not be any immediate pressure on the company to pay a dividend on this portion of shareholders equity. Moreover, the costs associated with the fresh issue of securities like underwriting, brokerage etc., could be avoided.

ii) **Stable dividend policy:** Retained earnings help the corporation to pursue a stable dividend policy. During the surplus profit periods it can retain its profits in the business and the accumulated surpluses can be used to meet the deficiency when there are insufficient profits or losses. Thus, the company can pay a uniform dividend. The retention of earnings act as a shock absorber in facing business hazards. Retained earnings provide the necessary financial strength to the corporation to face the hazards resulting from trade cycles like recessions and depressions.

iii) **Increased creditworthiness:** Retained earnings increase the creditworthiness of the corporation (the firm's ability to borrow) as they increase the equity base of the shareholders. They assist the company in securing funds for working capital purposes. Borrowing costs also tend to decline as the common equity base increase.

iv) **Retirement of long-term debts burden:** Retained earnings may also be used for retiring the debentures/preferences shares and for reducing the long-term debt which impose a fixed burden of interest charges on the corporation. On retirement the corporation will be relieved of the fixed charges. Thus the profits of the corporation will go on increasing. A heavy current debt or heavy long-term debt or preferred stock often makes it desirable to retain a part of the earning.

v) **Increased Efficiency:** Retention of earnings increases the operating efficiency of the company. These retained earnings can be utilized to make up the deficiencies of depreciation, depletion and obsolescence of plant, machinery, equipment and other assets.

vi) **Boosts up the morale of management;** The large accumulated profits in a corporation will boost up the morale of the management and help it to take bold and beneficial decisions relating to expansions, replacements, etc.

ii) SHAREHOLDERS

The following benefits will accrue to the shareholders of companies:

i) **Increased value of share:** With the accumulation of undistributed profits, the financial position of the corporation will be stabilized. It will raise the prices of shares in the open market because of the increased intrinsic value. Those shareholders who are interested in getting an immediate monetary benefit can sell their holdings at higher prices than at the face value. Thus the shareholders will be benefited indirectly.

ii) **Increased equity:** The retained earnings, in the long run, may be converted into equity through the process of capitalization of profits. This will increase the equity holding of shareholders. The increased equity base of the corporation will in turn give them security against the business hazards. As a matter of fact, this enlarged equity base of the corporation enhances its credit worthiness. Consequently, shareholders may also benefited in the form of large dividends.

iii) **Increased collateral value of shares:** Increase in the market value of shares resulting from large accumulated profits will benefit the shareholders in another way also. As the value of shares in market increases, they will be accepted as a collateral security to the borrowings of the shareholders. They will be in a position to dictate the borrowing terms ultimately.

iv) **Reduced tax burden:** Where the personal income-tax rates are high the retention of earnings by the corporation is preferable to the declaration of dividends. It will reduce the tax burden of individual shareholders who are already in the higher income tax brackets. Any appreciation in the market value of the shares on account of retained earnings does not create any personal income tax liability for the shareholders. Even when these shares are sold, the resultant long-term capital gains will be taxed at a much lower rate than the tax rate on ordinary incomes.

III) SOCIETY

The following benefits accrue to the society in general:

i) **Capital formation:** In under-developed countries, capital formation assumes much importance. Retained earnings are recognized as one of the important methods of increasing the capital formation. It is a pre-requisite for the economic development of any country. Inadequate capital formation, particularly in developing countries has been a stumbling block in their development. The ability of the company to expand its business activities will largely depend upon the amount of retained earnings.

ii) **Increased social welfare:** The use of retained earnings by the company entails automatic allocation of surpluses for the expansion of the business and that of the supply of goods and services. They make themselves available to the industrialist for investment in the most desirable areas. Increased supply of goods and services will bring down the prices. Consequently, the purchasing power of the consumers will increase. As such, it will have a cumulative effect of creating demand for new goods and services. On account of all these favorable aspects the standard of living of the people will improve which is the ultimate objective of economic planning in the developing counties. Thus, it contributes towards rational economic development, stability, growth and expansion.

CHECK YOUR PROGRESS – 2

What are the advantages of retained earnings to the company?

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19.6 DEMERITS OF RETAINED EARNINGS

Retention of earnings is not free from limitations. When the earnings are retained indiscriminately a few evils occur in business. Some of the important demerits that result from the excessive retention of earnings are given below:

i) **Creation of Monopolies:** The policy of retained earnings helps the big firms to grow bigger on account of continuous ploughing back of profits, while the smaller or new ones will be discouraged for want of finances. At times they may go out of business on account of the monopoly power exercised by the big firms. Moreover, the retained earnings may tempt the corporations to invest them in those ventures which promise higher returns. Thus they may ignore industries, with a low profit margin, though essential for rapid economic development.

ii) **Fear of over-capitalization:** Indiscriminate accumulation of profits and their capitalisation in the course of time may result in over-capitalisation of a corporation. An over-capitalised corporation cannot make efficient and economical use of capital. Consequently, the earnings per share may decline leading to the creation of an adverse environment for the free sale of shares in the stock exchanges. Of course, a higher rate of dividend can be expected during inflationary periods. But during normal periods it is not possible to pay similar dividends.

iii) **Fraudulent practices of management:** The availability of large accumulated profits in the corporation may induce the management to indulge in certain fraudulent practices which are detrimental to the interests of shareholders. For example, the management may declare a low rate of dividend by retaining a large portion of profits in the business in order to bring down the market value of the shares, thereby creating conditions for the heavy disposal of shares by the shareholders. Again, the promoters or owners after purchasing all the shares or the required number of shares at a lower rate, may again declare a higher rate of dividend with the help of the retained earnings in order to raise the market value of shares. They may sell these shares and make money at the cost of innocent shareholders.

iv) **Misutilisation of funds:** At times the retention of earnings may tempt the management to use the funds in such a manner that only a few individuals are benefited. Instead of using the retained earnings for the growth of the company, the management may divert them to the corporations in which a few shareholders are interested. Thus the retention of earnings will not lead to the growth of the company, if they are not utilized properly.

v) **Inefficient capital market:** An indiscriminate policy concerning retained earnings may render the capital market irrelevant. Industry comprises different sectors with different needs and different prospects. Proper distribution of the available surplus resources is possible only through the efficient functioning of capital market. It ensures that funds are used only where capital should be invested and not where it should not be invested. If a large proportion of profits are retained by the corporations the other companies in need of funds will be starved of funds needed for meeting their resource requirements. Prof. Pigou has also opined that excessive retained earnings entail social waste because the money is not made available to those who can use it to the best advantage for the community but is retained by those who have earned it.

vi) **Restriction on the freedom of shareholders:** The policy of retained earnings will restrict the freedom of the shareholder to invest his portion of profits in venture/industry in which he is interested, since they may be invested in a venture/industry in which the management is interested.

19.7 SUMMING UP

Retained earnings is that portion of profits left with the firm after declaring and paying the dividends. This forms a major internal resource to expand the business activities. The factors determining the retained earnings include earnings of the corporation, dividend policy of the industry, taxation and Government policy, general state of the economy, liquidity of the companies, ability of the companies to borrow, repayment of debts, desire of control among shareholders, etc. The retention of earnings is justified when the company is in a position to earn a higher rate of return than the expected rate of return of the shareholders. A company may resort to retention of earning when it is difficult for the company to sell a fresh issue of securities in the market. Retention of earnings has many advantages to many parties. The main beneficiaries of retained earnings are: (i) company; (ii) shareholders; and (iii) society. The amount of retained earnings is very useful for meeting the requirements of expansion, replacement of fixed assets and repayment of long-term debts.

19.8 CHECK YOUR PROGRESS: MODEL ANSWERS

1. The following are the factors determining the retained earnings:
   - i) Earnings of the company;
   - ii) Dividend policy of the industry;
   - iii) Taxation policy of the government;
   - iv) Government attitude and control;
   - v) State of the economy;
   - vi) Liquidity of the company;
   - vii) Ability of the company to borrow;
   - viii) Repayment of debt; and
   - ix) Desire of control among shareholders.

2. The following advantages accrue to the company on account of retention of earnings:
   - i) works as a cheap source of finance to invest the expansion programmes;
   - ii) helps the companies to follow a stable dividend policy;
   - iii) increases the creditworthiness of the companies;
   - iv) long-term debts can be repaid;
   - v) increases the operating efficiency of the company;
   - vi) boosts up the morale of management of the company.

19.9 MODEL EXAMINATON QUESTIONS

I. Answer the following questions in about 30 lines each.

1. When is the policy of retained earnings justified?
2. What are the factors of that determine the quantum of retained earnings?

3. What are the advantages of retained earnings from the points of view (i) Company and (ii) Shareholders?

4. What are retained earnings? Explain the demerits of retained earnings.

5. Why do the companies retain earnings?

II. Answer the following questions in about 15 lines each.

6. How does the retention of earnings affect the dividend policy of a corporation?

7. How does the taxation policy affect the retention of earnings policy of the enterprise?

8. When does the policy of retention of earnings benefit the corporation?

9. How does the retention of earnings by a company benefit the Society?

10. How does the retained earnings policy lead to the creation of monopolies?

19.10 RECOMMENDED BOOKS

1. S.C. Kuchhal : **Corporation Finance**

2. I.M. Pandey : **Financial Management**

3. V.E. Ramamurthy : **Working Capital Management**

19.11 GLOSSARY

Retained earnings : The portion of profits which remains undistributed and which is retained in the business.

Dividend : Profits distributed to the shareholders.

UNIT – 20 : BONUS SHARES

Contents

20.0 AIMS AND OBJECTIVES

The aim of this Unit is to explain meaning, importance, advantages of Bonus Shares.

After studying the Unit, you should be able to:

- explain the meaning of bonus shares;
- list out the objectives of bonus shares;
- discuss the advantages and disadvantages of issuing bonus shares;
- explain the legal aspects of the issue of bonus shares; and
- state the guidelines for the issue of bonus shares.

20.1 INTRODUCTION

Companies issue shares in lieu of consideration. The consideration may be in the form of either cash or kind. The bonus shares are issued to the existing shareholders without payment of any consideration. Bonus shares are issued by converting the reserves and surplus of the company into shares. These shares are also known as 'stock dividend'. It forms an important part of the dividend policy of a corporation. A company can distribute the dividend in the form of cash dividend or stock dividend. Of these forms, the issue of bonus shares of stock dividend is preferred by shareholders. If a company retains a major portion of income, it cannot declare a high rate of dividend. In such a case, the shareholders may feel dissatisfied with the management of the company. Further it may lead to the reduction of the market value of shares. Thus the purpose of the ploughing back of earnings will be defeated. If the company needs resources from internal sources, it can issue bonus shares. This will raise the prestige of the company and the market value of share will go up. Keeping all these in view the corporation should adopt a long-run dividend payout ratio. (Dividend pay out ratio means the percentage of earnings distributed as dividends to shareholders).

In this Unit we will explain the meaning, advantages and disadvantages of bonus shares and legal aspects to be considered for the issue of bonus shares. At the end, the latest guidelines issued by Securities and Exchange Board of India for the issue of bonus shares are also presented.

20.2 MEANING OF BONUS SHARES

The issue of bonus shares is a form of payment of dividend to shareholders by which the accumulated earnings or surplus of a corporation are retained and transferred to the capital accounts of shareholders. Obviously, bonus shares can be issued only by companies which have accumulated large free reserves i.e., reserves not created for any specific purpose and which can distributed as dividend. However, bonus shares can be issued out of balance in the share premium account. Thus it avoids depletion of cash from the company. According to the provisions of Companies Act, Capital Redemption Reserve Account (Section 80, sub section 5) and Share Premium Account (Section 78, subsection 2) can be applied to the issue of bonus shares. Therefore, the issue of bonus shares is also known as 'capitalisation of undistributed profits'.

In brief, the bonus share means the payment of dividend in the form of shares instead of cash. Bonus shares may be issued by following either of the methods mentioned below:

a) Making the partly paid equity shares fully paid without asking for cash from shareholders. This method is not invogue in India, as it is not equally permitted.

b) Issuing and allotting equity shares to the shareholders in a predetermined proportion without receiving cash. With the issue of bonus shares the shareholding in absolute terms of the shareholders in the company will increase. In other words, the ratio of shareholding among the members will not change. Even though the issue of bonus shares is regarded as dividend distribution, it will not cause any cash payment. As such, the liquidity position of the company will be intact and the financial condition will be strengthened.

20.3 OBJECTIVES OF ISSUE OF BONUS SHARES

The following are the important objectives of the issue of bonus shares to the shareholders:

a) **To conserve cash:** The primary objective of bonus shares is to conserve cash for the corporation so as to secure a comfortable working capital position. But a corporation can declare bonus shares even though its earnings are sufficiently large. By issuing the bonus shares the corporation will be able to avoid the dissatisfaction among the shareholders. This will also help in preventing the falling of the prices of shares in the Stock Exchange. Further, the corporation will be able to share its earnings, with the shareholders without any changes in its assets structure.

b) **To solve the problem of under-capitalisation:** Undercapitalisation in any enterprise results in high rates of earnings on capital employed. This will attract new entrepreneurs into the field and create competition in the market. To solve this problem bonus shares are issued to the existing shareholders of company. It means that the number of shares will increase thereby bringing down the rate of dividend per share. Thus it stops potential entrepreneurs from entering the field. Further the demand for higher wages by workmen and price reductions by consumers will not be induced.

c) **To control the speculative activities:** There should be accumulated reserves in the corporation for the issue of bonus shares. If such reserves are not used for bonus shares, the corporate management may be tempted to indulge in speculative activities. Further, the management may manipulate the value of shares in the capital market. Through the issue of bonus shares, these speculative activities will be reduced to a minimum, as the reserves are capitalized, and it provides a true picture of the earning capacity of the company.

d) **To evoke a better response in the capital market:** Issue of bonus shares will increase the credit worthiness and status of the company in the eyes of its creditors as the equity base of the company is enlarged. It helps the companies to borrow large amount at a reasonable cost. In the capital market, securities of the company will have a good response.

e) **To finance the expansion programmes:** Since the declaration of stock dividend (bonus shares) does not result in cash outflow, the corporation will be able to expand its business, because the accumulated reserve becomes a permanent part of the capital structure of corporation. Thus the expansion and modernization programmes can easily be financed.

f) **To widen the capital market:** The declaration of stock dividend will bring down the rate of the dividend creating sense of loss in the minds of the existing shareholders. Therefore, they may prefer to dispose off their holdings. This unexpected release of shares will reduce their market value which the middle class investors can afford. Thus it leads to a wider ownership of shares.

g) **To obtain tax advantage:** Bonus shares are also issued by company to avoid the payment of distribution tax. If the companies distribute dividends they have to be pay tax as per the provisions of the Finance Act.

CHECK YOUR PROGRESS – 1

State the objectives of issue of Bonus Shares.

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20.4 ADVANTAGES AND DISADVANTAGES OF ISSUING BONUS SHARES

Advantages of bonus shares may be discussed from the point of view of (a) The issuing company; (b) Shareholders; and (c) Creditors.

a) For the Issuing company

The issuing company will get the following advantages on account of issue of bonus shares:

i) **Maintenance of liquidity position:** by issuing bonus shares the issuing company can maintain its liquidity position, as there is no outflow of cash. This enables the company to satisfy its creditors through prompt payments. Thus it creates confidence in the creditors.

ii) **Satisfying the shareholder:** By issuing the bonus shares, the shareholders can also be satisfied, as their desire to have large amounts of dividends is indirectly met. Though the rate of dividend may fall, the amount accruing to them, as dividend will increase. Further, their equity base in the company will also increase.

iii) **Economy in raising funds:** The issue of bonus shares is a more economical method of securing funds than that of issuing debenture bonds.

iv) **True position of earnings:** If the accumulated earnings are not capitalized, a false impression about the rate of profits is created. Profits continue to be high as the earnings are retained because of which the capital base remains unchanged. Consequently, the apparent rate of earnings on the old share capital will be high. As a matter of fact, assets are expanded on account of retained earnings and they are used for the purpose of business. In such a case to express earnings or dividends in relation to actual assets is more realistic than to consider it in proportion to the unchanged share capital. Apart from the above mentioned advantages the prestige of the company, its credit worthiness, status and solvency will be enhanced in the eyes of lending institutions. Internal programmes of expansion and modernization of the companies can also be undertaken without any difficulty.

b) For the Shareholders

The following advantages accrue to shareholders:

i) **Increase in equity:** With the issue of bonus shares, the equity of the existing shareholders in the company will increase. It also helps in maintaining the status and the controlling power of the shareholders.

ii) **Increase in income:** As a consequence of the issue of bonus shares the rate of dividend will come down, but the total income accruing to the shareholders will increase.

iii) **Favourable psychological effect:** Generally the issue of bonus shares indicates the growth of the company. However, the dividend may decrease and the management may expect earnings to continue to grow. Thus the decreased rate of returns is offset by the total increased earnings for the shareholders. Consequently, it increases the confidence of the investors in the financial soundness of the company.

iv) **Increased marketability of shares:** When a company issues bonus shares, some of the shareholders may be tempted to sell their shares so as to obtain cash. On account of sudden release of shares, the market price for the shares may come down. Therefore, a number of potential investors may be tempted to purchase shares. Thus the sale of shares in the Stock market for the brokers will become easy.

c) For the Creditors

The issue of bonus shares will instill confidence in the creditors. Conservation of cash resulting from the issue of bonus shares will increase the margin of safety for the creditors. But if the corporation continues to declare the old high rate of dividend, there will be a great drain on the cash resources because the share capital on which the dividend is to be paid is enlarged on account of the bonus issue. In such a case the creditors will be adversely affected.

DISADVANTAGES

The disadvantages of issue of bonus shares can also be discussed from the point of view (i) Companies; and (ii) Shareholders.

a) For Company

The following are the disadvantages of bonus issue from the point of view of the issuing company:

i. The issue of bonus shares is not justified unless there has been a proportionate increase in the earning capacity of the company, since liability in respect of future dividends of the company may increase.

ii. It is more expensive than the cash dividend to administer.

iii. Owing to the fall in the prices of the company's shares in capital market, new investors may come forward to buy the shares. This may result in the dilution of the controlling power of the existing shareholders.

iv. Bonus shares with low face value may tend to distort the company's perceived growth in earnings.

v. There are cost implications such as stamp duty, printing and stationery, etc.

b) For Shareholders

The shareholders may be in a disadvantageous position with the issue of bonus shares in the following:

i) If earnings per share are not adjusted after the issue of the bonus shares the growth in terms of earnings per share will be less than the true increase in earnings. Thus, it may lead to reduction in earning per share.

ii) The shareholders who prefer cash dividends will get disappointed.

Consideration for the issue of Bonus Shares

Generous and liberal declaration of bonus shares will create many problems for the company. The issue of bonus shares entails expansion of the capital base of the company and this can only be justified by a proportionate increase in the earning capacity of the corporation. Companies with uncertain earnings or with fluctuating income are likely to take a great risk by declaring stock dividends. As a matter of fact, every stock dividend carries an implied promise that the future cash dividends will be maintained at a steady level. Unless this is satisfied there is no justification for issuing bonus shares. The mere existence of accumulated reserves does not warrant the issue. There should be other considerations for the issue of the stock dividend. They are:

i) The issue of bonus shares should not lead to concentration of economic power.

ii) The capital market will be deprived of 'Secondary' funds which would otherwise have flowed into more widely dispersed investment. Secondary funds means the investible surpluses available with corporations, institutions, etc.

iii) The bonus shares deprives the companies of the use of the undistributed profits for their own purpose such as increasing the wages of labour or reducing the prices for the consumers.

In view of the above mentioned factors the company has to consider whether it is appropriate to issue the bonus shares or not.

20.5 LEGAL ASPECTS OF THE ISSUE OF BONUS SHARES

Before declaring the bonus shares, the issuing company should ensure that:

i) sufficient undistributed profits are available in the company;

ii) the Articles of Association of the Company permits such an issue;

iii) as per the listing agreement, at least 7 days prior to the Board meeting in which bonus will be considered, a notice has been given about the declaration of bonus shares to each stock exchange where securities of the company are listed.

iv) a resolution to that effect has been passed by the Board to approve the bonus ratio, fixation of record date or book closure notice, etc;

v) the result of the board meeting on the same day immediately after the closure of the market hours has been intimated to such stock exchanges;

vi) intimation, at least 42 days in advance has been sent to such stock exchanges about the closure of register of members or fixing of record date for allotting bonus shares to the shareholders;

vii) at least 21 days clear notice has been sent to all the shareholders about the general meeting;

viii) general body meeting has been convened to pass resolutions for amending Memorandum, Articles of Association to increase authorized capital and capitalize the reserves;

ix) form No. 23 has been filed with the Registrar of Companies (ROC) regarding the amendment made in memorandum and articles of association along with certified true copy of the resolutions passed, explanatory statement and prescribed fee;

x) all the transfers received before the closure of register of members or record date have been given effect;

xi) after the issue of share certificates, Form No. 2 has been filed with the ROC with the list of shareholders.

It is very important legal aspect to be noted that bonus shares have to be issued within a period of 6 months from the date of board meeting at which the bonus issue was declared.

20.6 GUIDELINES FOR ISSUE OF BONUS SHARES

Securities and Exchange Board of India (SEBI) is playing a vital role in regulating capital markets in our country. Offer documents/prospectus for almost all types of issues are to be sent for its clearance. SEBI framed guidelines for all types of issues including Bonus issue.

In case of Bonus shares issue, there is no offer document as there will not be any consideration. Therefore, companies are applicable to the existing listed companies. While making a bonus issue, companies should ensure the following conditions:

i) Bonus shares cannot be issued if the company has come out with any public/rights issue during the past 12 months. That means, no bonus issue should be made within a period of 12 months of any public or rights issue.

ii) Bonus shares cannot be issued in lieu of dividend.

iii) No bonus issue should be made which would dilute the rights of debentureholders, convertible, fully or partly.

vi) Bonus shares can be issued only out of free reserves built out of the genuine profits or share premium collected in cash only.

v) Bonus shares cannot be issued out of the reserves created by revaluation of fixed assets.

vii) If the existing shares are partly paid up, the company cannot issue bonus shares. It will be appropriate to first make the shares fully paid up before issuing bonus shares.

vii) Bonus issue cannot be made if the company has defaulted in the payment of interest or principal, with respect to fixed deposits and interest on existing debentures or principal or redemption thereof. Bonus issue cannot also be made if the company has defaulted in payment of statutory dues of the employees, such as provident fund, gratuity and bonus.

viii) If the company has already issued either fully convertible debenture or partly convertible debentures, the company is required to extend similar benefits to such holders of securities through reservation of shares in proportion to their holding or in proportion to such convertible part. The bonus shares so reserved may be allotted to such holders at the time of conversion.

ix) It should be checked whether Articles of Association contains the provision of capitalization of reserves. If no such provisions are contained steps should be taken to alter the Articles of Association by the consent of the members of company.

x) It should be checked whether the post bonus capital is within the limits of authorized share capital. If it is not so, steps should be taken to increase the authorized share capital by amending Memorandum and Articles of Association.

xi) The issuer company shall forward to the SEBI, a certificate duly countersigned by its auditor or company secretary starting that the guidelines have been complied with.

xii) After the approval of the bonus by the board of directors, it should be implemented within six months.

xiii) All the shares issued by way of bonus will rank pari-passu with existing shares. The company cannot create any other rights for the bonus shares.

CHECK YOUR PROGRESS – 2

What are the reserves which can be used for the purpose of issuing bonus shares?

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21.7 SUMMING UP

The shares which are issued to the existing shareholders without payment of any consideration are known as bonus shares. These are issued by converting the reserves and surplus of the company into shares. The issue of bonus shares has certain objectives like, to conserve cash, to solve the problem of under capitalisation, to control speculative activities, to finance the expansion programmes, etc. The issue of bonus shares has certain advantages. These are discussed from the point of view of the issuing company, shareholders and the creditors.

There are many legal aspects to be considered at the time of issuing bonus shares. The listed companies have to issue bonus shares as per the guidelines issued by the SEBI. The following are some of the important conditions to be satisfied by the companies:

i) No bonus issue should be made within 12 months of any public/rights issue.

ii) The bonus issue can be made only out of free reserves built out of genuine profits or share premium collected in cash only.

iii) Reserves created out of revaluation of fixed assets are not to be capitalized.

iv) Bonus shares cannot be declared in lieu of dividend.

v) After the approval of bonus issue by the board, it should be implemented within 6 months.

vi) Capitalisation of reserves should be provided for in the Articles of Association and if not, a resolution should be passed by the general body for its provision.

21.8 CHECK YOUR PROGRESS: MODEL ANSWERS

1. The objectives of issue of bonus shares are:

   i) to conserve cash;

   ii) to solve the problem of undercapitalisation;

   iii) to control speculative activities;

   iv) to evoke better response in the capital market;

   v) to finance expansion programmes;

   vi) to widen the capital market; and

   vii) to obtain tax advantage.

2. Bonus shares can be issued only out of free reserves i.e., reserves not set apart for any specific purpose, built out of the genuine profits or share premium collected in cash only. Reserves created by revaluation of fixed assets cannot be used for the purpose of issuing bonus shares. The effect of issuing bonus shares will be reduction in the free reserves and increase in the share capital.

21.9 MODEL EXAMINATION QUESTIONS

I. Answer the following questions in about 30 lines each.

1. What are the different advantages of issue of Bonus Shares?
2. What are the guidelines issued by the Securities Exchange Board of India with regard to issue of Bonus Shares?
3. Explain the legal aspects to be considered for issuing bonus shares.

II. Answer the following questions in about 15 lines each.

4. What is the impact of bonus issue on the economic position of the company?
5. What are the matters to be considered in the issue of Bonus Shares?
6. Explain the statutory requirements for the issue of bonus shares?
7. What are the advantages of issue of bonus shares to the shareholders?
8. Explain the disadvantages of issuing bonus shares to the company.

21.10 RECOMMENDED BOOKS

1. S.C. Kuchhal : **Corporation Finance**
2. I.M. Pandey : **Financial Management**
3. V.E. Ramamurthy : **Working Capital Management**

21.11 GLOSSARY

Bonus Shares : The payment of dividend in the form of shares instead of cash.

Free Reserves : Reserves which are not set apart for any specific purpose.

Stock Dividend : Dividends distributed in the form of stock.

SYLLABUS

B.COM. III YEAR

BUSINESS FINANCE

BLOCK – I : INTRODUCTION TO BUSINESS FINANCE

Unit – 1 : Business Finance : An Introduction
Unit – 2 : Finance Function
Unit – 3 : Financial Planning –Nature and Scope
Unit – 4 : Capitalisation – Over Capitalisation and Under Capitalisation

BLOCK – II : FINANCIAL INSTRUMENTS AND MARKETS

Unit – 5 : Corporation Securities
Unit – 6 : Capital and Money Markets
Unit – 7 : Guidelines for Capital Issues
Unit – 8 : Functions of Stock Exchange
Unit – 9 : Regulation and Control of Stock Exchange
Unit – 10 : Foreign Capital and Collaboration

BLOCK – III : FINANCIAL INSTITUTIONS

Unit – 11 : Development Banking
Unit – 12 : Major Investment Institutions
Unit – 13 : State Financial Development Corporations
Unit – 14 : Role of Commercial Banks in Industrial Finance
Unit – 15 : Financial Services

BLOCK – IV : WORKING CAPITAL FINANCING

Unit – 16 : Nature and Sources of Working Capital
Unit – 17 : Determinants of Working Capital
Unit – 18 : Estimation of Working Capital Requirement

BLOCK – V : INTERNAL FINANCING

Unit – 19 : Retained Earnings
Unit – 20 : Bonus Shares

Dr. B.R. AMBEDKAR OPEN UNIVERSITY

UNDER GRADUATE COURSE – III YEAR

B. Com., PROGRAMME

SUBJECT : COMMERCE

COURSE : BUSINESS FINANCE

ASSIGNMENT - I

Note:

1. Do not copy the answer directly from any of the books.
2. As far as possible try to answer the questions independently in your own words.
3. If it is necessary to quote from any source, give the correct reference.
4. Use your own foolscap pages for writing the assignment.
5. Leave sufficient margin for the comments of the evaluator.
6. Completion of this assignment normally should not take more than two hours time.

SECTION – A

I. Answer the following questions in about 30 lines each.

1. Explain the various steps in company promotion.
2. Discuss the different types of underwriting.
3. What is over-capitalisation? Explain the causes and effects of over-capitalisation.

SECTION – B

II. Answer the following questions in about 15 lines each.

1. How does the modern concept of finance function differ from the traditional concept?
2. Explain different kinds of promoters.
3. What are the factors determining capital structure of a company?

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UNDER GRADUATE COURSE – III YEAR

B. Com., PROGRAMME

SUBJECT : COMMERCE

COURSE : BUSINESS FINANCE

ASSIGNMENT - II

Note:

1. Do not copy the answer directly from any of the books.
2. As far as possible try to answer the questions independently in your own words.
3. If it is necessary to quote from any source, give the correct reference.
4. Use your own foolscap pages for writing the assignment.
5. Leave sufficient margin for the comments of the evaluator.
6. Completion of this assignment normally should not take more than two hours time.

SECTION – A

I. Answer the following questions in about 30 lines each.

1. What are the services that stock exchange renders to community, investors and company?
2. Discuss the importance of capital market in the economic development of a country.
3. Discuss the functions and growth of the Unit Trust of India.

SECTION – B

II. Answer the following questions in about 15 lines each.

1. Explain the criteria for listing of securities.
2. What are the objectives of development banks?
3. Explain the defects of money market in India.

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UNDER GRADUATE COURSE – III YEAR

B. Com., PROGRAMME
SUBJECT : COMMERCE

COURSE : BUSINESS FINANCE

ASSIGNMENT - III

Note:

1. Do not copy the answer directly from any of the books.
2. As far as possible try to answer the questions independently in your own words.
3. If it is necessary to quote from any source, give the correct reference.
4. Use your own foolscap pages for writing the assignment.
5. Leave sufficient margin for the comments of the evaluator.
6. Completion of this assignment normally should not take more than two hours time.

SECTION – A

I. Answer the following questions in about 30 lines each.

1. What is lease financing? Explain its characteristics.
2. Explain the factors influencing the working capital needs of a company.
3. What do you mean by "ploughing back of profits"?
4. Explain the recent guidelines for the issue of bonus shares.

SECTION – B

II. Answer the following questions in about 15 lines each.

1. What are the sources of working capital?
2. What are the legal aspects that govern the dividend decisions?
3. What are the objectives of nationalisation of commercial banks.

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FACULTY OF COMMERCE

B.Com. 3rd Year (3 Y.D.C)
Subject Code No. & Name : 09-COMMERCE, Group 'B'
Course Code No. & Name : 4 - Business Finance

Time : 3 Hours] **[Max. Marks. 100**
[Min. Marks. 35

MODEL QUESTIN PAPER

SECTION - A
[Marks : 4 x 15 = 60]

Instructions to the candidtes :

1) ***Answer any four of the following questions in about 30 lines each.***
క్రింది ప్రశ్నలలో ఏ నాల్గింటికైనా ఒక్కొక్కదానికి సుమారు 30 పంక్తులలో జవాబులు వ్రాయండి.

2) Each question carries 15 marks.
ప్రతి ప్రశ్నకు 15 మార్కులు

1) Define the concepts of working capital. Explain the factors influencing working capital needs of company.
నిర్వహణ మూలధన భావనలను నిర్వచించండి. ఒక కంపెనీ నిర్వహణ మూలధన అవసరాలపై ప్రభావితం చూపే కారకాలను వివరించండి.

2) What is over capitalisation ? Explain the causes and effects of over capitalisation.
అతిమూల ధనీకరణ అనగానేమి? దాని కారణాలను, ప్రభావాలను వివరించండి.

3) What are primary and secondary markets? Explain different methods of issue of securities in the primary market.
ప్రాథమిక, ద్వితీయ మార్కెట్లు అనగానేమి? వివిధ పద్ధతులలో ప్రాథమిక మార్కెటులో సెక్యూరిటీల జారీని వివరించండి.

4) Critically examine the role of LIC in the economic developement.
ఆర్థిక అభివృద్ధిలో జీవిత భీమా సంస్థ పాత్రను విమర్శనాత్మకంగా వివరించండి

5) What is a Debenture ? Explain the features of convertible debentures.
డిబెంచరు అనగానేమి? కన్వర్టబుల్ డిబెంచర్ల లక్షణాలను వివరించండి.

6) What is factoring ? Discuss its advantages and disadvantages.
ఫ్యాక్టరింగ్ అనగానేమి? దాని ప్రయోజనాలను అప్రయోజనాలను చర్చించండి.

7) What is a foreign capital ? Explain the various sources of foreign capital in India.
విదేశీ మూలధనం అంటే ఏమిటి?భారతదేశంలో దానికి గల వివిధ వనరులను వివరించండి.

8) What are the stock exchanges? Explain their objectives, functions and limitations.
స్టాక్ ఎక్ఛేంజీలనగానేమి? వాటి ఉద్దేశాలను, విధులను, పరిమితులను వివరించండి.

SECTION - B

[Marks : 5 x 8 = 40]

Instructions to the candidates :

1) Answer any **five** of the following questions in about 15 lines each.
క్రింది ప్రశ్నలలో ఏ **ఐదింటికైనా** ఒక్కొక్క దానికి సుమారు 15 పంక్తులలో సమాధానాలు వ్రాయుము.

2) Each question carries **eight** marks.
ప్రతి ప్రశ్నకు **8** మార్కులు.

9) Explain the various steps in the company promotion.
కంపెనీ స్థాపనలో వివిధ దశలను వివరించండి.

10) What are the various sources of working capital?
నిర్వహణ మూలధనానికి ఉన్న వివిధ రకాలైన వనరులేవి?

11) Explain different kinds of underwriting agtreements
వివిధ రకాలైన చందపూచీ ఒప్పందాలను వివరించండి.

12) What ae the defects of capital market in India.
భారతదేశంలో ఉన్న మూలధన మార్కెటు లోపాలేమిటి?

13) What are the functions of commercial Banks.
వాణిజ్య బాంకుల విధులేవి?

14) What is lease financing? What are its advantages?
లీజు ఫైనాన్సింగ్ అంటే ఏమిటి? దాని ప్రయోజనాలేవి?

15) What are the advantages of listing of securities.
సెక్యూరిటీల లిస్టింగ్ ప్రయోజనాలేమిటి?

16) Explain the relationship between reserve policy and dividend policy.
రిజర్వు విధానానికి డివిడెండు విధానానికి గల సంబంధాన్ని వివరించండి.

17) Discuss the stages of operating cycle.
ఆపరేటింగ్ చక్రము దశలను చర్చించండి.

18) Discuss the role of SEBI in the regulation of Indian capital market.
భారతదేశ మూలధన మార్కెటు నియంత్రణలో SEBI పాత్రను చర్చించండి.