UNIT 5 FINANCING OF BUSINESS – OVERVIEW

LESSON 13 FINANCING

TABLE OF CONTENTS:

13. FINANCING

13.0 Objectives

At the end of this lesson, you will be able to understand and learn about:

- Fundamentals of Financing
- Functions of a Finance Manager

13.1 Introduction

The discipline of financing can be divided into long-term and short-term decisions and techniques.

13.2 Long – term

Capital investment decisions are long-term choices about which projects receive investment, whether to finance that investment with equity or debt (capital Structure), and when or whether to pay dividends to shareholders. These decisions are based on several inter-related criteria. Corporate management seeks to maximize the value of the firm by investing in projects which yield a positive net present value when valued using an appropriate discount rate. These projects must also be financed appropriately. If no such opportunities exist, maximizing shareholder value dictates that management returns excess cash to shareholders.

Capital investment decisions thus comprise of:

a) Financing decision

b) Investment decision

c) Dividend decision

a) Financing Decision

- Helps to decide what type of **Capital structure** the company needs to have re: whether these funds would be raised re: from loans/borrowings or from internal source (share capital).
- To raise sufficient long term funds to finance fixed assets and other long term investments and to provide for the needs of working capital.

b) Investment Decision (Project Financing)

- In projects using the various capital budgeting tools like Payback method, accounting rate of return, internal rate of return, net present value.

- Assets management policies are to be laid down regarding the various items of current assets like accounts receivable by coordinating with the sales personnel, inventory with production

c) Dividend Decision

- Taking into consideration, earnings trend, share market price trend, fund requirement for future growth, cash flow situation and others.

13.3 Short – term

On the other hand, the short-term decisions can be grouped under the heading "Working capital management". This subject deals with the short-term balance of current assets and current liabilities; the focus here is on managing cash, inventories, and short-term borrowing and lending (such as the terms on credit extended to customers).

13.4 Management of Working Capital

Management will use a combination of policies and techniques for the management of working capital. These policies aim at managing the current assets (generally cash and cash equivalents, inventories and debtors) and the short term financing, such that cash flows and returns are acceptable.

- **Cash management:** Identify the cash balance, which allows for the business to meet day-to-day expenses, but reduces cash holding costs.

- **Inventory management:** Identify the level of inventory which allows for uninterrupted production but reduces the investment in raw materials - and minimizes reordering costs - and hence increases cash flow; see Supply chain management; Just In Time (JIT); Economic order quantity (EOQ); Economic production quantity (EPQ).

- **Debtors' management:** Identify the appropriate credit policy, i.e. credit terms which will attract customers, such that any impact on cash flows and the cash conversion cycle will be offset by increased revenue and hence Return on Capital (or vice versa); see Discounts and allowances.

- **Short term financing:** Identify the appropriate source of financing, given the cash conversion cycle: the inventory is ideally financed by credit granted by the supplier; however, it may be necessary to utilize a bank loan (or overdraft), or to "convert debtors to cash" through "factoring".

Self-check Questions

1. Critically assess various short – term and long – term decisions taken by the management.

13.5 Functions of a Finance Manager

The main objective of the Finance Manager is to manage funds in such a way so as to ensure their optimum utilization and their procurement in a manner that the risk, cost and control considerations are properly balanced in a given situation. To achieve the objective, the Finance Manager performs the following functions in the following areas: -

13.5.1 Forecasting and Planning (Budgeting)

- The need to estimate/forecast the **requirement of funds** for both the short term (working capital requirements) and the long-term purpose (capital investments).
- Forecasting the requirements of funds involves the use of budgetary control and long-range planning

13.5.2 Capital Investment Decisions

a) Financing Decision

- Helps to decide what type of **Capital structure** the company needs to have re: whether these funds would be raised re: from loans/borrowings or from internal source (share capital).
- To raise sufficient long term funds to finance fixed assets and other long term investments and to provide for the needs of working capital .

b) Investment Decision (Project Financing)

- In projects using the various capital budgeting tools like Payback method, accounting rate of return, internal rate of return, net present value.
- Assets management policies are to be laid down regarding the various items of current assets like accounts receivable by coordinating with the sales personnel, inventory with production

c) Dividend Decision

- Taking into consideration, earnings trend, share market price trend, fund requirement for future growth, cash flow situation and others.

13.5.3 Cash Management (Working Capital)

- The finance manager needs to ensure the supply of adequate, timely and cheap fund to the various parts of the organization

- That there is no excessive cash idling around (Balanced Cash Inflow-Outflow)

13.5.4 Financial Negotiation

- Plays a very important role in carrying out negotiations with the various financial institutions, banks and public depositors for raising funds on favourable terms.

13.5.5 Monitoring and Evaluating Financial Performance

- Constant monitoring about adherence of financial policies, programmes and progress.

- Need to constantly review the financial performance of the various units of organization generally in terms of ROI (return on investment. Such review assists management in seeing how the funds have been utilized in the various divisions and what can be done to improve it.

13.5.6 Dealing with Relevant Parties in the Financial Markets

- Where the company is a listed entity, the need to interact with the Stock Exchange

- To deal with money markets and capital markets for financing or investment of idling funds

- To foster relationships with bankers, investors, underwriters of equity and bond issuances and other government regulatory bodies.

13.6 References and Suggested Further Reading

1. Desai, Vasant Dr. (2004) Management of Small Scale Enterprises New Delhi: Himalaya Publishing House,

2. Gupta, CB, Modern Business Organization: Mayur Paper Backs

3. Lundy, J.L., Effective Industrial Management, New Delhi: Eurasia Publishing House, 1986

4. Taneja, Gupta, Entrepreneur Development New Venture Creation. 2nd ed. Galgotia Publishing Company

5. Business organization-YKBHUSHAN

6. Business Organisation & Management- CR Basu

7. Entrepreneurship Development- New Venture Creation David Holt

8. Student;s Guide to Business Organisation, Dr. Neeru Vashistha,Taxman

9. en.wikipedia.org

10. basiccollegeaccounting.com

LESSON 14 SOURCES OF FUNDS

TABLE OF CONTENTS:

14. SOURCES OF FUNDS

14.0 Objectives

At the end of this lesson, you will be able to understand and learn about:

- Various sources of Funds.
- Long term, Mid -term and Short term sources of Finance.
- Description of major sources of Finance.

14.1 Introduction

SOURCES OF FUNDS:

An enterprise in India has access to various types of short-term and long term financing. In the present days there exist several sources of finance. Keeping in view the type of requirement, the **finance sources** are chosen.

14.1.1 Long – term Sources of Finance

The long-term sources of finances can be raised from the following sources:

- Share capital or Equity Share.
- Preference shares.
- Retained earnings.
- Debentures/Bonds of different types.
- Loans from financial institutions.
- Loan from State Financial Corporation.
- Loans from commercial banks.
- Venture capital funding.
- Asset securitization.
- International

14.1.2 Medium – term Sources of Finance

The medium-term sources of finance can be raised from the following sources.

- Preference shares.
- Debentures/Bonds.
- Public deposits/fixed deposits for duration of three years.
- Commercial banks.
- Financial institutions.
- State financial corporations.
- Lease financing / Hire Purchase financing.
- External commercial borrowings.
- Euro-issues.
- Foreign Currency bonds.

14.1.3 Short – term Sources of Finance

- Trade credit.
- Commercial banks.
- Fixed deposits for a period of 1 year or less.
- Advances received from customers.

14.2 Descriptions of Some Major Financing Sources

14.2.1 Short – term Financing

Short-term financing, mainly for working capital purposes, is usually provided by the commercial banks as a mix of cash credit and bills discounting facilities.

- There is also an active short-term money market for inter-corporate specific-period borrowings. The RBI has permitted issuance of **commercial paper** by later corporations fulfilling certain conditions. The maximum maturity period for commercial paper is six months. Such paper is sold at a discount and redeemed at face value. Commercial paper rates of interest are below the bank prime-lending rate.

- **Certificates of Deposits (CD)** can be issued by scheduled commercial banks at a discount from face value, with a maturity period ranging from 3 months to 1 year.
- Commercial **working capital finance** for exports is provided by the commercial banks, which are in turn refinanced for this activity by the Export Import Bank of India (EXIM Bank).

14.2.2 Long – term Financing

It is available through various equity and debt instruments.

- **Equity instruments** include common and preferred stock and may be used to raise finance by public issue upon obtaining requisite approvals. The guidelines issued by the Securities and Exchanges Board of India for disclosures and investor protection must be complied with.
- The main sources of **long-term debt** are development finance by the all-India and state financial institutions, who lend mainly for investment in priority sector, and **debentures** (cumulative and non cumulative), which is a capital market instrument. A debt-equity norm of 1.5:1 is generally acceptable. A minimum level of promoter's contribution is also required, which is non-transferable during a lock-in period of 5 years.
- **Medium-term finance** for non-priority sectors is also provided by commercial banks, who also participate with the financial institutions in financing priority sector projects.
- **Foreign currency loans** may also be accessed through lines of credit available to banks and financial institutions.
- **Venture capital finance** is also available now. A few units, mostly in the public sector, have been set up which provide equity/loan support to companies entering high-technology/high-risk areas.

14.3 References and Suggested Further Reading

1. Desai, Vasant Dr. (2004) Management of Small Scale Enterprises New Delhi: Himalaya Publishing House,
2. Gupta, CB, Modern Business Organization: Mayur Paper Backs
3. Lundy, J.L., Effective Industrial Management, New Delhi: Eurasia Publishing House, 1986
4. Taneja, Gupta, Entrepreneur Development New Venture Creation. 2nd ed. Galgotia Publishing Company
5. Business organization-YKBHUSHAN

6. Business Organisation & Management- CR Basu
7. Entrepreneurship Development- New Venture Creation David Holt
8. Student’s Guide to Business Organisation, Dr. Neeru Vashistha,Taxman
9. basiccollegeaccounting.com

LESSON 15 FINANCING INSTITUTIONS

TABLE OF CONTENTS:

15. FINANCING INSTITUTIONS

15.0 Objectives

At the end of this lesson, you will be able to understand and learn about:

- National Financial Institutions.
- Specialized Financial Institutions.
- Investment Institutions.
- State Corporations.
- International Financial Institutions
- Banking in India.

15.1 National Financial Institutions

The major post-independence institutional innovations of relevance to long and medium term finance for the industry can be grouped as below:

i. National Level Industrial Development Banks

- Industrial Development Bank of India (IDBI)
- Industrial Finance Corporation of India (IFCI)
- Industrial Credit and Investment Corpn. of India (ICICI)
- Small Industries Development Bank of India (SIDBI)
- Industrial Reconstruction Bank of India (IRBI)
- Shipping Credit and Investment Company of India (SCICI)

ii. Specialized Financial Institutions

- Technology Development & Information Company of India Limited (TDICI)
- Risk Capital & Technology Finance Corporation Limited (RCTC)
- Tourism Finance Corporation of India (TFCI)

iii. Investment Institutions:

- Unit Trust of India (UTI)
- General Insurance Corporation of India (GIC)
- Life Insurance Corporation of India (LIC)

iv. State Corporations:

- State Industrial Development Corporations
- State Finance Corporations

15.2 Some Examples

1. Industrial Development Bank of India (IDBI)

- The Industrial Development Bank of India Limited commonly known by its acronym IDBI is one of India's leading public sector banks and 4th largest Bank in overall ratings. RBI categorised IDBI as "other public sector bank".It was established in 1964 by an Act of Parliament to provide credit and other facilities for the development of the fledgling Indian industry. It is currently the tenth largest development bank in the world. Some of the institutions built by IDBI are The National Stock Exchange of India (NSE), The National Securities Depository Services Ltd. (NSDL) and the Stock Holding Corporation of India (SHCIL). IDBI BANK as a private bank after government policy for new generation private banks. IDBI initially having confined itself to medium and long- term credit to industry now has expanded its services to include anything a corporate customer would ask for. Already into a wide range of activities in the financial sector, it has also recently started a commercial bank-IDBI Bank.

2. Industrial Finance Corporation of India (IFCI)

IFCI offers a wide range of products to the target customer segments to satisfy their specific financial needs. The product range includes following credit products:

- Short-term Loans (up to two years) for different short term requirements including bridge loan, Corporate Loan etc

- Medium-term Loans (more than two years to eight years) for business expansion, technology up-gradation, R&D expenditure, implementing early retirement scheme, Corporate Loan, supplementing working capital and repaying high cost debt

- Long-term Loans (more than eight years up to 15 years) - Project Finance for new industrial/ infrastructure projects Takeout Finance, acquisition financing (as per extant RBI guidelines / Board approved policy), Corporate Loan, Securitisation of debt

- Structured Products: acquisition finance, pre-IPO investment, IPO finance, promoter funding, etc.
- Lease Financing
- Takeover of accounts from Banks / Financial Institutions / NBFCs
- Financing promoters contribution (private equity participation)/subscription to convertible warrants
- Purchase of Standard Assets and NPAs

The product mix offering varies from one business/ industry segment to another. IFCI customizes the product-mix to maximize customer satisfaction. Its domain knowledge and innovativeness make the product-mix a key differentiator for building enduring and sustaining relationship with the borrowers.

Major activities are lending money with or without security, guarantees, leasing and hire purchase, ware housing, consultancy and merchant banking in and outside India, bill marketing, factoring, custodial services, dealing in foreign exchange and mutual funds.

3. State Financial Corporations (SFCs)

- State Financial Corporations (SFCs), operating at the state-level, form an integral part of the development financing system in the country. They function with the objective of financing and promoting small and medium enterprises for achieving balanced regional socio- economic growth, catalyzing higher investment, generating greater employment opportunities and widening the ownership base of industry.
- At present, there are 18 SFCs in the country.
- SFCs extend financial assistance to industrial units by way of term loans, direct subscription to equity / debenture, guarantees and discounting of bills of exchange.

4. Unit Trust of India

Unit Trust of India was created by the UTI Act passed by the Parliament in 1963.For more than two decades it remained the sole vehicle for investment in the capital market by the Indian citizens. In mid- 80's public sector banks were allowed to open mutual funds

Functions:

(1) Selling and purchasing units;

(2) Investing in, and acquiring, holding or disposal of securities

(3) Granting of loans and advances upon the security of any movable or immovable property or otherwise;

(4) Accepting, collecting, discounting, rediscounting, purchasing, selling or negotiating or otherwise dealing with, any bills of exchange, promissory notes, coupons, drafts, etc.

(5) Purchasing, selling or issuing participation certificates in relation to any loan or advance granted by any public financial institution or scheduled bank

(6) Keeping money on deposit with companies or other corporate bodies, scheduled banks or such other institutions as may be prescribed;

(7) Investing in any special paper or security floated by the Central Government or the Reserve Bank or by any such foreign government or foreign bank as may be prescribed;

(10) Providing leasing and hire purchase finance to persons, companies, and other corporate bodies;

(11) Providing merchant banking and investment advisory services;

(14) Buying or selling of, or entering into such other dealings in, foreign exchange, as may be necessary for the discharge of its functions.

Self-check Questions

Write short notes on:

1. SFCs
2. IDBI
3. IFCI
4. SIDBI

15.3 International Financial Institutions

1. **International Monetary Fund (IMF)**

The IMF supports its membership by providing:

- Policy advice to governments and central banks based on analysis of economic trends and cross-country experiences;

- Research, statistics, forecasts, and analysis based on tracking of global, regional, and individual economies and markets;
- Loans to help countries overcome economic difficulties;
- Concessional loans to fight poverty in developing countries; and
- Technical assistance and training to help countries improve the management of their economies.

The IMF was founded more than 60 years ago toward the end of World War II. The founders aimed to build a framework for economic cooperation that would avoid a repetition of the disastrous economic policies that had contributed to the Great Depression of the 1930s and the global conflict that followed.

Since then the world has changed dramatically, bringing extensive prosperity and lifting millions out of poverty, especially in Asia. In many ways the IMF's main purpose—to provide the global public good of financial stability—is the same today as it was when the organization was established. More specifically, the Fund continues to -

- Provide a forum for cooperation on international monetary problems
- Facilitate the growth of international trade, thus promoting job creation, economic growth, and poverty reduction;
- Promote exchange rate stability and an open system of international payments; and
- Lend countries, foreign exchange when needed, on a temporary basis and under adequate safeguards, to help them address balance of payments problems.

2. World Bank

The World Bank is a vital source of financial and technical assistance to developing countries around the world. It is made up of two unique development institutions owned by 185 member countries—

- The International Bank for Reconstruction and Development (IBRD) and
- The International Development Association (IDA).

Each institution plays a different but collaborative role to advance the vision of an inclusive and sustainable globalization.

The IBRD focuses on middle income and creditworthy poor countries, while IDA focuses on the poorest countries in the world. Together we provide low-interest loans, interest-free credits and grants to developing countries for a wide array of purposes that include investments in education, health, public administration, infrastructure, financial and private sector development, agriculture, and environmental and natural resource management.

WORLD BANK GROUP

The World Bank Group (WBG) is a family of five international organizations responsible for providing finance and advice to countries for the purposes of economic development and eliminating poverty. The Bank came into formal existence on 27 December 1945 following international ratification of the Bretton Woods agreements, which emerged from the United Nations Monetary and Financial Conference (1 July – 22 July 1944). Its five agencies are:

i. International Bank for Reconstruction and Development (IBRD)

ii. International Development Association (IDA)

iii. International Finance Corporation (IFC)

iv. Multilateral Investment Guarantee Agency (MIGA)

v. International Centre for Settlement of Investment Disputes (ICSID)

The term "World Bank" generally refers to the IBRD and IDA, whereas the World Bank Group is used to refer to the institutions collectively.

- The World Bank's (i.e. the IBRD and IDA's) activities are focused on developing countries, in fields such as human development (e.g. education, health), agriculture and rural development (e.g. irrigation, rural services), environmental protection (e.g. pollution reduction, establishing and enforcing regulations), infrastructure (e.g. roads, urban regeneration, electricity), and governance (e.g. anti-corruption, legal institutions development). The IBRD and IDA provide loans at preferential rates to member countries, as well as grants to the poorest countries. Loans or grants for specific projects are often linked to wider policy changes in the sector or the economy. For example, a loan to improve coastal environmental management may be linked to development of new environmental institutions at national and local levels and the implementation of new regulations to limit pollution.

- The activities of the IFC and MIGA include investment in the private sector and providing insurance respectively.

- ICSID works with governments to reduce investment risk.

- The World Bank Institute is the capacity development branch of the World Bank, providing learning and other capacity-building programs to member countries. Two countries, Venezuela and Ecuador, have recently withdrawn from the World Bank.

15.4 Banking in India

Banking in India is controlled by the Reserve Bank of India (RBI). Commercial Banks and Co-operative Banks are the two main categories of banks in the country. Commercial Banks fall into four classes. Public sector banks, Private sector banks, Foreign Banks and Regional rural banks. There are 28 banks in the public sector, comprising of the State Bank of India and its 7 associate banks and the rest are nationalized banks. There are 18 large private sector banks. There are 38 Private sector banks in total and 196 Regional rural banks. The foreign banks number 24.

- The **Public sector banks** account for 90 per cent of the total banking business in India.
- **Foreign banks** numbering 24 with a total of 141 branches specialize in foreign trade and international banking.
- **Co-operative banks** serve mainly the needs of agriculture and allied activities, rural based industries and to a lesser extent, trade and industry in urban centres.

The National Bank for Agriculture and Rural Development (NABARD)

- The National Bank for Agriculture and Rural Development (NABARD), in keeping with its role as an apex institution in the organised rural credit structure provides refinance facilities to various financial intermediaries. NABARD devises suitable policies and operational arrangements, from time to time, in order to vitalize the rural credit delivery system and to augment the flow of credit for rural development.
- NABARD provides finance for seasonal agricultural operations and refinance assistance to Regional Rural Bank for enabling them to conduct their various activities including assistance under minor irrigation, grant of loans under IRDP, dairy development, farm mechanization, etc.
- In so far as commercial banks are concerned, NABARD provides only refinance against the term loans issued by them under schematic landing for agriculture and for certain specific non-agricultural purposes as commercial banks are expected to meet their short term requirements out of their own resources.

Self-check Questions

5. Explain in detail the banking structure in India
6. Discuss the role of NABARD towards rural development.

15.5 References and Suggested Further Reading

1. Desai, Vasant Dr. (2004) Management of Small Scale Enterprises New Delhi: Himalaya Publishing House,
2. Gupta, CB, Modern Business Organization: Mayur Paper Backs
3. Lundy, J.L., Effective Industrial Management, New Delhi: Eurasia Publishing House, 1986
4. Taneja, Gupta, Entrepreneur Development New Venture Creation. 2nd ed. Galgotia Publishing Company
5. Business organization-YKBHUSHAN
6. Business Organisation & Management- CR Basu
7. Entrepreneurship Development- New Venture Creation David Holt
8. Student;s Guide to Business Organisation, Dr. Neeru Vashistha,Taxman
9. indiadays.com
10. en.wikipedia.org
11. finmin.nic.in