Unit:1

Basic concepts in finance

Finance is the lifeline of any business. However, finances, like most other resources, are always limited. On the other hand, wants are always unlimited. Therefore, it is important for a business to manage its finances efficiently. As an introduction to financial management, in this article, we will look at the nature, scope, and significance of financial management, along with financial decisions and planning.

"Financial management is the activity concerned with planning, raising, controlling and administering of funds used in the business." – Guthman and Dougal

"Financial management is that area of business management devoted to a judicious use of capital and a careful selection of the source of capital in order to enable a spending unit to move in the direction of reaching the goals." – J.F. Brandley

"Financial management is the operational activity of a business that is responsible for obtaining and effectively utilizing the funds necessary for efficient operations."- Massie
The finance function is the process of acquiring and utilizing funds of a business. Finance functions are related to overall management of an organization. Finance function is concerned with the policy decisions such as like of business, size of firm, type of equipment used, use of debt, liquidity position.
Nature of Finance Function

The finance function is the process of acquiring and utilizing funds of a business. Finance functions are related to overall management of an organization. Finance function is concerned with the policy decisions such as like of business, size of firm, type of equipment used, use of debt, liquidity position. These policy decisions determine the size of the profitability and riskiness of the business of the firm. Prof. K.M.Upadhyay has outlined the nature **of finance function** as follows:

1. In most of the organizations, financial operations are centralized. This results in economies.

2. Finance functions are performed in all business firms, irrespective of their sizes / legal forms of organization.

3. They contribute to the survival and growth of the firm.

4. Finance function is primarily involved with the data analysis for use in decision making.

5. Finance functions are concerned with the basic business activities of a firm, in addition to external

environmental factors which affect basic business activities, namely, production and marketing.

6. Finance functions comprise control functions also

7. The central focus of finance function is valuation of the firm.

Scope of Finance Function

The scope of finance function is very wide. While accounting is concerned with the routine type of work, finance function is concerned with financial planning, policy formulation and control. Earnest W. Walker and William are of the opinion that the financial function has always been important in business management. The financial organiastion depends upon the nature of the organization – whether it is a proprietary organsation, a partnership firm or corporate body. The significance of the finance function depends on the nature and size of a business firm. The role of various finance officers must be clearly defined to avoid conflicts and the overlapping of responsibilities. The operational functions of finance include:

Financial planning

Deciding the capital structure

Selection of source of finance

Selection of pattern of investment

Financial Planning

The first task of a financial manager is to estimate short-term and long-term financial requirements of his business. For this purpose, he will prepare a financial plan for present as well as for future. The estimation of fund is essential to purchase fixed assets as well as for the rotation of working capital. The estimations should be based on sound financial principles so that neither there are inadequate nor excess funds with the concern. The inadequacy of funds will adversely affect the day-to-day operations of the concern whereas excess funds may tempt a management to indulge in extravagant spending or speculative activities.

Deciding Capital Structure

The Capital structure refers to the kind and proportion of different securities for raising funds. After deciding about the quantum of funds required it should be decided which type of securities should be raised. It may be wise to finance fixed assets through long-term debts. Even if gestation period is longer, then share capital may be most suitable. Long-term funds should be raised. It may be wise to finance fixed assets through long-term debts. Even here if gestation period is longer, then share capital may be most suitable. Long-term funds should be employed to finance working capital also, if not wholly then partially. Entirely depending upon overdrafts and cash creditors for meeting working capital needs may not be suitable. A decision about various sources for funds should be linked to the cost of raising funds. If cost of raising funds is very high then such sources may not be useful for long.

Selection of Source of Finance

After preparing a capital structure, an appropriate source of finance is selected. Various sources, from which finance may be raised, include share capital, debentures, financial institutions, commercial banks, public deposits, etc. If finances are needed for short periods then banks, public deposits and financial institutions may be appropriate; on the other hand, if long-term finances are required then share capital and debentures may be useful. If the concern does not want to tie down assets as securities then public deposits may be a suitable source. If management does not want to dilute ownership then debentures should be issued in preference to share.

Selection of Pattern of Investment

When funds have been procured then a decision about investment pattern is to be taken. The selection of an investment pattern is related to the use of funds. A decision will have to be taken as to which assets are to be purchased? The funds will have to be spent first on fixed assets and then an appropriate portion will be retained for Working Capital. The decision-making techniques such as Capital Budgeting, Opportunity Cost Analysis, etc. may be applied in making decisions about capital expenditures. While spending on various assets, the principles of safety, profitability and liquidity should not he ignored. A balance should be struck even in these principles.

The scope of financial management is explained in the diagram below:

In organizations, managers in an effort to minimize the costs of procuring finance and using it in the most profitable manner, take the following decisions:

Investment Decisions: Managers need to decide on the amount of investment available out of the existing finance, on a long-term and short-term basis. They are of two types:

Long-term investment decisions or Capital Budgeting mean committing funds for a long period of time like fixed assets. These decisions are irreversible and usually include the ones pertaining to investing in a building and/or land, acquiring new plants/machinery or replacing the old ones, etc. These decisions determine the financial pursuits and performance of a business.

Short-term investment decisions or Working Capital Management means committing funds for a short period of time like current assets. These involve decisions pertaining to the investment of funds in the inventory, cash, bank deposits, and other short-term investments. They directly affect the liquidity and performance of the business.
Financing Decisions: Managers also make decisions pertaining to raising finance from long-term sources (called Capital Structure) and short-term sources (called Working Capital). They are of two types:

Financial Planning decisions which relate to estimating the sources and application of funds. It means pre-estimating financial needs of an organization to ensure the availability of adequate finance. The primary objective of financial planning is to plan and ensure that the funds are available as and when required.
Capital Structure decisions which involve identifying sources of funds. They also involve decisions with respect to choosing external sources like issuing shares, bonds, borrowing from banks or internal sources like retained earnings for raising funds.
Dividend Decisions: These involve decisions related to the portion of profits that will be distributed as dividend. Shareholders always demand a higher dividend, while the management would want to retain profits for business needs. Hence, this is a complex managerial decision.

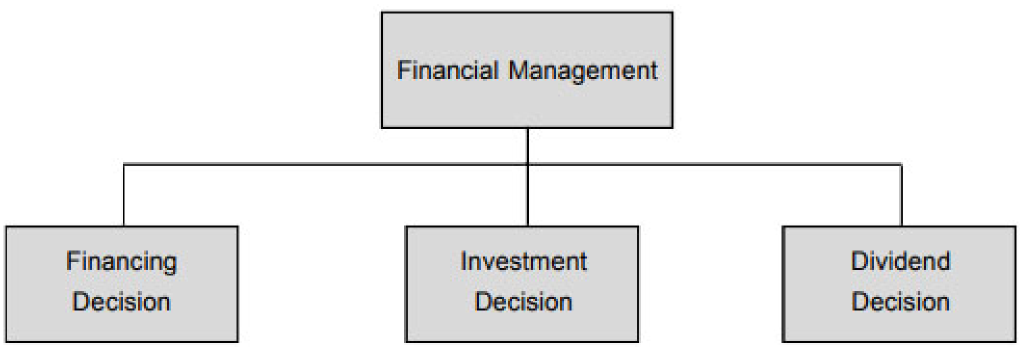

Fig. 1 - The scope of Financial Management

Financial Management Approach – Traditional and Modern

The **Modern Approach**:
It includes both rising of funds as well as their effective utilisation under the purview **of finance**.
The **modern approach** considers the three basic **management** decisions, i.e., investment decisions, financing decisions and dividend decisions within the scope **of finance** function.

In respect to this, what is traditional and modern approach?
A “Traditional approach” refers to old or well-established techniques or customs. A “modern approach” refers to something being used now based on new developments in science, engineering, or social changes.

Also Know, what do you mean by traditional approach? Traditional approach , customs,beliefs, or methods are ones that have existed for a long time without changing. Dealing with something with those long existing methods is called a traditional approach.

Secondly, what is traditional approach of finance function?

Traditional Approach. The traditional approach to the scope of financial management refers to its subject matter in the academic literature in the initial stages of its evolution as a separate branch of study. According to this approach, the scope of financial management is confined to the raising of funds.

What is financial management and example?

Financial management is defined as dealing with and analyzing money and investments for a person or a business to help make business decisions. An example of financial management is the work done by an accounting department for a company.

The Objectives of Financial Management

1. Profit Maximization
One of the reasons a company employs a financial manager is to maximize profit while managing the finance of the company.

The gain can be in the short or long-term. But the main focus is that the individual or department handling the financial issues of the company must ensure that the company in question is making sufficient profit.

2. Wealth Maximization
Wealth maximization is a modern approach to financial management. Maximization of profit used to be the main aim of a business and financial management till the concept of wealth maximization came into being. It is a superior goal compared to profit maximization as it takes broader arena into consideration. Wealth or Value of a business is defined as the market price of the capital invested by shareholders.

It simply means maximization of shareholder’s wealth. It is a combination of two words viz. wealth and maximization. A wealth of a shareholder maximizes when the net worth of a company maximizes. To be even more meticulous, a shareholder holds share in the company/business and his wealth will improve if the share price in the market increases which in turn is a function of net worth. This is because wealth maximization is also known as net worth maximization.

Role of finance manager.

1. Estimating the Amount of Capital Required:
This is the foremost function of the financial manager. Business firms require capital for:
(i) purchase of fixed assets,
(ii) meeting working capital requirements, and
(iii) modernisation and expansion of business.
The financial manager makes estimates of funds required for both short-term and long-term.

2**. Determining Capital Structure:**
Once the requirement of capital funds has been determined, a decision regarding the kind and proportion of various sources of funds has to be taken. For this, financial manager has to determine the proper mix of equity and debt and short-term and long-term debt ratio. This is done to achieve minimum cost of capital and maximise shareholders wealth.

3**. Choice of Sources of Funds:**
Before the actual procurement of funds, the finance manager has to decide the sources from which the funds are to be raised. The management can raise finance from various sources like equity shareholders, preference shareholders, debenture- holders, banks and other financial institutions, public deposits, etc.

4. Procurement of Funds:
The financial manager takes steps to procure the funds required for the business. It might require negotiation with creditors and financial institutions, issue of prospectus, etc. The procurement of funds is dependent not only upon cost of raising funds but also on other factors like general market conditions, choice of investors, government policy, etc.

5. Utilisation of Funds:
The funds procured by the financial manager are to be prudently invested in various assets so as to maximise the return on investment: While taking investment decisions, management should be guided by three important principles, viz., safety, profitability, and liquidity.

6. Disposal of Profits or Surplus:
The financial manager has to decide how much to retain for ploughing back and how much to distribute as dividend to shareholders out of the profits of the company. The factors which influence these decisions include the trend of earnings of the company, the trend of the market price of its shares, the requirements of funds for self- financing the future programmes and so on.

7. Management of Cash:

Management of cash and other current assets is an important task of financial manager. It involves forecasting the cash inflows and outflows to ensure that there is neither shortage nor surplus of cash with the firm. Sufficient funds must be available for purchase of materials, payment of wages and meeting day-to-day expenses.

8. Financial Control:

Evaluation of financial performance is also an important function of financial manager. The overall measure of evaluation is Return on Investment (ROI). The other techniques of financial control and evaluation include budgetary control, cost control, internal audit, break-even analysis and ratio analysis. The financial manager must lay emphasis on financial planning as well.

Unit:2
Sources of Finance

Every business requires finances at every stage of its operations. Right from the start up stage to day to day operations to funding expansions, finances are required at each stage. Businesses have several sources from which these finances can be generated. The source of finance has to be decided taking into consideration several factors including quantum of finance, cost of finance, time frame for payback etc. Thus, it is necessary to understand the features of different sources of finance.

This article looks at meaning of and difference between two types of sources of finance – internal and external.

Definitions and explanations

Internal sources of finance:

These are funds that are generated internally from within the business organization. Typical examples of internal sources of finance include funds generated from business operations i.e. profit from sales, utilization of accumulated reserves and funds raised from sale of business assets.

The cost of raising these funds is generally a notional cost i.e., a lost opportunity cost of earning profits by investing those funds elsewhere. For example, cash profit generated by a business if alternatively deposited in the bank can earn interest which would be foregone for being used as a source of finance. As such they rarely require an actual outflow of cash.

Internal sources of finances are generally sought out by profit making entities that are generating enough surplus from their business operations. Internal sources are typically used for funding day to day operations of the business.

External sources of finance:

These are funds that are raised through external means i.e., from outside entities.

External sources of funds can be either raised through debt or equity.

Debt essentially means any kind of loan or borrowing. This can include loans from banks, financial institutions, public deposits, letter of credit etc.

Equity means raising of capital by issue of shares to existing or new shareholders. These can be ordinary shares or preference shares.

External sources of funds involve incurring a cost of raising the funds. As these are raised from outside entities, they need to be compensated for providing funds. Debt funds carry interest as compensation. Equity funds on the other hands carry dividend as compensation.

External sources of funds are preferred when large sums of money have to be raised especially for funding expansion plans. Loss making companies may also have to rely on external sources of finance to fund their day to day operations.

Difference between internal and external sources of finance:

The points of difference between internal and external sources of finance have been listed below:

1. Meaning

Internal sources of finance represent means of generating funds by the business itself from its own operations.

External sources of funds represents means of generating funds through outside entities.

2. Source

Internal sources of funds lie within the organization.

External sources of funds lie outside the organization.

3. Examples

Examples of internal sources of finance include profits arisen from business operations, funds generated from sale of assets of the business.

Examples of external sources of finance include debt funds such as loans, advances, deposits taken and equity funds such as equity and preference share capital.

4. Cost of finance

The cost of internal sources of finance is much lower than external sources of finance. In fact, the cost is more in the nature of an opportunity cost foregone rather than an actual cost outflow.

The cost of external sources of finance has to be paid to outside entities and is thus much higher.

5. Quantum of finance

Generally lower amounts can be generated through internal sources of finance. The quantum depends on the profitability of the entity.

Considerably higher amounts can be generated through external sources of finance.

6. Security required

Internal sources do not require the presence of any security or collateral.

External sources may require attachment of security as a guarantee for repayment.

7. Used for

Internal sources are generally used for funding day to day business operations. High-profit making entities can however use these for growth plans as well if the funds generated are sufficient.

External sources are generally used for setting up a business or at later stages for growth and expansion, when funds generated from internal operations do not suffice. Loss making companies may also use these sources for business revival or to keep their operations going.

8. Process for obtaining

Raising funds from internal sources generally do not involve any formal process. It is a more automatic process where funds generated from business operations are re-applied in the business.

Raising funds from external involves a more structured and formal process. This includes deliberation of the management, director and shareholder resolutions, holding meetings with financers, discussing terms and finalizing documentation

9. Parties involved

Raising funds through internal sources generally does not involve any third party except where business assets are sold to generate funds.

Raising funds through external sources necessarily involves one or more external third parties.

10. Tax benefits

Internal sources of finance do not have any specific tax benefits.

External sources of finance may involve incurring of tax-deductible financing costs such as interest. This can help reduce tax incidence on profits of the entity.

Shares

Shares are units of equity ownership interest in a corporation that exist as a financial asset providing for an equal distribution in any residual profits, if any are declared, in the form of dividends. Shareholders may also enjoy capital gains if the value of the company rises.

In simple words, a share indicates a unit of ownership of the particular company. If you are a shareholder of a company, it implies that you as an investor, hold a percentage of ownership of the issuing company. As a shareholder you stand to benefit in the event of the company's profits, and also bear the disadvantages of the company's losses.

Types Of Shares

1. **Equity shares**
2. **Preference shares**

Equity Shares Meaning

These are also known as ordinary shares, and it comprises the bulk of the shares being issued by a particular company. Equity shares are transferable and traded actively by investors in stock markets. As an equity shareholder, you are not only entitled to voting rights on company issues, but also have the right to receive dividends. However, the dividends - issued from the profits of the company - are not fixed. You must also note that equity shareholders are subject to the maximum risk - owing to market volatility and other factors affecting stock markets - as per their amount of investment. The types of shares in this category can be classified on the basis of:

Share capital

Definition

Returns

Classification Of Equity Shares On The Basis Of Share Capital

Equity financing or share capital is the amount raised by a particular company by issuing shares. A company can increase its share capital by additional Initial Public Offerings (IPOs). Here is a look at the classification of equity shares on the basis of share capital:

Authorised Share Capital: Every company, in its Memorandum of Associations, requires to prescribe the maximum amount of capital that can be raised by issuing equity shares. The limit, however, can be increased by paying additional fees and after completion of certain legal procedures.

Issued Share Capital: This implies the specified portion of the company's capital, which has been offered to investors through issuance of equity shares. For example, if the nominal value of one stock is Rs 200 and the company issues 20,000 equity shares, the issued share capital will be Rs 40 lakh.

Subscribed Share Capital: The portion of the issued capital, which has been subscribed by investors is known as subscribed share capital.

Paid-Up Capital: The amount of money paid by investors for holding the company's stocks is known as paid-up capital. As investors pay the entire amount at once, subscribed and paid-up capital refer to the same amount.

Classification Of Equity Shares On The Basis Of Definition

Here is a look at the equity share classification on the basis of definition:

Bonus Shares: Bonus share definition implies those additional stocks which are issued to existing shareholders free-of-cost, or as a bonus.

Rights Shares: Right shares meaning is that a company can provide new shares to its existing shareholders - at a particular price and within a specific time-period - before being offered for trading in stock markets.

Sweat Equity Shares: If as an employee of the company, you have made a significant contribution, the company can reward you by issuing sweat equity shares.

Voting And Non-Voting Shares: Although the majority of shares carry voting rights, the company can make an exception and issue differential or zero voting rights to shareholders.

Classification Of Equity Shares On The Basis Of Returns

On the basis of returns, here is a look at the types of shares:

Dividend Shares: A company can choose to pay dividends in the form of issuing new shares, on a pro-rata basis.

Growth Shares: These types of shares are associated with companies that have extraordinary growth rates. While such companies might not provide dividends, the value of their stocks increase rapidly, thereby providing capital gains to investors.

Value Shares: These types of shares are traded in stock markets at prices lower than their intrinsic value. Investors can expect the prices to appreciate over a period of time, thus providing them with a better share price.

Features of Equity Shares Capital

1. Equity share capital remains with the company. It is given back only when the company is closed.
2. Equity Shareholders possess voting rights and select the company's management.
3. The dividend rate on the equity capital relies upon the obtainability of the surfeit capital. However, there is no fixed rate of dividend on the equity capital.

Advantages of Equity Shares

From the Shareholder's Point of View:

• Equity shares are liquid in nature and can be sold easily in the capital market.
• The dividend rate is higher for the equity shareholders when the company earns high profits.
• The equity shareholders have the right to control the company's management.
• The equity shareholders not only get the benefit of dividend but they also get the benefit of price appreciation in the value of their investment.

From the Company's Point of View:

• Equity shares are the permanent source of capital for a company.

• There is no requirement of creating a charge over the assets of the company when equity shares are issued.

• The liability of the equity shares is not required to be paid.

• The company does not have any obligation to pay dividend to the shareholders.

• The credit worthiness of the company increases among the investors and creditors when the company has a larger equity capital base.

Preference Shares Meaning

These are among the next types of shares issued by a company. Preferential shareholders receive preference in receiving profits of a company as compared to ordinary shareholders. Also, in the event of liquidation of a particular company, the preferential shareholders are paid off before ordinary shareholders. Here is a look at the different types of shares in this category:

Cumulative And Non-Cumulative Preference Shares Meaning: In the case of cumulative preference shares, if a particular company doesn't declare an annual dividend, the benefit is carried forward to the next financial year. Non-cumulative preference shares don't provide for receiving outstanding dividends benefits.

Participating/Non-Participating Preference Share Definition: Participating preference shares allow shareholders to receive surplus profits, after payment of dividends by the company. This is over and above the receipt of dividends. Non-participating preference shares carry no such benefits, apart from the regular receipt of dividends.

Convertible/Non-Convertible Preference Shares Meaning: Convertible preference shares can be converted into equity shares, after meeting the requisite stipulations by the company's

Article of Association (AoA), while non-convertible preference shares carry no such benefits.

Redeemable/Irredeemable Preference Share Definition: A company can repurchase or claim redeemable preference share at a fixed price and time. These types of shares are sans any maturity date. Irredeemable preference shares, on the other hand, have no such conditions.

Features of preference shares:

Preference shares have a wide range of features as corporate emphasize a set of features while issuing them such as:

1. Dividends for preference shareholders
2. Preference shareholders have no right to vote in the annual general meeting of a company
3. These are a long-term source of finance
4. Dividend payable is generally higher than debenture interest
5. Right on assets when the company is liquidated
6. Par value of preference shares
7. Fixed-rate of dividend irrespective of the volume of profit gained
8. Preemptive right of preference shareholders
9. Hybrid security of preference shares because it also bears some characteristics of debentures
10. The dividend is not tax-deductible expenditure
11. Shareholders also enjoy preferential right to receive dividend

Debenture

The term debenture is derived from the Latin word “debere” which means “to owe a debt”. A debenture may, be defined as document issued by the company as an evidence of debt. It is the acknowledgement of the company’s indebtedness to its holders.

The debentures may be secured or unsecured. In the American terminology, only unsecured bonds are called as debentures. But we have borrowed our terminology from Britain where no such distinction is made between the two terms. Therefore, in our discussion, we will treat both the words as interchangeable.

The debentures provide for a fixed rate of interest to the debenture holders. A debenture holder cannot vote in the company meetings. Generally, debentures are secured. They may have a floating charge on the whole of the assets of the company.

Issue of Debentures

No company can solely depend on its ownership capital, though it is desirable. Some investors are more cautious and hesitate to invest their funds in the risk capital of the companies. To attract such type of investors to lend money as a loan, bonds and debentures are issued. These securities are also known as "Creditorship securities". Just as uniform parts of capital are known as shares, uniform parts of loan raised by the companies are known as debentures or bonds. The issue of debentures is governed almost by the same consideration as shares.

Features of debentures

The following are the features of debentures.

1. Debenture-holders are entitled to periodical payment of interest at an agreed rate.

2. They are also entitled to redemption of their capital as per the agreed terms.

3. They have no voting rights.

4. Usually debentures are secured by charge on or mortgage of the assets of the company.

5. Debenture holders have the right to sue the company for any unpaid dues.

6. They can enforce the security by sale in case of default.

7. They can apply for winding up of the company to safeguard their interests.

Types of Debentures

Debentures on the basis of Registration

1**. Registered Debentures**
The debentures which are payable to the registered debenture holders are called registered debentures. These debentures are not transferable by mere delivery. The names of the holders of these debentures with details of the number, value and type of debenture held are recorded

in the register of debenture holders. Registered debentures are not negotiable instruments. Transfer of such debentures requires registration.

2. **Bearer Debentures**

Bearer debentures are those which are payable to the bearer. These debentures are transferable by mere delivery. The register of debenture holders does not have the names of the debenture holder recorded. Hence they are transferable by mere delivery. Registration of transfer is not necessary. Bearer debentures are also called as Unregistered Debentures.

Debentures on the basis of Security

1. Secured Debentures

The debentures, which are secured fully or partly by a charge over the assets of the company are called secured debentures. The charge may be either a fixed charge or a floating charge. The charge, when created should be registered with the Registrar within 30 days of its creation.

2**. Unsecured Debentures**

The debentures, which are not secured fully or partly by a charge over the assets of the company are called unsecured debentures. They are also called Naked Debentures. They are not mortgaged. The general solvency of the company is the only security for the holders. The debenture holders are treated as only unsecured creditors. Issue of such debentures are not much popular.

Debentures on the basis of Redemption

1. Redeemable Debentures

The debentures, which are repayable after a certain period as per the terms of their issue, are called redeemable debentures. Sometimes, they can be redeemed by the company on demand by the holders or at the discretion of the company.

2. **Irredeemable Debentures**

They are perpetual debentures. The debentures, which are not repayable during the life time of the company, are called irredeemable debentures. The company has no obligation to make the payment of the principal of these debentures during its life time.

The company may repay the money at the time of liquidation or on the happening of a contingency or on the expiration of a longer period or when the company breaches the terms of issue of the debentures.

Debentures on the basis of Conversion

1. Convertible Debentures

The debentures, which are convertible into equity shares or preference shares at the option of the holders, after a certain period, are called convertible debentures.

2. Non-Convertible Debentures

The debentures, which are not convertible into equity shares, are called non-convertible debentures.

Advantages of debentures

The following are the advantages of debentures:

1. Secured investments

Debentures provide greatest security to the investors. They make a very good appeal to the conservative minds.

2. Fixed return

Debentures guarantee a fixed rate of interest.

3. Stable prices

Their prices are more stable as compared to shares because the changing monetary conditions affect the price movement of the debentures very little.

4. Non-interference in management

The debenture holders do not interfere in the management of the company.

5. Economical

It is a cheaper method of raising finance. Lower rate of interest further makes them more economical.

6. Availability of funds

The companies can raise money through debentures easily compared to equity and preference shares.

7. Regular source of income

The investors get fixed and regular interest, whether the company earns profit or not.

Disadvantages of debentures
The following are the limitations of Debentures.

1. Permanent burden of interest
Interest on debentures is always cumulative. It is to be paid irrespective of the profits or otherwise of the company. During the period of depression, it becomes a heavy burden.

2. Limits company's credit
Since in most of the cases, the assets of the company are mortgaged with the debenture holders as a security against their advances, the credit worthiness of the company falls in the eyes of the public as well as the banks. Borrowings from other sources becomes difficult.

3. No right to participate in company management
Ordinarily debenture holder do not enjoy any voting rights in the companies. They have no interest in the election of directors. They do not have representation in the management of the affairs of the companies

Public Deposits

A company can accept deposits from the public to finance its medium- and short-term requirements of funds. This source has become very popular off late because companies offer higher interest than the interest offered by banks.

Features of Public Deposits:
The following are the features of public deposit:

1. Total public deposits cannot exceed 25 per cent of the paid up capital and free reserves of the company.

2. It is an uncertain source of financing.

3. There are legal restrictions on the acceptance and renewal of public deposits.

Advantages of Public Deposits
Companies find the public deposits as an attractive source for medium and short-term finances. This is due to following advantages:

1. Lower Rate of Interest
Public deposits are beneficial to the company as it receives funds at a lower rate of interest when compared to the rates charged by commercial banks and financial institutions.

2. Low Administration Costs
Cost of administering public deposits is lower when compared to the issue of debentures. The company has to fulfill fewer formalities and follow a simple procedure. It receives money and issues only a deposit receipt to every depositor and nothing more.

3. Facilitates trading on Equity
Public deposits help in trading on equity if the company is earning more than the rate of interest paid on the deposits. The excess profit shall go to the equity holders. At the same time, their control over the company is also not diluted.

4. Unsecured
Public deposits are generally unsecured. The company need not create any charge over its assets. Hence, its borrowing capacity is not affected.

5. Flexible
Public deposits facilitates flexibility in the financial planning. The deposits can be paid back any time, when there is no further need for retaining the fund. Thus, it is a convenient method to avoid over capitalization.

Disadvantages of Public Deposits
Though public deposits constitute an attractive source of finance and the investors do prefer them, there are certain severe limitations and dangers. Some of the dangers associated with this practice are given below:

1. Unreliable Source
This method is not reliable because it is difficult to predict whether the company can procure such deposits to the desired level. Such deposits are termed “Fair weather friend” The depositors may not respond favorably when the conditions of the company are not satisfactory. Similarly, new companies cannot depend on this source of finance.

2. Interest of the Investors

The interest of the depositors is not fully protected. These depositors are unsecured and no charge is created over the assets of company. Moreover, the management very often uses these funds for non-productive purposes. In the event of failure of the company, the depositors have no assurance of getting their money back.

3. Threat to Bank Resources
An uncontrollable growth of company deposits should be viewed with great concern. It diverts the bank resources to the non-banking sector. It also poses a threat not only to bank deposits but also to the credit planning and effective monetary policy.

In fact, the RBI has substantially failed to implement its general policy of credit restraint and enforcement of selective credit control only due to the sudden spurt of the company deposits.

4. Distortion of Plan Priorities
These deposits even distort the plan priorities for credit allocation and blunt the edge of monetary policy specially the dear money policy. They frustrate even the very object of reducing the sectoral and regional imbalances and also develop disparities between sectors and regions.

5. Unhealthy Trend in the Capital Market
Such deposits also create unhealthy trends in the capital market. There are numerous rates of interest offered by different companies. This is detrimental to the development of the capital market.

Borrowing from Bank
Bank Loan
A loan is an amount of money borrowed for a set period within an agreed repayment schedule. The repayment amount will depend on the size and duration of the loan and the rate of interest.

Loans are generally most suitable for:

paying for assets - eg vehicles and computers
start-up capital
instances where the amount of money you need is not going to change
The terms and price of loans will vary between providers and will reflect the risk and cost to the bank in providing the finance. For larger sums, the pricing and terms may be negotiable.

Banks will loan money to businesses on the basis of an adequate return for their investment, to reflect the risks of defaulting and to cover administrative costs. If you have an established relationship with your bank, they will have developed a good understanding of your business. This will help them to advise you about the best product for your financial needs.

Different types of bank loan include:

working capital loans - for short notice or emergency situations
fixed asset loans - for buying assets where the asset itself is collateral
factoring loans - loans based on money owed to your business by customers
hire purchase loans - for long-term purchase of assets such as vehicles or machinery

Advantages of term loans

1. The loan is not repayable on demand and so available for the term of the loan - generally three to ten years - unless you breach the loan conditions.
2. Loans can be tied to the lifetime of the equipment or other assets you're borrowing the money to pay for.
3. At the beginning of the term of the loan you may be able to negotiate a repayment holiday, meaning that you only pay interest for a certain amount of time while repayments on the capital are frozen.
4. While you must pay interest on your loan, you do not have to give the lender a percentage of your profits or a share in your company.
5. Interest rates may be fixed for the term so you will know the level of repayments throughout the life of the loan.
6. There may be an arrangement fee that is paid at the start of the loan but not throughout its life. If it is an on-demand loan, an annual renewal fee may be payable.

Disadvantages of loans

1. Larger loans will have certain terms and conditions or covenants that you must adhere to, such as the provision of quarterly management information.
2. Loans are not very flexible - you could be paying interest on funds you're not using.
3. You could have trouble making monthly repayments if your customers don't pay you promptly, causing cashflow problems.
4. In some cases, loans are secured against the assets of the business or your personal possessions, eg your home. The interest rates for secured loans may be lower than for unsecured ones, but your assets or home could be at risk if you cannot make the repayments.

5. There may be a charge if you want to repay the loan before the end of the loan term, particularly if the interest rate on the loan is fixed.

Bank Overdraft

An overdraft is a borrowing facility attached to your bank account, set at an agreed limit. It can be drawn on at any time and is most useful for your day-to-day expenses as it can help you to manage your cashflow more flexibly.

It is worth noting that loans are probably more appropriate for long-term funding. An overdraft is likely to cost more than a loan for a long-term purchase.

Advantages of an overdraft

1. An overdraft is flexible - you only borrow what you need at the time which may make it cheaper than a loan.
2. It's quick to arrange.
3. There is not normally a charge for paying off the overdraft earlier than expected.

Disadvantages of an overdraft

1. If you have to extend your overdraft, you usually have to pay an arrangement fee.
2. Your bank could charge you if you exceed your overdraft limit without authorisation.
3. The bank has the right to ask for repayment of your overdraft amount at any time, although this is unlikely to happen unless you get into financial difficulties.
4. Overdrafts may be secured against business assets.
5. Unlike loans you can only get an overdraft from the bank where you maintain your current account. In order to get an overdraft elsewhere you need to transfer your business bank account.
6. The interest rate applied is nearly always variable, making it difficult to accurately calculate your borrowing costs.
7. Unutilised overdraft facilities may be reduced by the banks at short notice, although this is unlikely to happen unless you get into financial difficulties.

Bear in mind that what starts out as a good deal may change - as may your business needs. It's worth reviewing your options regularly.

Internal Sources of Finance

The term “internal finance” (or internal sources of finance) itself suggests the very nature of finance/capital. This is the finance or capital which is generated internally by the business unlike finances such as loan which is externally arranged by banks or financial institutions. The internal source of finance is retained profits, the sale of assets, and reduction / controlling of working capital.

Reserve & Surplus

Reserves and Surplus are all the cumulative amount of retained earnings recorded as a part of the Shareholders Equity and are earmarked by the company for specific purposes like buying of fixed assets, payment for legal settlements, debts repayments or payment of dividends etc.

Types of Reserves and Surplus on Balance Sheet

General Reserve

A general reserve is also known as a revenue reserve. The amount kept separately by an entity from its profits for future purpose is known as revenue reserves. It is simply the retained earnings of an entity kept aside from the entity’s profits for meeting certain or uncertain obligations.

Capital Reserve

Capital reserve refers to a part of the profit which is kept by an entity for a specific purpose like providing for financing long-term projects or writing off any capital expenses. This reserve is created from any capital profit of an entity that is the profit earned from profit other than the core operations of a business.

Capital Redemption Reserve

Capital Redemption Reserve is created out of the undistributed profits that are general reserve or the Profit and loss account on the redemption of preference shares or during buyback of own shares to reduce the share capital.

Dividend Reserve

A dividend reserve is an amount that is kept in a separate account for ensuring that a similar amount of the dividend is declared every year.

Advantages

- Reserves are considered to be a vital source of financing by internal means. So when the company is in the need of funds for its business activities and for meeting the company's obligations the first and the easiest possible way to get funds is from the accumulated general reserves of the company.
- With the help of reserves, the company can maintain its working capital requirements as the reserves can be used to contribute towards working capital at the time of the insufficiency of funds in the working capital of the company.
- One of the main advantages of having reserves and surplus is to overcome the future losses of the companies as the time of losses reserves can be used to pay off the existing liabilities.
- Reserves are the main source of the amount required for dividend distribution available. It helps in maintaining the uniformity in the dividend distribution rate by providing the amount required for maintaining the uniform rate of the dividend when there is a shortage of amount available for distribution.

Disadvantages

- If the losses are incurred by the company and the same are adjusted/set-off with the reserves of the company then this will somehow lead to the manipulation of accounts as the correct picture of the company's profitability will not be shown to the users of financial statements.
- The general reserves that constitute the major part of reserves and surplus are not created for any specific purpose but the general use so there are chances that there can be a misappropriation of funds accumulated in general reserves by the management of the company and there is a possibility that the funds will not be used properly for business expansion.

- The Creation of more reserves by the company may lead to a reduction in the distribution of dividend to the shareholders of the company.

Important Points about Reserves and Surplus

- The utilization of the reserves and surplus includes purposes such as dividend distribution, meeting future obligations, overcoming losses, managing working capital requirements, fulfilling funds requirement for expansion of business, etc.

- It is required for the company to maintain reserves sometimes in cash to manage the reduction in revenues and slow-paying customers. Generally, the maintenance of cash reserves depends upon the type of business of the company.

Retained Profits / Retained Earnings

Retained profits/earnings are called the internal source of finance for a business for the simple reason that they are the end product of running a business. The phenomenon is also known as 'Ploughing Back of Profits'. Retained profits can be defined as the profit left after paying a dividend to the shareholders or drawings by the capital owners.

Formula for Retained Profits

It can be stated as below:

Retained Profits / Retained Earnings = Net Profits – Dividend / Drawings

Characteristics of Retained Profits

1. Retained earnings are a long-term source of finance for a company because there is no compulsory maturity like term loans and debentures.

2. Retained profits are also not characterized by the fixed burden of interest or installment payments like borrowed capital

Advantages and Disadvantages of Retained Profits as an Internal Source of Finance / Capital

Advantages of Retained Earnings as an Internal Source of Finance
The advantage of having retained profits/earnings is clearly seen in its characteristics.

First, they are long-term finance and nobody can ask for their payments.
Secondly, since there is no additional equity to be issued, there is no dilution of control and ownership in the business.
Thirdly, there is no fixed obligation of interest or installment payments.
Fourthly, retained earnings as an internal source of finance are cost-effective considering the fact that there is no issue cost attached to it which ranges between 2 – 3 %.
Lastly, investing retained earnings in the projects, with IRR better than ROI of the business, will directly have a positive impact on the shareholder's wealth and thereby the core objective of management will be served.
Disadvantages of Retained Earnings as an Internal Source of Finance

There is practically no disadvantage in generating or using retained earnings for financing the investments of the business. Assuming that the funds generated internally are not free as they are the funds belonging to the shareholders and the cost of these funds is equal to the cost of equity. There is only one alternative which can be explored i.e. debt financing sources. The purpose of exploring the option leads to thinking about two points. One, financial leverage that can be gained by introducing debt financing. Second, if the leverage is possible and practical, dividend decision regarding using the retained earnings to pay dividends to shareholders can be explored.

Bonus Share

Bonus shares are issued by companies in lieu of paying a cash dividend. As with any form of wealth transfer, these also have their own advantages and disadvantages. There are two parties involved, the issuing company and the shareholder or investor, and we discuss the advantages and disadvantages from the point of view of both.

Investor's Point of View:

Why does an investor buy equity shares of a company? It can be for two reasons –

1) investing for the long term, and

2) generating an annual income by means of dividends.

The first goal is fulfilled when the company is managed properly and adds economic value. The second goal depends on the payout policies of the company. A growth stage company may refrain from paying any cash dividend and reinvesting everything back into the business while a mature company may have to pay a regular annual cash dividend. But both types of companies can pay a stock dividend through a bonus issue.

Advantages of Bonus Shares from Investor's Point of View

1. The investor doesn't need to pay any tax upon receiving the bonus shares.
2. It is specifically beneficial for the investors who believe in the long-term story of the company and want to increase their investment in the same.
3. Issuing additional shares and using cash for the business growth of the company increases the investor's belief in operations of the company.
4. If the company starts paying the cash dividend in the future, the investor receives more because he holds a number of shares in the company due to past policy of paying a stock dividend.

Disadvantages of Bonus Shares from Investor's Point of View

1. Not all investors may be interested in receiving the shares as a dividend; some may want liquidity for fulfilling other objectives. When such investors sell their bonus shares for generating liquidity, their stake in the company is reduced.
2. The stock dividend doesn't give any extra wealth to the shareholders because share price drops by a proportionate amount to keep the market capital of the company same as before.

Advantages of Bonus Shares from Company's Point of View:

Over the course of a company's lifetime, the capital needs of the company keep on changing. In the initial growth phase, preserving cash is of utmost importance while satisfying the return desires of its shareholders takes precedence when the company is mature. A company has various means at its disposal to satisfy its objectives and one of these is the type of dividend pay-out. A company can either choose or is forced to (because of cash constraints) to pay a cash or stock-based dividend. Each carries its own advantages and disadvantages which are discussed below.

Advantages of Bonus Shares from Company's Point of View

1. Bonus issue allows the company to conserve cash for reinvesting back into the business.
2. It has a signaling effect and gives a positive sign to the market that company believes in its long-term growth story.
3. Sometimes, the company may not be in a position to pay any cash, so bonus issue is the only means to satisfy the shareholders' desire for a dividend.
4. Increasing the number of outstanding shares through a bonus issue increases the participation of smaller investors in the company's shares and hence enhances the liquidity of the stock.
5. The Increase in the issued share capital increases the perception of company's size.

Disadvantages of Bonus Shares from Company's Point of View

1. Bonus issue increases the number of outstanding shares of the company and this will decrease the future EPS and cash dividend yield. This can have a negative impact on the market's perceived value of the company.
2. The company doesn't receive any cash upon issuing bonus shares. So, the company's ability to raise money by follow-on offerings is reduced.
3. The cost of administering a Bonus Share Plan is more than that of paying a cash dividend. This cost can add up over the years if the company keeps on issuing bonus shares

Unit:3
Capital Structure

Meaning of Capital Structure

Capital Structure is referred to as the ratio of different kinds of securities raised by a firm as long-term finance. The capital structure involves two decisions-

1. Type of securities to be issued are equity shares, preference shares and long term borrowings (Debentures).
2. Relative ratio of securities can be determined by process of capital gearing.

On this basis, the companies are divided into two-

1. Highly geared companies - Those companies whose proportion of equity capitalization is small.
2. Low geared companies - Those companies whose equity capital dominates total capitalization.

Few definitions of capital structure given by some financial experts:

"Capital structure of a company refers to the make-up of its capitalisation and it includes all long-term capital resources viz., loans, reserves, shares and bonds."—**Gerstenberg**.

"Capital structure is the combination of debt and equity securities that comprise a firm's financing of its assets."—**John J. Hampton.**

"Capital structure refers to the mix of long-term sources of funds, such as, debentures, long-term debts, preference share capital and equity share capital including reserves and surplus."—**I. M. Pandey.**

For instance - There are two companies A and B. Total capitalization amounts to be USD 200,000 in each case. The ratio of equity capital to total capitalization in company A is USD 50,000, while in company B, ratio of equity capital is USD 150,000 to total capitalization, i.e, in Company A, proportion is 25% and in company B, proportion is 75%. In such cases, company A is considered to be a highly geared company and company B is low geared company.

Factors Determining Capital Structure

1. **Trading on Equity**- The word “equity” denotes the ownership of the company. Trading on equity means taking advantage of equity share capital to borrowed funds on reasonable basis. It refers to additional profits that equity shareholders earn because of issuance of debentures and preference shares. It is based on the thought that if the rate of dividend on preference capital and the rate of interest on borrowed capital is lower than the general rate of company’s earnings, equity shareholders are at advantage which means a company should go for a judicious blend of preference shares, equity shares as well as debentures. Trading on equity becomes more important when expectations of shareholders are high.
2. **Degree of control**- In a company, it is the directors who are so called elected representatives of equity shareholders. These members have got maximum voting rights in a concern as compared to the preference shareholders and debenture holders. Preference shareholders have reasonably less voting rights while debenture holders have no voting rights. If the company’s management policies are such that they want to retain their voting rights in their hands, the capital structure consists of debenture holders and loans rather than equity shares.
3. **Flexibility of financial plan**- In an enterprise, the capital structure should be such that there is both contractions as well as relaxation in plans. Debentures and loans can be refunded back as the time requires. While equity capital cannot be refunded at any point which provides rigidity to plans. Therefore, in order to make the capital structure possible, the company should go for issue of debentures and other loans.
4. **Choice of investors-** The company’s policy generally is to have different categories of investors for securities. Therefore, a capital structure should give enough choice to all kind of investors to invest. Bold and adventurous investors generally go for equity shares and loans and debentures are generally raised keeping into mind conscious investors.
5. **Capital market condition-** In the lifetime of the company, the market price of the shares has got an important influence. During the depression period, the company’s capital structure generally consists of debentures and loans. While in period of boons and inflation, the company’s capital should consist of share capital generally equity shares.
6. **Period of financing**- When company wants to raise finance for short period, it goes for loans from banks and other institutions; while for long period it goes for issue of shares and debentures.
7. **Cost of financing**- In a capital structure, the company has to look to the factor of cost when securities are raised. It is seen that debentures at the time of profit earning of company prove to be a cheaper source of finance as compared to equity shares where equity shareholders demand an extra share in profits.

8. **Stability of sales**- An established business which has a growing market and high sales turnover, the company is in position to meet fixed commitments. Interest on debentures has to be paid regardless of profit. Therefore, when sales are high, thereby the profits are high and company is in better position to meet such fixed commitments like interest on debentures and dividends on preference shares. If company is having unstable sales, then the company is not in position to meet fixed obligations. So, equity capital proves to be safe in such cases.
9. **Sizes of a company**- Small size business firms capital structure generally consists of loans from banks and retained profits. While on the other hand, big companies having goodwill, stability and an established profit can easily go for issuance of shares and debentures as well as loans and borrowings from financial institutions. The bigger the size, the wider is total capitalization.

Capitalization

It is an accounting method in which a cost is included in the value of an asset and expensed over the useful life of that asset, rather than being expensed in the period the cost was originally incurred.

Meaning of Over-Capitalisation:

The phrase 'over-capitalisation' has been misunderstood with abundance of capital. In actual practice, over-capitalized concerns have been found short of funds. Truly speaking, over-capitalisation is a relative term used to denote that the firm in question is not earning reasonable income on its funds.

According to Bonneville, Dewey and Kelly, "When a business is unable to earn a fair rate of return on its outstanding securities, it is over-capitalized."

Likewise, Gerstenberg opines that "a corporation is over-capitalized when its earnings are not large enough to yield a fair return on the amount of stocks and bonds that have been issued."

Thus, over-capitalisation refers to that state of affairs where earnings of the corporation do not justify the amount of capital invested in the business. In other words, an over-capitalized company earns less than what it should have earned at fair rate of return on its total capital.

To ascertain whether a company is earning reasonable rate of return or not, a comparison of the company's rate of earnings should be made with earning rate of the like concerns. If the company's rate of return is less than the average rate of return, it is indicative of the fact that the company is not able to earn fair rate of return on its capital.

It may not be out of place to mention that a company is said to be over-capitalized only when it has not been able to earn fair income over a long period of time. However, if earning position of a company is adversely affected temporarily, owing to occurrence of abnormal events like strikes, lockouts' and fire accident it would be misnomer to consider such company in the plight of over-capitalisation. As a matter of fact, over--capitalisation is the consequence of prolonged irregularities.

Causes of Over-Capitalisation:
There are various factors responsible for over-capitalized state of a company; important among them being as under:

(1) Promotion of a Company with Inflated Assets:
A company right from its incorporation falls prey to overcapitalization if it has been established with assets acquired at higher prices which do not bear any relation to their earning capacity. Such a situation arises particularly when corporate form of organisation is adopted by converting a partnership firm or when private limited company is converted into public limited firm because in that process assets may be transferred at price higher than their real value with the result that the book value of the corporation will be higher than its real value.

(2) Company Promoted with High Promotion Expenses:
Over-capitalisation may sometimes result because high expenses were incurred in promoting an enterprise and promoters were fabulously paid high price for their promotional services, particularly when the earnings of the company do not subsequently justify the capital employed.

(3) Over-estimating Earnings at the Time of Promotion:
A mistake in initial estimate of earnings may subsequently land a corporation into over-capitalisation since capitalisation based on such an estimate is not justified by income which the firm actually earns. For example, a company's initial earning was estimated at Rs. 10,000 and industry's average rate of return was fixed at 12 percent.

Accordingly, company's capitalisation was decided at Rs. 83,333 (10,000 × 25/3). Subsequently, it was found that company actually earned Rs. 8,000. Evidently in such a case company's capitalisation should have been fixed at Rs. 66,000. Thus, the company will be said to be over-capitalized by Rs. 16,667.

(4) Applying High Capitalisation Rate to Capitalize Earnings:
Despite correct estimate of earnings a company may plunge in state of over-capitalisation if higher capitalisation rate was applied to determine its total capitalisation. For example, a company's earning was estimated at Rs. 10,000 and the industry average rate of return was fixed at 8 percent.

Hence capitalisation rate applied was 12.5 percent. By applying this rate the company's capitalisation was worked out at Rs. 1, 25,000. Subsequently, it was found that industry average rate of return was 10 percent and hence company's fair amount of capitalisation would be Rs. 1,00,000 . Obviously, there is over-capitalisation in the company to the extent of Rs. 25,000.

(5) Company Formed or Expanded During Inflationary Period:
Generally, companies started in the days of inflationary conditions turn into over-capitalized concerns afterward when the inflationary conditions subside because assets were acquired at inflated prices which do not bear any relation with their earning capacity. Alongside this, in anticipation of high earnings during boom period there is strong tendency to fix the capitalisation at high figure.

With slackening of boom conditions followed by declining trends in earning level, companies gradually turn into over-capitalized ones. Even the existing ventures expand the scale of their business to exploit the earning opportunities which will necessitate the raising of further capital. These firms find themselves overcapitalized after the boom period is over.

(6) Shortage of Capital:
Sometimes, over-capitalisation may be the result of shortage of capital. Because of under-estimation of financial requirements a firm may be capitalized at low level. This may cause serious problem to the firm subsequently when it experiences shortage of funds to meet emergent requirements compelling the firm to procure necessary funds at unreasonably high rate of interest.

Consequently, lion share of firm's income may be swallowed by the lenders who come to the firm's rescue in eventuality, leaving little income available for the shareholders. This will naturally bring down the real value of the firm.

(7) Defective Depreciation Policy:
Many companies become over-capitalized because they did not make adequate provision for depreciation, replacement or obsolescence of assets. Inadequate depreciation causes inefficiency in the company which, in turn, results in its reduced earning capacity.

(8) Liberal Dividend Policy:
Liberal dividend policy may also contribute to over-capitalization of a company. Companies following too liberal dividend policy continuously for long period of time shall be definitely deprived of the benefits of retained earnings. Thus, in the first instance such companies fail to build up sufficient funds to replace old and worn-out assets and consequently, their operating efficiency suffers.

Secondly, these companies may, in times of necessity, be compelled to take recourse to costlier borrowing which, in turn adversely affects their earning position. The combined effects of these may land these companies in state of over-capitalisation.

(9) Fiscal Policy:
Taxation policy of the Government may also be responsible for company's over-capitalisation. Due to negative taxation policy firms tax liability increases and is left with small residual income for dividend distribution and retention purposes. Further, such policy also restricts the benefits to tax deduct-ability on account of depreciation provision. Consequently, operating efficiency of companies suffers drastically and state of over-capitalisation develops in companies.

Consequences of Over-Capitalisation:
Over-capitalisation is a state that affects not only the company and its owners but also the society as a whole.

On Company:
Effect of over-capitalisation on company is disastrous. Company's financial stability is jeopardized. It loses investors' confidence owing to irregularity in dividend declaration caused by reduced earning capacity. Consequently, it has to encounter enormous problems in raising capital from the capital market to cover its developmental and expansion requirements. Commercial banks too feel shy of lending short-term advances to such a company to meet its working capital requirements. As a result, production work hampers.
Over-capitalized concerns, more often than not, fail to make regular payments of interest and repay principal money on stipulated date. Under the situation creditors may demand liquidation of reorganization of company.

In its desperate bid to regain its lost confidence over-capitalized concerns have been found manipulating books of accounts to show inflated profits. Large dividends are distributed. As a matter of fact, such payments are made out of capital and to cover capital deficiency they take recourse to debt which would further aggravate the crisis.

Over-capitalized concerns gradually lose market to their competitors because in the first instance they fail to produce goods at competitive cost owing to lack of adequate provision for replacement of depleted or worn-out assets.

Secondly, these companies are also not capable of providing as much facility to their customers as their competitors could with the result that they fail to maintain their customers. Inventories lie in store for pretty long time and substantially large amount of capital is unnecessarily tied up in them. This may ultimately spell death knell upon the company.

On Shareholders:

Shareholders suffer doubly the brunt of over-capitalisation. Not only does their dividend income fall but also its receipt becomes uncertain. They also suffer because capital invested by them in these companies depreciates due to fall in market value of their shares. Value of their holdings as collateral securities declines simultaneously.

Shareholders find it difficult to borrow money against the security of their shares. Banks and other financial institutions for similar reasons hesitate to lend money against such securities. Even if they agree to grant loan, they insist upon the stricter terms and conditions hardly acceptable to an ordinary borrower.

On Society:

Over-capitalisation may prove to be a menace to society as a whole. Over-capitalized concerns, in their endeavour to maintain their credit, take every possible measure to prevent declining tendency of income. They try to increase the prices and deteriorate the quality of products. But to take recourse to such practices becomes difficult under the perfect competition and the result is the liquidation of such concerns.

The failure of such over-capitalized concerns tends to precipitate panic. Industrial development languishes, and labourers lose employment. Wage rate also tends to decline. Owing to fall in purchasing power of the labour class their demand tends to decline. This tendency may gradually permeate over the whole society and recession may follow. Such a situation is most dangerous. Process of capital formation is hampered and development activity slackens and the economy is thrown out of gear.

Remedies of Over-Capitalisation:
Effects of over-capitalisation are so grave that the management should take immediate measures to remedy the situation of over-capitalisation as soon as the symptoms of the over-capitalisation are observed.

Various remedial measures such as reduction in bonded debt, reduction of rate of interest paid on debentures, redemption of high dividend preferred shares, reduction of par value of shares and reduction of number of shares are suggested. We shall now examine efficacy of each of these measures as curative to the problem of over-capitalisation.

(1) Reduction in Bonded Debt:
To cut the knot of over-capitalisation, over-capitalized concerns are suggested to reduce the amount of bonded indebtedness to prune the amount of capital in accordance with their earning position. This measure seems to be inexpedient. Redemption of debt needs additional funds which can be procured either from reinvested earnings, or from sale of additional stock.

Since profit of over-capitalized concerns might be extremely low, it would be necessary for them to go to stock market for sale of their securities. They would, however, find it difficult to raise required amount of share capital because public response to their issues might not be very encouraging in view of their reduced earning position and increased financial instability.

Furthermore, shares of such companies are quoted at low prices in stock markets. Consequently, they might be compelled to issue large stock to raise the money. This, instead of remedying the problem, might aggravate it.

(2) Reduction of Fixed Charges on Debt:
It is also suggested that with a view to improving their earning position over-capitalized concerns should slash down the burden of fixed charges on debt. For that matter, existing bond holders will have to be made to agree to accept new bonds carrying lower interest rate in lieu of their old ones. The bondholders might agree to accept the new bonds provided these are issued to them at premium. This again fails to remedy the situation.

(3) Redemption of High Dividend Preferred Stock:

To reduce the burden of fixed charges on the over-capitalized company it is suggested to reduce preferred stock bearing high dividend rate. However, this might also not prove more meaningful because large amount of funds would be needed to redeem the preferred stock, raising of which would increase the amount of capitalisation instead of reducing it.

(4) Reducing Par Value of Shares:

It is often suggested that an over-capitalized concern should reduce the amount of stock outstanding by reducing par value of shares. This is nothing but reorganization of share capital which helps the concern in obscuring the real state of affairs. Supposing a company is capitalized at Rs. 10,00,000 with 5,000 ordinary shares of Rs. 200 per share and the company's average annual earning is Rs. 50,000.

Thus, the company's earnings per share is Rs. 10 and return on total capital employed is Rs. 5. Now, if the company reduces the par value of shares by 50% and transfers the same to surplus account, it would result in increase in return on capital by 100%.

Thus, through simple process of accounting, condition of over-capitalisation can be converted into that of undercapitalization. But it would be difficult to convince the shareholders in this respect. They may believe it to be management trick to dupe them by giving them lower par value stock in exchange for higher value stock though in fact real value of shares is in no way affected.

(5) Reducing Number of Shares:

By reducing number of outstanding shares, efforts are made to correct the outward symptoms of overcapitalization. For example, a company is capitalized with 10,000 shares of Rs. 10/- each. If the management decides to issue one new share in exchange of four old shares and shareholders agree to accept the decision, number of shares is reduced to 2,500.

As a result of this, earning per share tends to go up by the same proportion. This, in turn, may help the company to improve its credit position in the market and its share values consequently may soar.

In sum, reorganization of share capital either by reducing par value of shares or by reducing number of outstanding shares is the only panacea to the problem of over-capitalisation provided the management succeeds to convince the shareholders about the utility of this step.

Meaning of Under-Capitalisation:

The phrase 'Under-capitalisation' should never be misconstrued with inadequacy of capital. Truly speaking, this term is used to denote the state of affairs just converse of over-capitalisation.

When a company succeeds in earning abnormally large income consistently for a pretty long time, symptoms of under-capitalisation gradually develop in the company; the most important one being that market value of shares of the company exceeds their book value. Under-capitalisation is an index of effective and proper utilisation of funds employed in the enterprise. It should be noted in this regard that if a company under exceptionally good conditions makes substantially large earnings in a year or so, it should not be considered that the company is under-capitalized. Over--capitalised concerns have always earning superiority over average concerns engaged in the same line of activity.

Thus, under-capitalisation is indicative of sound financial health and good management of the company. Bonneville and Dewey rightly observed that "Under-capitalisation is not an economic problem but a problem in adjusting the capital structure".

Causes of Under-Capitalisation:
Potent causes of under-capitalisation in a company are as follows:

(1) Under-Estimation of Initial Earnings
If earnings of new venture were under-estimated and the enterprise was capitalized accordingly, it may find itself in condition of under-capitalisation afterwards when it's actual earning was much more than what was anticipated.

(2) Using Low Capitalisation Rate:
If low capitalisation rate was employed to determine capitalisation of a company, it might plunge in state of under-capitalisation subsequently when it would be found that actual capitalisation rate was much higher than the employed one.

(3) Deflationary Condition:
Companies set up in recessionary condition generally become under-capitalized after recession is over. There are two factors contributing to this tendency. In the first instance, during recession assets are purchased at exceptionally low prices which bear no relation with their

income producing capacity. As period of recession abates, earning position of the companies tends to improve.

This would result in increase in real value of assets while book value of assets remains as before and the consequence would be under-capitalisation. Secondly, companies set up in period of recession are capitalized at low figure anticipating low level of business income. But as the period of recession is over, company's earning capacity improves and the result is undercapitalization.

(4) Conservative Dividend Policy:
Company following conservative dividend policy builds up substantially large funds available for replacement and renovation of obsolete assets and for financing developmental and expansion purposes. This thus goes a long way in improving earning position of the company.

(5) Maintaining High Standards of Efficiency:
By employing new techniques of production and rationalization of production activities, operating efficiency of a company can be improved.

Consequences of Under-capitalisation:
On Company:
Although under-capitalisation does not threaten financial stability and solvency of the enterprise, management should not be complacent towards this situation because the company may suffer in the following ways:

(i) Under-capitalisation intensifies the degree of competition which may have telling effect on profit margin of under-capitalized concerns. High earning rate of under-capitalized companies may entice entrepreneurs to set up enterprises in the same line of business who may put up tough fight with the under-capitalized concerns.

(ii) Tax liability of under-capitalized concerns increases in correspondence with increase in volume of profits. Also belts of state control and intervention over these enterprises are tightened.

(iii) Marketability of shares of under-capitalized concerns tends to be narrow because of exceptionally high market price of these shares. Share prices register violent fluctuations and speculators take undue advantage of this situation.

(iv) In view of continued rise in profitability rate workers may demand increase in their wage rates and if their demand is not fulfilled it may cause discontentment among them. Labour-management relation is disturbed which may adversely affect production efficiency of the corporation.

(v) Consumers may feel being fleeced by the management of under-capitalized company who are, it is alleged, thriving at their cost. They may raise hue and cry for reducing price of the product and demand vociferously for the state to intervene and control their operations.

On Share-Holders:

Under-capitalisation is advantageous to shareholders in as much as they get high dividend income regularly. Because of soaring rise in share price of under-capitalized concerns, shareholders' investment in these companies appreciates phenomenally which they may encash at any time.

In another way also, under-capitalisation benefits the shareholders. They can, in periods of necessity, get loans on soft-terms against the security of their shares because of high credit standing of the under-capitalized concerns in the market.

On Society:

Under-capitalisation does not pose any economic problem to the society. On the contrary, it may prove boon to it. It encourages new entrepreneurs to set-up new ventures and encourages the existing ones to expand. This as a result, boosts industrial production. Consumers get variety of products at relatively cheaper rate.

Establishment of more and more firms and expansion of existing ones helps to mitigate sufferings of unemployed persons. Purchasing power of newly employed people increases resulting in a rise in demand which, in turn leads to increase in investment and production. Through demand-investment and employment spiral the economy marches ahead to reach the pinnacle of prosperity.

However, society may plunge in state of turmoil when psychic feeling develops among consumers and workers that they are being plundered by capitalists. This feeling may sow seeds of dissension among consumers at large and labour-management relation is disrupted.

The whole society is mired in plight of discontentment and agitation forcing government to intervene immediately and to clamp, for that matter, numerous types of controls such as price control, dividend ceiling and dividend freeze.

Remedies for Under-Capitalisation:
To correct condition of under-capitalisation it is inevitable on the part of the company to reorganize its capital structure in such a way that number of shares increases and earning per share is reduced.

For this purpose the following two measures might be helpful:

(1) Capitalisation of Surplus of the Company:
If a company has adequate surplus in hand the whole or a part of it can be capitalized by issue of bonus shares. This will, in no way, affect the quantum of capitalisation. Of course, make-up of capitalisation will undergo marked change. Thus, with issue of bonus shares, share capital will increase and so also the number of shares but surplus of the company will lie reduced by the amount of bonus shares.
In consequence, earnings per share automatically are reduced. Take for example, a company has total capitalisation of Rs. 2,00,000 comprising share capital of Rs. 1,50,000 (divide in 3,000 shares of Rs. 50 per share) and surplus of Rs. 50,000. The company's present earning is Rs. 60,000.

Thus earning per share in this case comes to Rs. 20 per share. Management may save this company against the effects of under-capitalisation by issuing bonus shares. If, for example, it is decided that the company will issue 5,000 bonus shares of Rs. 10 each, share capital in the company will increase from Rs. 1,50,000 to Rs. 2,00,000 and number of shares from 3,000 to 8,000 though of course amount of total capitalisation remains unchanged.

As a result of this, earning per share which was earlier Rs. 20 would, after capitalisation, decline to Rs. 7.50. However, owner's income is no longer affected. They would continue to receive the same amount of income even after recapitalization. This would keep the management free from workers' threats; consumers do not feel being exploited by capitalists.

(2) Splitting Stock:
Another effective way of reorganizing capitalisation of a company to reduce the effects of under-capitalisation is to split up the stock into a large number of shares and reduce the value of each share in accordance with the rate of split up. The effect of this split is that the earnings

would be spread over a greater number of shares, Supposing a company is capitalized with Rs. 1,00,000 divided into 1000, its earning per share would come to Rs. 10.

Management may reduce earning per share if it so likes by taking recourse to stock split. If, for example, the management decides to reduce par value of shares by 50 percent and increase the number of shares in the same proportion, number of shares in the company would after splitting double to reach 20,000 shares and earning per share would be halved to Rs. 5.

The shareholders will have no objection to this procedure because they are not going to lose anything. Thus, by this simple device the management can neutralize the effects of under-capitalisation and save the company from any eventuality.

It is evident from the foregoing discussions that both the strategy under-capitalisation and over-capitalisation are undesirable and should be discouraged as far as possible. Over-capitalisation means a great strain on the financial structure of a company, an evil for shareholders and a menace to economic prosperity, and stability of society.

On the other hand, under-capitalisation encourages competition on the part of business rivals, sows seeds of dissension among labourers and creates psychic feeling of being exploited among consumers. On comparison, state of over-capitalisation relatively is more harmful. However, the management should avoid emergence of both these situations and its ideal should be of fair capitalisation.

Unit:4
Recent Trends in business finance

Venture Capital

It is a private or institutional investment made into early-stage / start-up companies (new ventures). As defined, ventures involve risk (having uncertain outcome) in the expectation of a sizeable gain. Venture Capital is money invested in businesses that are small; or exist only as an initiative, but have huge potential to grow. The people who invest this money are called venture capitalists (VCs). The venture capital investment is made when a venture capitalist buys shares of such a company and becomes a financial partner in the business.

Venture Capital investment is also referred to risk capital or patient risk capital, as it includes the risk of losing the money if the venture doesn't succeed and takes medium to long term period for the investments to fructify.

Venture Capital typically comes from institutional investors and high net worth individuals and is pooled together by dedicated investment firms.

It is the money provided by an outside investor to finance a new, growing, or troubled business. The venture capitalist provides the funding knowing that there's a significant risk associated with the company's future profits and cash flow. Capital is invested in exchange for an equity stake in the business rather than given as a loan.

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

Features of Venture Capital investments

1. High Risk
2. Lack of Liquidity
3. Long term horizon
4. Equity participation and capital gains

5. Venture capital investments are made in innovative projects
6. Suppliers of venture capital participate in the management of the company

Methods of Venture capital financing

Equity

participating debentures

conditional loan

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

1. Idea generation
2. Start-up
3. Ramp up
4. Exit

Step 1: Idea generation and submission of the Business Plan

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

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

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

Step 2: Introductory Meeting

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

Step 3: Due Diligence

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

Step 4: Term Sheets and Funding

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

Types of Venture Capital funding

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

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

1. Seed money: Low level financing for proving and fructifying a new idea
2. Start-up: New firms needing funds for expenses related with marketingand product development
3. First-Round: Manufacturing and early sales funding
4. Second-Round: Operational capital given for early stage companies which are selling products, but not returning a profit
5. Third-Round: Also known as Mezzanine financing, this is the money for expanding a newly beneficial company
6. Fourth-Round: Also calledbridge financing, 4th round is proposed for financing the "going public" process

A) Early Stage Financing:

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

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

B) Expansion Financing:

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

Second-stage financing is provided to companies for the purpose of beginning their expansion. It is also known as mezzanine financing. It is provided for the purpose of assisting a particular company to expand in a major way. Bridge financing may be provided as a short term interest only finance option as well as a form of monetary assistance to companies that employ the Initial Public Offers as a major business strategy.

C) Acquisition or Buyout Financing:

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

Advantages of Venture Capital

1. They bring wealth and expertise to the company

2. Large sum of equity finance can be provided
3. The business does not stand the obligation to repay the money
4. In addition to capital, it provides valuable information, resources, technical assistance to make a business successful

Disadvantages of Venture Capital

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

Exit route

There are various exit options for Venture Capital to cash out their investment:

1. IPO
2. Promoter buyback
3. Mergers and Acquisitions
4. Sale to other strategic investor

Considering the high risk involved in the venture capital investments complimenting the high returns expected, one should do a thorough study of the project being considered, weighing the risk return ratio expected. One needs to do the homework both on the Venture Capital being targeted and on the business requirements.

Lease

A lease is a contract under which one party, the lessor (owner of the asset), gives another party (the lessee) the exclusive right to use the asset usually for a specified time in return for the payment of rent.

Leasing is the process by which a firm can obtain the use of certain fixed assets for which it must make a series of contractual, periodic, tax-deductible payments. A lease is a contract that enables a lessee to secure the use of the tangible property for a specified period by making payments to the owner.

Major Features of Lease

The major features or elements of the leasing are the following:

1. The Contract: There are essentially two parties to a contract of lease financing, namely the owner and the user.
2. Assets: The assets, property to be leased are the subject matter lease financing contract.
3. Lease Period: The basic lease period during which the lease is non-cancelable.
4. Rental Payments: The lessee pays to the lessor for the lease transaction is the lease rental.
5. Maintain: Provision for the payment of the costs of maintenance and repair, taxes, insurance, and other expenses appertaining to the asset leased.
6. Term of Lease: The term of the lease is the period for which the agreement of lease remains in operation.
7. Ownership: During the lease period, ownership of the assets is being kept with the lessor, and its use is allowed to the lessee.
8. Terminating: At the end of the period, the contract may be terminated.
9. Renew or Purchase: An option to renew the lease or to purchase the assets at the end of the basic period.
10. Default: The lessee may be liable for all future payments at once, receiving title to the asset in exchange.

Advantages of Lease Financing

The advantages from the viewpoint of the lessee

1. Saving of Capital: Leasing covers the full cost of the equipment used in the business by providing 100% finance. The lessee is not to provide or pay any margin money as there is no down payment. In this way, the saving in capital or financial resources can be used for other productive purposes, e.g., purchase of inventories.
2. Flexibility and Convenience: The lease agreement can be tailor-made in respect of lease period and lease rentals according to the convenience and requirements of all lessees.
3. Planning Cash Flows: Leasing enables the lessee to plan its cash flows properly. The rentals can be paid out of the cash coming into the business from the use of the same assets.
4. Improvement in Liquidity: Leasing enables the lessee to improve its liquidity position by adopting the sale and leaseback technique.

5. Shifting of Risk of Obsolescence: The lessee can shift the risk upon lessor by acquiring the use of assets rather than buying the asset.
6. Maintenance And Specialized Services: In case of special kind of lease arrangement, the lessee can avail specialized services of the lessor for maintenance of asset leased. Although lesser charges higher rentals for providing such services, leases see overall administrative, and service costs are reduced because of specialized services of the lessor.
7. Off-the-Balance-Sheet-Financing: Leasing provides "off-balance-sheet" financing for the lessee in that the lease is recorded neither as an asset nor as a liability.

The advantages from the viewpoint of the lessor

There are several extolled advantages of acquiring capital assets on lease:

1. Higher profits: The Lessor can get higher profits by leasing the asset.
2. Tax Benefits: The Lessor being the owner of an asset, can claim various tax benefits such as depreciation.
3. Quick Returns: By leasing the asset, the lessor can get quick returns than investing in other projects of the long gestation period.

Disadvantages of Lease Financing

The disadvantages from the viewpoint lessee

1. Higher Cost: The lease rental includes a margin for the lessor as also the cost of risk of obsolescence; it is, thus, regarded as a form of financing at a higher cost.
2. Risk: Risk of being deprived of the use of assets in case the leasing company winds up.
3. No Alteration in Asset: Lessee cannot make changes in assets as per his requirement.
4. Penalties On Termination of Lease: The lessee has to pay penalties in case he has to terminate the lease before the expiry lease period.

The disadvantages from the viewpoint lessor

1. High Risk of Obsolescence: The Lessor has to bear the risk of obsolescence as there are rapid technological changes.
2. Price Level Changes: In the case of inflation, the prices of an asset rises, but the lease rentals remain fixed.
3. Long term Investment: Leasing requires the long term investment in the purchase of an asset, and takes a long time to cover the cost of that asset

Types of the Lease

Leasing takes different types which are given below;

A. **Based on Nature**.
1. Operating lease.
2. Financial lease.

B. Based on the Method of Lease.
1. Direct lease.
2. Sale & Leaseback.
3. Leverage lease.

1. **Operating Lease:** An operating lease is a cancelable contractual agreement whereby the lessee agrees to make periodic payments to the lessor, often for 5 or fewer years, to obtain an asset set’s services. According to the International Accounting Standards (IAS-17), an operating lease is one that is not a finance lease.
2. **Financial Lease:** A financial (or capital) lease is a longer-term lease than an operating lease that is non-cancelable and obligates the lessee to make payments for the use of an asset over a predetermined .period of time. According to the International Accounting Standard (IAS-17), in a financial lease, the lessor transfer to the lessee substantially all the risks and rewards identical to the ownerships of the asset whether or not the title is eventually transferred.
3. **Direct Lease:** Under direct leasing, a firm acquires the right to use an asset from the manufacture directly. The ownership of the asset leased out remains with the manufacture itself.
4. **Sale & Leaseback**: Under the sale & leaseback arrangement, the firm sells an asset that it owns and then leases to the same asset back from the buyer. This way, the lessee gets the assets for use, and at the same time, it gets cash.

5. **Leveraged Lease**: Leveraged lease is the same as the direct lease, except that a third party, the lender, is involved in addition to the lessee & lessor. The lender partly finances the purchase of the asset to be leased; the lessor turns to be a borrower

Distinguish between the Operating and Financial Lease

Topics	Operating Lease	Financial Lease
Definition	Operating lease is short term lease used to finance assets & is not fully amortized over the life of the asset.	A financial lease is the lease used in connection with long term assets & amortizes the entire cost of the asset over the life of the lease.
Duration	Short term leasing	Long term leasing
Cost	The lessor pays the maintenance cost.	Lessee pays the maintenance cost.
Cancel & Changeable	Cancelable lease & It is a changeable lease contract.	Non-cancelable lease & It is not a changeable lease contract.
Risk	lessor bears the risk of the asset.	The lessee bears the risk of the asset.
Purchase	At the end of the asset is hot purchasable.	At the end of the contract, the asset is purchasable.
Renew	It is a renewable contract.	It is not a renewable contract.
Also called	Service lease, short term lease, cancelable lease.	A capital lease, long term lease, non-cancelable lease.

lease is a contract under which one party the lessor (owner) of an asset agrees agreed to grant the use of that asset to another, the lessee in exchange for periodic rental payments. The rent is a tax-deductible expense.

Microfinance

Microfinance is a banking service provided to unemployed or low-income individuals or groups who otherwise would have no other access to financial services. Microfinance allows people to take on reasonable small business loans safely, and in a manner that is consistent with ethical lending practices.

Microfinance—also called microcredit—is a way to provide small business owners and entrepreneurs access to capital. Often these small and individual business don't have access to traditional financial resources from major institutions. This means it is harder to access loans, insurance, and investments that will help grow their business.

Microfinance generally refers to the provision of basic financial services such as loans, saving accounts and insurances for low-income but economical active people. In most instances the term microfinance refers to the provision of small loans (=micro credits) for micro-entrepreneurs.

The UN believes microfinance to play a central role in the battle against poverty and proclaimed the year 2005 as the "International Year of Microcredit".

The idea of microfinance, however, is not new but can be traced back to the principle of self-help and solidarity which was devised by savings banks and cooperative banking groups (e.g. Raiffeisen) 150 years ago.

In the 70s Muhammad Yunus, professor of economics, began to hand out small loans in his home country Bangladesh. He founded the Grameen Bank in 1983 which today is active in over 70,000 villages in Bangladesh. The Grameen Bank employs 25,000 people and has 7.4 m borrowers, 97 % of which are women. Muhammad Yunus was awarded the 2006 Nobel Peace Prize. His concept is employed in 60 developing countries today.

This is where microfinance comes into its own. Thanks to a regulated access to money microfinance offers three characteristics:

1. security,
2. economic growth,
3. the opportunity, to take one´s future into one´s own hands.

Essentially, microfinance is providing loans, credit, access to savings accounts—even insurance policies and money transfers—to the small business owner and entrepreneur. There are many such enterprises in the developing world.

How Microfinancing Works

Microfinance, pioneered by the Nobel-Prize winner Muhammad Yunus, helps the financially marginalized by providing them with the necessary capital to start a business and work toward financial independence. These loans are significant because they are given even though the borrower has no collateral. However, the interest rates for these microloans are often very high due to the risk of default.

Why Is It Important?

Microfinance is important because it provides resources and access to capital to the financially underserved, such as those who are unable to get checking accounts, lines of credit, or loans from traditional banks.

Without microfinance, these groups may have to resort to using loans or payday advances with extremely high-interest rates or even borrow money from family and friends. Microfinance helps them invest in their businesses, and as a result, invest in themselves.

Who Benefits from Microfinancing?

While microfinance can certainly benefit those stateside, it can also serve as an important resource for those in the developing world. For example, cell phones are being used as a way to bring financial services such as microlending to those living in Kenya.7

It's also made headway in the United States, where burgeoning entrepreneurs with no collateral are able to take out loans of less than $50,000 to jump-start their business ventures.8

Microfinance can also help women break the cycle of poverty. Often, these loans can be as small as $60. For example, a young single mother from Paraguay took this small investment of $60 to start an empanada and snack stand. She continued building her business, repaying this loan and taking out larger loans to buy a building for her stand, complete with a refrigerator and attached home for her family.9 This is microfinance at its best.

In fact, women are major microfinance borrowers, making up 80% of loans in 2018, according to the 2019 Microfinance Barometer. Around 65% of total borrowers live in rural areas, which means that a large number of female microfinance borrowers live in rural areas with limited resources.

The microfinance industry is also growing rapidly. In 2018, there were 139.9 million microfinance borrowers, for a total of $124 billion in loans. India accounted for most of these borrows, followed by Bangladesh, and Vietnam

The term microfinance encompasses microloans, micro-savings, and microinsurance. Microfinance institutions provide small loans and other resources to business owners and entrepreneurs to help them get their businesses off the ground. Many of the recipients are in developing countries, and could otherwise not obtain a traditional loan.

Micro-savings accounts are also under the microfinance umbrella. They allow entrepreneurs to have a savings account with no minimum balance. And microinsurance provides these borrowers with insurance, at a lower rate, and with lesser premiums.

Mutual Fund

Mutual fund is a financial instrument that pools money from different investors. The pooled money is then invested in securities like stocks of listed companies, government bonds, corporate bonds, and money market instruments.

As an investor, you don't directly own the company's stocks that mutual funds purchases. However, you share the profit or loss equally with the other investors of the pool. This is how the word "mutual" is associated with a mutual fund.

You get the advantage of the expertise of the fund manager and regulatory safety of the Securities Exchange and Board of India (SEBI). The professional fund manager ensures a maximum return to investors.

Now you get the understanding about mutual funds. Let's explore how it works.

How Do Mutual Funds Work?

Mutual fund investment is simple. You invest in a fund consisting of several assets. Thus, you need not risk putting all eggs in one basket.

Additionally, the headache of tracking market movements is not there. The mutual fund house takes care of the research, fund management, and market tracking. This makes the mutual fund a highly popular investment option for all types of investors.

A mutual fund is managed by the asset management company (AMC). Mutual fund investment starts with the pooling of money from several investors.

The pooled money is invested in a meticulously built portfolio of different asset classes like equity, debt, money market instruments, and other funds. Hence, you have the advantage of diversification, the time tested market mantra.

Additionally, your money is invested in instruments like Government bonds, that you wouldn't be able to afford individually.

The best part about mutual funds is that a team of experts along with the fund manager picks all the investments to build a portfolio. The investments are made according to the defined objective of the mutual fund.

Expert and professional fund management help you outperform the returns of traditional investment vehicles like a bank savings account and fixed deposits.

As an investor, you are allotted units for your contribution to the pooled fund.

The portfolio value depends on the price movements of the underlying assets. The portfolio value is net assets divided by the number of outstanding units which is called the net asset value or NAV.

The gains are reflected in higher NAV and lower NAV indicates a loss in portfolio value.

Advantages and benefits of investing in Mutual Funds in India

1. **Liquidity**
   The most important benefit of investing in a Mutual Fund is that the investor can redeem the units at any point in time. Unlike Fixed Deposits, Mutual Funds have flexible withdrawal but factors like the pre-exit penalty and exit load should be taken into consideration.
2. **Diversification**
   The value of an investment may not rise or fall in tandem. When the value of one investment is on the rise the value of another may be in decline. As a result, the portfolio's overall performance has a lesser chance of being volatile.

Diversification reduces the risk involved in building a portfolio thereby further reducing the risk for an investor. As Mutual Funds consist of many securities, investor's interests are safeguarded if there is a downfall in other securities so purchased.

3. **Expert Management**
   A novice investor may not have much knowledge or information on how and where to invest. The experts manage and operate mutual funds. The experts pool in money from investors and allocates this money in different securities thereby helping the investors incur a profit.

The expert keeps a watch on timely exit and entry and takes care of all the challenges. One only needs to invest and be least assured that rest will be taken care of by the experts who excel in this field. This is one of the most important advantages of mutual funds

4. **Flexibility to invest in Smaller Amounts**
   Among other benefits of Mutual Funds the most important benefit is its flexible nature. Investors need not put in a huge amount of money to invest in a Mutual Fund. Investment can be as per the cash flow position.
   If You draw a monthly salary then you can go for a Systematic Investment Plan (SIP). Through SIP a fixed amount is invested either monthly or quarterly as per your budget and convenience.

5. **Accessibility – Mutual Funds are Easy to Buy**
   Mutual Funds are easily accessible and you can start investing and buy mutual funds from anywhere in the world. An asset management companies (AMC) offers the funds and distributes through channels like :

   1. Brokerage Firms
   2. Registrars like Karvy and CAMS
   3. AMC'S Themselves
   4. Online Mutual Fund Investment Platforms

5. Agents and Banks

This factor makes mutual funds universally available and easily accessible. More so, you do not require a Demat Account to invest in Mutual Funds. Mutual funds are easy to buy, track performance and one-click investment with Scripbox

6. **Schemes for Every Financial Goals**

The best part of the Mutual Fund is the minimum amount of investment can be Rs. 500. And the maximum can go up to whatever an investor wishes to invest.

The only point one should consider before investing in the Mutual Funds is their income, expenses, risk-taking ability, and investment goals. Therefore, every individual from all walks of life is free to invest in a Mutual Fund irrespective of their income.

7. **Safety and Transparency**

With the introduction of SEBI guidelines, all products of a Mutual Fund have been labeled. This means that all Mutual Fund schemes will have a color-coding. This helps an investor to ascertain the risk level of his investment, thus making the entire process of investment transparent and safe.

This color-coding uses 3 colors indicating different levels of risk-

1. Blue indicates low risk
2. Yellow indicates medium risk, and
3. Brown indicates a high risk.

Investors are also free to verify the credentials of the fund manager, his qualifications, years of experience, and AUM, solvency details of the fund house.

8. **Lower cost**

In a Mutual Fund, funds are collected from many investors, and then the same is used to purchase securities. These funds are however invested in assets which therefore helps one save on transaction and other costs as compared to a single transaction. The savings are passed on to the investors as lower costs of investing in Mutual Funds.

Besides, the Asset Management Services fee cost is lowered and the same is divided between all the investors of the fund.

9. **Best Tax Saving Option**
   Mutual Funds provide the best tax saving options. ELSS Mutual Funds have a tax exemption of Rs. 1.5 lakh a year under section 80C of the Income Tax Act. You can use Scripbox's income tax calculator to ensure tax plan requirement
   All other Mutual Funds in India are taxed based on the type of investment and the tenure of investment.
   ELSS Tax Saving Mutual Funds has the potential to deliver higher returns than other tax-saving instruments like PPF, NPS, and Tax Saving FDs.

10. **Lowest Lock-in Period**
    Tax Saving Mutual Funds have the lowest lock-in periods of only 3 years. This is lower as compared to a maximum of 5 years for other tax saving options like FD, ULIPs, and PPF. On top of that one has the option to stay invested even after the completion of the lock-in period.
11. **Lower Tax on the Gains**
    With Equity linked saving scheme you can save tax up to Rs. 1.5 Lakh a year under section 80C of Income Tax (IT) Act. All other types of Mutual Funds are taxable depending on the type of fund and tenure.
    Before making an investment one should keep in mind the various advantages Mutual Fund provides. Thorough knowledge of the benefits of Mutual Funds would lead to better gains in the future.