UNIT-I- FINANCIAL MANAGEMENT

Financial Management Meaning

Financial Management is to plan, organize and govern all the financial activities of a company. It applies management ethics to the financial resources of a company. This practice controls all the economic operations of an enterprise like utilization of funds, procurement of funds, payment, accounting, risk assessment and everything related to the cash.

Financial Management Definition

"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**

Nature of Financial Management

- It is an indispensable organ of business management.
- Its function is different from accounting function.
- It is a centralized function.

- Helpful in decisions of top management.
- It applicable to all types of concerns.
- It needs financial planning, control and follow-up.
- It related with different disciplines like economics, accounting, law, information technology, mathematics and so on

OBJECTIVES OF FINANACIAL MANAGEMENT

The primary objective of financial management is to maximize shareholder's wealth by maximizing the current market value of equity share.

(a) Maximize shareholder's wealth

- This is the primary objective of financial management, which is also known as "the wealth maximization concept".
- This means to maximize the current market value of equity shares of the company, which is only possible if there is optimum utilization of funds to achieve organizational objectives.
- Shareholder's wealth can be calculated as;

The number of equity shares held by a shareholder X Current market value of each share.

(b) Procurement of sufficient funds at the lowest possible costs

- Funds must be procured at the lowest possible cost.
- The company should try to minimize the cost involved in the procurement of funds.
- Cost of capital is a very important parameter in deciding long term success of the financial plan.

(c) Optimum utilization of acquired funds

- The major challenge in front of an enterprise is to ensure that the returns must exceed the costs.

- This objective ensures that available funds are utilized effectively and efficiently.

(d) Ensure safety of investment

- A good financial decision is focused on the safety of the investment.
- The companies have to build their reserves of funds and maintain them.
- The money acquired should be invested judiciously to get the maximum return on investment.

(e) To achieve a sound capital structure

- A proper mix of equity and debt should be maintained so that there are a sound and fair composition of capital.

Roles of Financial Management

Financial management governs all the financial activities of a company. A few key roles are mentioned below:

- **Bookkeeping and Accounting**:
    - It is essential to identify, take appropriate measures and record all the financial details of a company. Whatever funds are debited or credited from a company's account, the financial management efficient accounting system gives an overview. Also, the bookkeeping records the everyday transaction of a company and forms a base for the accounting system.
- **Reporting**:
    - Most of the stakeholders depend on the organization's financial statement before making any decision. The finance team shares a financial report to its shareholders regularly. Depending on the report, the shareholder forecast on when to buy or sell the stock. So, the accuracy of the financial data is essential to make a decision.
- **Receivables and Payables**:

- Managing what your company owes to the vendors and what the customer owes to the company is essential. It gives a clear view of how much liquid cash a company should have in all time.

- **Investment Opportunities**:
  - The Financial report gives the opportunity to invest in the right stock and at the right time. Only after seeing the financial status, an organization can leverage the correct openings.
- **Risk**:
  - A robust financial management system is mandatory to maximize the profit and minimize the risk and liabilities. An efficient financial team should incorporate sufficient insurance to all the essential elements of a company.

Scope and Importance of Financial Management

- Estimating the total requirements of funds for a given period.
- Raising funds through various sources, both national and international, keeping in mind the cost effectiveness;
- Investing the funds in both long term as well as short term capital needs;
- Funding day-to-day working capital requirements of business;
- Collecting on time from debtors and paying to creditors on time;
- Managing funds and treasury operations; • Ensuring a satisfactory return to all the stake holders;
- Paying interest on borrowings;
- Repaying lenders on due dates;
- Maximizing the wealth of the shareholders over the long term;
- Interfacing with the capital markets;
- Awareness to all the latest developments in the financial markets;
- Increasing the firm‘s competitive financial strength in the market; and
- Adhering to the requirements of corporate governance.

FINANCE FUNCTION

Finance function has been classified into three:

- **Long-Term Finance**– This includes finance of investment 3 years or more. Sources of long-term finance include owner capital, share capital, long-term loans, debentures, internal funds and so on.
- **Medium Term Finance**– This is financing done between 1 to 3 years, this can be sourced from bank loans and financial institutions.
- **Short Term Finance** – This is finance needed below one year. Funds may be acquired from bank overdrafts, commercial paper, advances from customers, trade credit etc.

Objectives of Finance Functions

- **Investment Decisions**– This is where the finance manager decides where to put the company funds. Investment decisions relating to the management of working capital, capital budgeting decisions, management of mergers, buying or leasing of assets. Investment decisions should create revenue, profits and save costs.
- **Financing Decisions**– Here a company decides where to raise funds from. They are two main sources to consider mainly equity and borrowed. From the two a decision on the appropriate mix of short and long-term financing should be made. The sources of financing best at a given time should also be agreed upon.
- **Dividend Decisions**– These are decisions as to how much, how frequent and in what form to return cash to owners. A balance between profits retained and the amount paid out as dividends should be decided here.

- **Liquidity Decisions**– Liquidity means that a firm has enough money to pay its bills when they are due and have sufficient cash reserves to meet unforeseen emergencies. This decision involves the management of the current assets so you don't become insolvent or fail to make payments.

Needs of Finance Functions

- **Helps Establish Business**– Without money, you cannot get labor, land and so on with the finance function you can determine what is required to start your business and plan for it.
- **Helps Run a Business**– To remain in business you must cater to the day to day operating costs such as paying salaries, buying stationery, raw material, the finance function ensures you always have adequate funds to cater to this.
- **To Expand, Modernize, Diversify**– A business needs to grow otherwise it may become redundant in no time. With the finance function, you can determine and acquire the funds required to do so.
- **Purchase Assets**-You need money to purchase assets. This can be tangible assets like furniture, buildings or intangible like trademarks, patents, etc. to get this you need finances.

Importance of Finance Functions

- **Identify Need of Finance**-To starts a business you need to know how much is required to open it. So, the finance function helps you know how much the initial capital is, how much of it you have and how much you need to raise.
- **Identify Sources of Finance**-Once you know what needs to be raised you look at areas you can raise these funds from. You can borrow or get from various shareholders.

- **Comparison of Various Sources of Finance**– After identifying various fund sources compare the cost and risk involved. Then choose the best source of financing that suits your business needs.
- **Investment**-Once the funds are raised it is time to invest them. Investment decisions should be done in a manner that a business gets higher returns. Cost of funds procurement should be lower than the return on investment, this will show a wise investment was made.

The Finance Function Involves

- Ensure enough funds at a reasonable cost.
- Ensure the safety of funds.
- Ensure efficient effective and profitable utilization of funds.
- Ensure that finance funds don’t remain idle.

FINANCIAL MANAGEMENT WITH OTHER FUNCTIONAL AREAS

1. **Financial Management and Production Department:**

   The financial management and the production department are interrelated. The production department of any firm is concerned with the production cycle, skilled and unskilled labour, storage of finished goods, capacity utilisation, etc. and the cost of production assumes a substantial portion of the total cost. The production department has to take various decisions like replacing machinery, installation of safety devices, etc. and all the decisions have financial implications.

2. **Financial Management and Material Department:**

   Financial management and the material department are also interrelated. Material department covers the areas such as storage, maintenance and supply of materials and stores, procurement etc. The finance manager and material manager in a firm may come together while determining Economic Order Quantity, safety level, storing place requirement, stores personnel requirement, etc. The costs of all these aspects are to be evaluated so the finance manager may come forward to help the material manager.

3. **Financial Management and Personnel Department:**

   The personnel department is entrusted with the responsibility of recruitment, training and placement of the staff. This department is also concerned with the welfare of the employees and their families. This department works with finance manager to evaluate employees' welfare, revision of their pay scale, incentive schemes, etc.

4. **Financial Management and Marketing Department:**

   The marketing department is concerned with the selling of goods and services to the customers. It is entrusted with framing marketing, selling, advertising and other related policies to achieve the sales target. It is also required to frame policies to maintain and increase the market share, to create a brand name etc. For all this finance is required, so the finance manager has to play an active role for interacting with the marketing department.

FINANCIAL ORGANISATION / FINANCIAL INSTITUTION

Financial organization - **an institution (public or private) that collects funds** (from the public or other institutions) and invests them in financial assets.

Financial Institutions are referred to as a company that deals in all types of finance-related businesses. They are different from banks and play a very important part in broadening the financial services in the country. They provide a very attractive rate of returns to the customers in comparison to any government-centric banks. It deals in loans and advances and also specializes in some specified sectors like hire purchases and leasing etc.

Meaning :

The financial institution deals with finance-related services. These are gaining popularity day by day nowadays. The attractive rate of returns on the customer's investment is very demanding. It also provides specialized services like hire purchase and leasing, etc. The simple and organized procedure of the institutions is becoming very complementary. It provides a broad range of business opportunities. There are different types of financial institutions. The goal of all the institutions is different and they provide different services and have different levels of risk associated with it. All the financial institutions have unique features and it works in a specialized way. The financial institution is gaining immense popularity in broadening the finance-related services in the country.

Role of Financial Institutions

- The financial institution provides varied kinds of financial services to the customers.
- The financial institution provides an attractive rate of return to the customers.
- Promotes the direct investment by the customers and making them understand the risk associated with that as well.
- It helps in forming the liquidity of the stock in case of an emergency in the financial markets.

Features

- It provides a high rate of return to the customers who have invested in the financial institution.
- It reduces the cost of financial services provided.
- It is considered very important for the development of financial services in the country.
- It also advises the customers on how to deal with the equity and the other securities bought and sold in the market.
- It helps to improvise decision making because it follows a systematic approach to calculate all the risks and rewards.

Functions of Financial Institution

Financial institutions work like banks in some ways. They give loans and advances to the customers and also set a platform for the customers to do some investments. The customers get exciting offers and returns from them and therefore these institutions are gaining popularity. It also provides consultancy services to the clients on their investments related to the financial markets where the huge amount of risk is involved. Moreover, the customers who are handing over their hard-earned monies to such institutions should check for the history and origin of this financial institution.

Types of Financial Institutions

- Investment Banks
- Commercial Banks
- Internet Banks
- Retail Banking
- Insurance companies
- Mortgage companies.

Functions

- The financial institutions provide loans and advances to the customers.
- The rate of return is very high in case of investment made in this type of institution.
- It also gives a high rated consultancy to the customers for their beneficial investments.
- It also serves as a depository for their customers.
- It can also make an effort to minimize the monitoring cost of the company.
- All the finance related work is done by the financial institution or on behalf of the customers.

Financial Institutions vs Banks

- The functions of payments of various services are done by the bank but the financial institutions will not be able to do so.
- It cannot accept the demand deposit whereas the banks can accept the demand deposit by the customers.
- Banks provide the guarantee of repayment of the deposit whereas the financial institutions may fail to do so.

Advantages and Disadvantages

Below are the advantages and disadvantages:

Advantages

- The financial institutions help in the upliftment of the economies of our country.
- It has been proved to be more successful in terms of return earned by the customers since the rate of return is higher compared to any other place.
- It is also a smart way to invest money and keep the money rotated in the finance market.
- It provides financial services to the customers.
- The repayment facility is also very well managed in the financial institutions.
- It also provides underwriting facilities.

Disadvantages

- The process is very complex for some customers because they try to indulge in various businesses and end up making confusion for themselves.
- In case of default done by the management of the financial institutions, the customers will have to face major worse circumstances. The money which they have invested may not be recovered. Sometimes the principal amount is not assured to be recovered because the government in case of default announces a certain sum of money which will be repaid

and most of the time the amount of government declares to be repaid is very less in comparison to the principal amount of the investment made.

Conclusion

The financial institutions provide the best way to invest the money and to earn good returns from that investment. It tries to help our nation in building up economies. They provide a very unique and advanced way to keep the money safe. The customers should also understand that the institutions also carry some risk factors associated with their services. The customers should very carefully understand the policies of the institutions and should check the Non-performing Asset of the company before investing their money in the financial institutions. The default in the case is a panic situation because the repayment can be very tough in that situation.

Recommended Articles

This is a guide to Financial Institution. Here we discuss the explanation, types, function, roles, features, with advantages and disadvantages. You can also go through our other related articles to learn more –

1. Financing Formula
2. Financial Risk
3. Financial Analysis Example
4. Financial Leverage

ROLE OF FINANCIAL MANAGER

A financial manager is a person who takes care of all the important financial functions of an organization. The person in charge should maintain a far sightedness in order to ensure that the funds are utilized in the most efficient manner. His actions directly affect the Profitability, growth and goodwill of the firm.

Following are the main functions of a Financial Manager:

1. Raising of Funds

In order to meet the obligation of the business it is important to have enough cash and liquidity. A firm can raise funds by the way of equity and debt. It is the responsibility of a financial manager to decide the ratio between debt and equity. It is important to maintain a good balance between equity and debt.

2. Allocation of Funds

Once the funds are raised through different channels the next important function is to allocate the funds. The funds should be allocated in such a manner that they are optimally used. In order to allocate funds in the best possible manner the following point must be considered

- The size of the firm and its growth capability
- Status of assets whether they are long-term or short-term
- Mode by which the funds are raised

These financial decisions directly and indirectly influence other managerial activities. Hence formation of a good asset mix and proper allocation of funds is one of the most important activities

3. Profit Planning

Profit earning is one of the prime functions of any business organization. Profit earning is important for survival and sustenance of any organization. Profit planning refers to proper usage of the profit generated by the firm.

Profit arises due to many factors such as pricing, industry competition, state of the economy, mechanism of demand and supply, cost and output. A healthy mix of variable and fixed factors of production can lead to an increase in the profitability of the firm.

Fixed costs are incurred by the use of fixed factors of production such as land and machinery. In order to maintain a tandem it is important to continuously value the depreciation cost of fixed cost of production. An opportunity cost must be calculated in order to replace those factors of production which has gone thrown wear and tear. If this is not noted then these fixed cost can cause huge fluctuations in profit.

4. **Understanding Capital Markets**

Shares of a company are traded on stock exchange and there is a continuous sale and purchase of securities. Hence a clear understanding of capital market is an important function of a financial manager. When securities are traded on stock market there involves a huge amount of risk involved. Therefore a financial manger understands and calculates the risk involved in this trading of shares and debentures.

It’s on the discretion of a financial manager as to how to distribute the profits. Many investors do not like the firm to distribute the profits amongst share holders as dividend instead invest in the business itself to enhance growth. The practices of a financial manager directly impact the operation in capital market.

Financial Planning and Control Definition

Financial planning and control defines as a combination of strategies it supports the entire **financial management** process for an organization. The process begins at financial planning, many times in the form of cash flow and forecasting **balance sheet**.

This information will be use of various reasons, in order to calculate your business ratios and financial indicators as a basis for the calculation otherwise in order to illustrate risk calculation or repayment purposes. Financial planning and control definition by different authors are:

In accordance to Ekweueme P. "Finance is that art as well as science of managing money, its concerned with each process, market, organizations and instrument involved in transfer of cash among as well as in between government and business."

Financial Planning and Control Process Flow Chart

Here we have presented an ideal financial planning and control process flow chart which a financial manager should undergo with. Typically, financial planning and control process flow goes through following steps:

- **Listening**: Focusing towards goals, desires and dreams of a company.
- **Analysis Information**: To perform data analysis for prepare a plan.
- **Planning**: Create a plan which will best suit for your client requirements.
- **Implementation**: Design strategies, methods and implementation of investment plan for a company.
- **Control & Monitoring**: Keep periodically check whether the designed techniques worked well for an organization or need further improvements.

Importance of Financial Planning and Control

One field that requires increased attention and understanding is precautionary financial planning and controlling processes. Many entrust their administrative as well as sinking fund money towards financial managers along with little or no investigation into the way regarding how financial supervisor handles financial planning and controlling internally. Here are listed out some of the key importance of financial planning and control within a management of an organization. They are:

Segregation of Tasks and Duties

When dividing responsibilities anywhere between people increases the risk of protection against errors, fraud, oversights, etc. For example, if someone reports cash received as well as then you check bank statements, it becomes smoother towards detect dishonesty. Segregation of tasks and duties is among the importance of financial planning and control for robust environment.

Qualification of Advisors and Employee

An organization must promise that your financial managers and advisory team are enough competent. Also they should be properly trained with their task for financial planning and control of an organization.

External Audits and Review

Certain organizations have always been legislatively forced to need audits prepared every year, other companies have a concern for performing external reviews and external audits.

Often those who have concerns regarding not to have externally audits performed. It is seriously advised to those who have concerns should discourage their thoughts. Provided costs are an issue, then maybe you can choose to go for external audit at least once in three years.

BREAK EVEN ANALYSIS

A break-even analysis is an economic tool that is used to determine the cost structure of a company or the number of units that need to be sold to cover the cost. Break-even is a circumstance where a company neither makes a profit nor loss but recovers all the money spent.

The break-even analysis is used to examine the relation between the fixed cost, variable cost, and revenue. Usually, an organisation with a low fixed cost will have a low break-even point of sale.

Importance of Break-Even Analysis

- **Manages the size of units to be sold:** With the help of break-even analysis, the company or the owner comes to know how many units need to be sold to cover the cost. The variable cost and the selling price of an individual product and the total cost are required to evaluate the break-even analysis.
- **Budgeting and setting targets:** Since the company or the owner knows at which point a company can break-even, it is easy for them to fix a goal and set a budget for the firm accordingly. This analysis can also be practised in establishing a realistic target for a company.
- **Manage the margin of safety:** In a financial breakdown, the sales of a company tend to decrease. The break-even analysis helps the company to decide the least number of sales required to make profits. With the margin of safety reports, the management can execute a high business decision.
- **Monitors and controls cost:** Companies' profit margin can be affected by the fixed and variable cost. Therefore, with break-even analysis, the management can detect if any effects are changing the cost.
- **Helps to design pricing strategy: The** break-even point can be affected if there is any change in the pricing of a product. For example, if the selling price is raised, then the quantity of the product to be sold to break-even will be reduced. Similarly, if the selling price is reduced, then a company needs to sell extra to break-even.

Components of Break-Even Analysis

- **Fixed costs:** These costs are also known as overhead costs. These costs materialise once the financial activity of a business starts. The fixed prices include taxes, salaries, rents, depreciation cost, labour cost, interests, energy cost, etc.
- **Variable costs:** These costs fluctuate and will decrease or increase according to the volume of the production. These costs include packaging cost, cost of raw material, fuel, and other materials related to production.

Uses of Break-Even Analysis

- **New business:** For a new venture, a break-even analysis is essential. It guides the management with pricing strategy and is practical about the cost. This analysis also gives an idea if the new business is productive.
- **Manufacture new products:** If an existing company is going to launch a new product, then they still have to focus on a break-even analysis before starting and see if the product adds necessary expenditure to the company.
- **Change in business model: The** break-even analysis works even if there is a change in any business model like shifting from retail business to wholesale business. This analysis will help the company to determine if the selling price of a product needs to change.

Break-Even Analysis Formula

Break-even point = Fixed cost/-Price per cost – Variable cost

Example of break-even analysis

Company X sells a pen. The company first determined the fixed costs, which include a lease, property tax, and salaries. They sum up to ₹1,00,000. The variable cost linked with manufacturing one pen is ₹2 per unit. So, the pen is sold at a premium price of ₹10.

Therefore, to determine the break-even point of Company X, the premium pen will be:

Break-even point = Fixed cost/Price per cost – Variable cost

= ₹1,00,000/(₹12 – ₹2)

= 1,00,000/10

= 10,000

Therefore, given the variable costs, fixed costs, and selling price of the pen, company X would need to sell 10,000 units of pens to break-even.

LEVERAGE

Meaning of Leverage:

The word 'leverage', borrowed from physics, is frequently used in financial management.

The object of application of which is made to gain higher financial benefits compared to the fixed charges payable, as it happens in physics i.e., gaining larger benefits by using lesser amount of force.

The term 'leverage' is used to describe the ability of a firm to use fixed cost assets or funds to increase the return to its equity shareholders. In other words, leverage is the employment of fixed assets or funds for which a firm has to meet fixed costs or fixed rate of interest obligation—irrespective of the level of activities attained, or the level of operating profit earned.

Leverage occurs in varying degrees. The higher the degree of leverage, the higher is the risk involved in meeting fixed payment obligations i.e., operating fixed costs and cost of debt capital. But, at the same time, higher risk profile increases the possibility of higher rate of return to the shareholders.

Definition of Leverage :-

James Horne has defined leverage as, "the employment of an asset or fund for which the firm pays a fixed cost or fixed return.

According to J. C. Van Home:

"Leverage is the employment of an asset or funds for which the firm pays a fixed cost of fixed return."

TYPES OF LEVERAGES

Leverage can be classified into

1. Operating leverage
2. Financial leverage and
3. Combined leverage

OPERATING LEVERAGE

Operating leverage refers to the use of fixed operating costs such as depreciation, insurance of assets, repairs and maintenance, property taxes etc. in the operations of a firm. But it does not include interest on debt capital. Higher the proportion of fixed operating cost as compared to variable cost, higher is the operating leverage, and vice versa.

Operating leverage may be defined as the "firm's ability to use fixed operating cost to magnify effects of changes in sales on its earnings before interest and taxes."

In practice, a firm will have three types of cost via:

(i) Variable cost that tends to vary in direct proportion to the change in the volume of activity,

(ii) Fixed costs which tend to remain fixed irrespective of variations in the volume of activity within a relevant range and during a defined period of time,

(iii) Semi-variable or Semi-fixed costs which are partly fixed and partly variable. They can be segregated into variable and fixed elements and included in the respective group of costs.

Operating leverage occurs when a firm incurs fixed costs which are to be recovered out of sales revenue irrespective of the volume of business in a period. In a firm having fixed costs in the total cost structure, a given change in sales will result in a disproportionate change in the operating profit or EBIT of the firm.

If there is no fixed cost in the total cost structure, then the firm will not have an operating leverage. In that case, the operating profit or EBIT varies in direct proportion to the changes in sales volume.

Operating leverage is associated with operating risk or business risk. The higher the fixed operating costs, the higher the firm's operating leverage and its operating risk. Operating risk is the degree of uncertainty that the firm has faced in meeting its fixed operating cost where there is variability of EBIT.

It arises when there is volatility in earnings of a firm due to changes in demand, supply, economic environment, business conditions etc. The larger the magnitude of operating leverage, the larger is the volume of sales required to cover all fixed costs.

Illustration 1:

A firm sells its product for Rs. 5 per unit, has variable operating cost of Rs. 3 per unit and fixed operating costs of Rs. 10,000 per year. Its current level of sales is 20,000 units. What will be the impact on profit if (a) Sales increase by 25% and (b) decrease by 25%?

Solution :

Particulars	Present	Expected (+ 25%)	Expected (–25%)
Sales (in units)	20,000	25,000	15,000
	Rs.	Rs.	Rs.
Sales revenues	1,00,000	1,25,000	75,000
Less : Variable operating cost	60,000	75,000	45,000
Contribution	40,000	50,000	30,000
Less : Fixed operating cost	10,000	10,000	10,000
Operating profit (EBIT)	30,000	40,000	20,000
Changes in sales	—	(+) 25,000	(–) 25,000
Changes in operating profit		(+) 10,000	(–) 10,000
Percentage changes in operating profit		$(+)\frac{10,000}{30,000}\times 100$	$(-)\frac{10,000}{30,000}\times 100$
		$= (+)\, 33\frac{1}{3}\%$	$= (-)\, 33\frac{1}{3}\%$

(a) A 25% increase in sales (from 20,000 units to 25,000 units) results in a 33 1/3% increase in EBIT (from Rs. 30,000 to Rs. 40,000).

(b) A 25% decrease in sales (from 20,000 units to 15,000 units) results in a 33 1/3% decrease in EBIT (from Rs. 30,000 to Rs. 20,000).

The above illustration clearly shows that when a firm has fixed operating costs an increase in sales volume results in a more than proportionate increase in EBIT. Similarly, a decrease in the level of sales has an exactly opposite effect. The former operating leverage is known as favourable leverage, while the latter is known as unfavourable.

Degree of Operating Leverage:

The earnings before interest and taxes (i.e., EBIT) changes with increase or decrease in the sales volume. Operating leverage is used to measure the effect of variation in sales volume on the level of EBIT.

The formula used to compute operating leverage is:

$$\text{Operating Leverage} = \frac{\%\text{ change in EBIT}}{\%\text{ change in sales}} = \frac{\dfrac{\text{Increse in EBIT}}{\text{EBIT}}}{\dfrac{\text{Increase in sales}}{\text{Sales}}}$$

The operating leverage at any volume of sales is defined as its degree. The degree of operating leverage is computed by dividing contribution by EBIT.

$$\text{Degree of operating leverage} = \frac{\text{Contribution}}{\text{EBIT}}$$

Here, contribution = Sales – Variable cost
EBIT = Sales – Variable cost – Fixed cost

A high degree of operating leverage is welcome when sales are rising i.e., favourable market conditions, and it is undesirable when sales are falling. Because, higher degree of operating leverage means a relatively high operating fixed cost for recovering which a larger volume of sales is required.

The degree of operating leverage is also obtained by using the following formula:
Degree of operating leverage (DOL) = Percentage change in EBIT / Percentage Change in Units Sold

The value of degree of operating leverage must be greater than 1. If the value is equal to 1 then there is no operating leverage.

Importance of Operating Leverage:
1. It gives an idea about the impact of changes in sales on the operating income of the firm.

2. High degree of operating leverage magnifies the effect on EBIT for a small change in the sales volume.

3. High degree of operating leverage indicates increase in operating profit or EBIT.

4. High operating leverage results from the existence of a higher amount of fixed costs in the total cost structure of a firm which makes the margin of safety low.

5. High operating leverage indicates higher amount of sales required to reach break-even point.

6. Higher fixed operating cost in the total cost structure of a firm promotes higher operating leverage and its operating risk.

7. A lower operating leverage gives enough cushions to the firm by providing a high margin of safety against variation in sales.

8. Proper analysis of operating leverage of a firm is useful to the finance manager.

2. Financial Leverage:

Financial leverage is primarily concerned with the financial activities which involve raising of funds from the sources for which a firm has to bear fixed charges such as interest expenses, loan fees etc. These sources include long-term debt (i.e., debentures, bonds etc.) and preference share capital.

Long term debt capital carries a contractual fixed rate of interest and its payment is obligatory irrespective of the fact whether the firm earns a profit or not.

As debt providers have prior claim on income and assets of a firm over equity shareholders, their rate of interest is generally lower than the expected return in equity shareholders. Further, interest on debt capital isa tax deductible expense.

These two facts lead to the magnification of the rate of return on equity share capital and hence earnings per share. Thus, the effect of changes in operating profits or EBIT on the earnings per share is shown by the financial leverage.

According to Gitman financial leverage is “the ability of a firm to use fixed financial charges to magnify the effects of changes in EBIT on firm’s earnings per share”. In other words, financial leverage involves the use of funds obtained at a fixed cost in the hope of increasing the return to the equity shareholders.

Favourable or positive financial leverage occurs when a firm earns more on the assets/ investment purchased with the funds, than the fixed cost of their use. Unfavourable or negative leverage occurs when the firm does not earn as much as the funds cost.

Thus shareholders gain where the firm earns a higher rate of return and pays a lower rate of return to the supplier of long-term funds. The difference between the earnings from the assets and the fixed cost on the use of funds goes to the equity shareholders. Financial leverage is also, therefore, called as 'trading on equity'.

Financial leverage is associated with financial risk. Financial risk refers to risk of the firm not being able to cover its fixed financial costs due to variation in EBIT. With the increase in financial charges, the firm is also required to raise the level of EBIT necessary to meet financial charges. If the firm cannot cover these financial payments it can be technically forced into liquidation.

Illustration 2:

One-up Ltd. has Equity Share Capital of Rs. 5,00,000 divided into shares of Rs. 100 each. It wishes to raise further Rs. 3,00,000 for expansion-cum-modernisation scheme.

The company plans the following financing alternatives:

(i) By issuing Equity Shares only.

(ii) Rs. 1,00,000 by issuing Equity Shares and Rs. 2,00,000 through Debentures @ 10% per annum.

(iii) By issuing Debentures only at 10% per annum.

(iv) Rs. 1,00,000 by issuing Equity Shares and Rs. 2,00,000 by issuing 8% Preference Shares.

You are required to suggest the best alternative giving your comment assuming that the estimated earnings before interest and taxes (EBIT) after expansion is Rs. 1,50,000 and corporate rate of tax is 35%.

Solution :

Computation of Earnings per share under alternative Financing Plans

Particulars	Plan I	Plan II	Plan III	Plan IV
	Rs.	Rs.	Rs.	Rs.
Existing Equity Shares of Rs. 100 each	5,00,000	5,00,000	5,00,000	5,00,000
New Equity Shares of Rs. 100 each	3,00,000	1,00,000	—	1,00,000
8% Preference shares	—	—	—	2,00,000
10% Debentures	—	2,00,000	3,00,000	—
Capital Structure	8,00,000	8,00,000	8,00,000	8,00,000
Earnings before Interest & Taxes (EBIT)	1,50,000	1,50,000	1,50,000	1,50,000
Less : Interest on Debenture	—	20,000	30,000	—
Earning before tax (EBT)	1,50,000	1,30,000	1,20,000	1,50,000
Less : Income tax @ 35%	52,500	45,500	42,000	52,500
Earning after tax (EAT)	97,500	84,500	78,000	97,500
Less : Preference dividend @ 8%	—	—	—	16,000
Earning available to Equity Shareholders	97,500	84,500	78,000	81,500
Number of Equity Shares	8,000	6,000	5,000	6,000
Earnings per share (EPS)	$\frac{97,500}{8,000}$	$\frac{84,500}{6,000}$	$\frac{78,000}{5,000}$	$\frac{81,500}{6,000}$
	= Rs. 12.19	= Rs. 14.08	= Rs. 15.60	Rs.=13.58

In the above example, we have taken operating profit (EBIT = Rs. 1,50,000) constant for alternative financing plans. It shows that earnings per share (EPS) increases with the increase in the proportion of debt capital (debenture) to total capital employed by the firm, the firm's EBIT level taken as constant.

Financing Plan I does not use debt capital and, hence, Earning per share is low. Financing Plan III, which involves 62.5% ordinary shares and 37.5% debenture, is the most favourable with respect to EPS (Rs. 15.60). The difference in Financing Plans II and IV is due to the fact that the interest on debt is tax-deductible while the dividend on preference shares is not.

Hence, financing alternative III should be accepted as the most profitable mix of debt and equity by One-up Ltd. Company.

Degree of Financing Leverage:

Financing leverage is a measure of changes in operating profit or EBIT on the levels of earning per share.

It is computed as:

Financial leverage = Percentage change in EPS / Percentage change in EBIT = Increase in EPS / EPS / Increase in EBIT/EBIT

The financial leverage at any level of EBIT is called its degree. It is computed as ratio of EBIT to the profit before tax (EBT).

Degree of Financial leverage (DFL) = EBIT / EBT

The value of degree of financial leverage must be greater than 1. If the value of degree of financial leverage is 1, then there will be no financial leverage. The higher the proportion of debt capital to the total capital employed by a firm, the higher is the degree of financial leverage and vice versa.

Again, the higher the degree of financial leverage, the greater is the financial risk associated, and vice versa. Under favorable market conditions (when EBIT may increase) a firm having high degree of financial leverage will be in a better position to increase the return on equity or earning per share.

Importance of Financial Leverage:

The financial leverage shows the effect of changes in EBIT on the earnings per share. So it plays a vital role in financing decision of a firm with the objective of maximizing the owner’s wealth.

The importance of financial leverage:

1. It helps the financial manager to design an optimum capital structure. The optimum capital structure implies that combination of debt and equity at which overall cost of capital is minimum and value of the firm is maximum.

2. It increases earning per share (EPS) as well as financial risk.

3. A high financial leverage indicates existence of high financial fixed costs and high financial risk.

4. It helps to bring balance between financial risk and return in the capital structure.

5. It shows the excess on return on investment over the fixed cost on the use of the funds.

6. It is an important tool in the hands of the finance manager while determining the amount of debt in the capital structure of the firm.

3. Combined Leverage:

Operating leverage shows the operating risk and is measured by the percentage change in EBIT due to percentage change in sales. The financial leverage shows the financial risk and is measured by the percentage change in EPS due to percentage change in EBIT.

Both operating and financial leverages are closely concerned with ascertaining the firm's ability to cover fixed costs or fixed rate of interest obligation, if we combine them, the result is total leverage and the risk associated with combined leverage is known as total risk. It measures the effect of a percentage change in sales on percentage change in EPS.

Degree of Combined Leverage:

The combined leverage can be measured with the help of the following formula:

Combined Leverage = Operating leverage x Financial leverage

$$= \frac{\%\text{ Change in EBIT}}{\%\text{ Change in sales}} \times \frac{\%\text{ Change in EPS}}{\%\text{ Change in EBIT}} = \frac{\%\text{ Change in EPS}}{\%\text{ Change in sales}}$$

The degree of combined leverage is measured by using the following formula :

Degree of Combined Leverage (DCL) = DOL × DFL

$$= \frac{\%\text{ Change in EBIT}}{\%\text{ Change in sales}} \times \frac{\%\text{ Change in EPS}}{\%\text{ Change in EBIT}} = \frac{\%\text{ Change in EPS}}{\%\text{ Change in sales}}$$

Or, alternatively, at any given level

$$\text{DCL} = \text{DOL} \times \text{DFL}$$

$$= \frac{\text{Contribution}}{\text{EBIT}} \times \frac{\text{EBIT}}{\text{EBT}} = \frac{\text{Contribution}}{\text{EBT}}$$

The combined leverage may be favorable or unfavorable. It will be favorable if sales increase and unfavorable when sales decrease. This is because changes in sales will result in more than proportional returns in the form of EPS. As a general rule, a firm having a high degree of operating leverage should have low financial leverage by preferring equity financing, and vice versa by preferring debt financing.

If a firm has both the leverages at a high level, it will be very risky proposition. Therefore, if a firm has a high degree of operating leverage the financial leverage should be kept low as proper balancing between the two leverages is essential in order to keep the risk profile within a reasonable limit and maximum return to shareholders.

Importance of Combined Leverage:

The importance of combined leverage are:

It indicates the effect that changes in sales will have on EPS.

2. It shows the combined effect of operating leverage and financial leverage.

3. A combination of high operating leverage and a high financial leverage is very risky situation because the combined effect of the two leverages is a multiple of these two leverages.

4. A combination of high operating leverage and a low financial leverage indicates that the management should be careful as the high risk involved in the former is balanced by the later.

5. A combination of low operating leverage and a high financial leverage gives a better situation for maximizing return and minimizing risk factor, because keeping the operating leverage at low rate full advantage of debt financing can be taken to maximize return. In this situation the firm reaches its BEP at a low level of sales with minimum business risk.

6. A combination of low operating leverage and low financial leverage indicates that the firm losses profitable opportunities.

UNIT –II WORKING CAPITAL MANAGEMENT

MEANING

Working capital is defined as the excess of current assets over current liabilities. It forms a part of the aggregate capital of the business. Now, a business needs working capital to fund its short term obligations. Typically, firms with an optimum level of working capital indicate efficiency in managing its operations. This further enables the firm to pay for its short-term dues and day-to-day operational expenses.

Therefore, working capital is a measure of business' liquidity position, operational efficiency, and short-term financial soundness.

Hence, working capital can be put into the following equation:

Working Capital = Current Assets – Current Liabilities

So, let's have a look at what forms current assets and current liabilities of a business in order to understand the above equation.

Current Assets

Current Assets are the assets of the business that can be easily converted into cash within a year or normal operating cycle of the business, whichever is greater. These assets typically include:

- Cash and cash equivalents
- Inventory
- Accounts Receivable
- Marketable Securities
- Prepaid Expenses
- Other Liquid Assets

Current Liabilities

Current Liabilities are the obligations of the business that are due within one operating cycle or a year, whichever is greater. Such liabilities are paid off by either using the current assets of the business or by creating other current liabilities.

Therefore, Current Liabilities include:

- Accounts Payable
- Notes Payable
- Current Portion of Long Term Debt
- Accrued Liabilities
- Unearned Revenues

Types of Working Capital

Depending upon the Periodicity & concept working capital can be classified as below:

- **Permanent Working Capital**
- **Regular Working Capital**
- **Reserve Margin Working Capital**
- **Variable Working Capital**
- **Seasonal Variable Working Capital**
- **Special Variable Working Capital**
- **Gross Working Capital**

- **Net Working Capital**

Permanent Working Capital

It is that portion of the working capital that remains permanently tied up in current assets to undertake business activity uninterruptedly. In other words, permanent working capital is the least amount of current assets needed to carry out business effortlessly. Thus, it is also known as fixed working capital.

The amount of fixed working capital required by a business depends upon the size and the growth of the business. For instance, minimum cash or stock required by a firm to undertake the operational activities of the business. Now, permanent working capital can be further subdivided into two categories:

Regular Working Capital

This is defined as the least amount of capital required by a business to fund its day-to-day operations of a business. Examples include payment of salaries and wages and overhead expenses for the processing of raw materials.

Reserve Margin Working Capital

Apart from day-to-day activities, a business may need some amount of capital for unforeseen circumstances. Reserve Margin Working Capital is nothing but the amount of capital kept aside apart from the regular working capital. These pools of funds are kept separately for unforeseen circumstances such as strikes, natural calamities, etc.

Variable Working Capital

This can be defined as the working capital invested for a temporary period of time in the business. For this reason, it is also called as fluctuating working capital. Such a capital varies with respect to the change in the size of the business or changes in the assets of the business.

Further, variable working capital is subdivided into two categories

Seasonal Variable Working Capital

This refers to the increased amount of working capital a business needs during the peak season of the year. A business may even have to borrow funds to meet its working capital needs. Such a working capital specifically meets the demands of business having a seasonal nature.

Special Variable Working Capital

Supplementary working capital may also be required by a business to undertake exceptional operations or unforeseen circumstances. The capital required for such circumstances is termed as special variable working capital. Funds needed to finance marketing campaigns, unforeseen events like accidental fires, floods, etc.

Gross Working Capital

This refers to the aggregate amount of funds invested in the current assets of the business. In other words, Gross Working Capital is the total of the current assets of the business. These include:

- Cash
- Accounts Receivable
- Inventory
- Marketable Securities and
- Short-Term Investments

Gross Working Capital

Gross Working Capital used alone neither shows the complete picture of the short-term financial soundness. Nor does it showcase the operational efficiency of the business. Current assets should be compared with the current liabilities to get a better understanding of a business's operational efficiency. That is, how efficiently a business utilizes its short term assets to meet its day-to-day cash requirements.

Net Working Capital

Net Working Capital is the amount by which current assets exceed the current liabilities of a business. Thus, the working capital equation is defined as the difference between current assets and current liabilities. Where current assets refer to the sum of cash, accounts receivable, raw material and finished goods inventory. Whereas, current liabilities include accounts payable.

The amount of working capital in a business is the indicator of liquidity, operational efficiency and short-term financial soundness of the business. Businesses having adequate working capital typically have the ability to invest and grow.

On the other hand, businesses having insufficient working capital have higher odds of going bankrupt. This is because of their inability to pay for their short-term obligations, thus making it difficult for them to grow.

Factors Determining Working Capital

1. Nature and Size of Business

The working capital need of a business depends a great deal on its nature and size. Let's consider various types of businesses to understand how the nature of business impacts its working capital requirements.

When it comes to trading firms, they require less amount of money to be invested in fixed assets. However, a huge pool of funds needs to be invested in the form of working capital. On the other hand, retail stores must keep a large quantity of inventory to meet the diversified and continuous needs of its customers.

Similarly, the need for working capital in manufacturing firms varies between small to a substantial amount. This working capital amount depends upon the type of business a firm is into. Likewise, public utility firms require less working capital but invest heavily in fixed assets. This is because they have cash sales only and supply services over products. Hence, they have fewer funds blocked in current assets such as debtors and inventories.

Finally, the size of the business also impacts the working capital needs of the business. Firms with large scale operations need more working capital as compared to smaller firms.

2. Business Cycle

Business cycle too has a significant impact on the working capital needs of a business. During the boom phase of the business cycle, businesses typically tend to expand thus requiring additional working capital. These periods of increased business activity require additional funds to meet the time lag between collection and sales. Further, funds are also needed to purchase additional raw material needed to produce additional goods for increased sales.

Not only that, the peak period leads to the increased prices of raw material and increased wages. Thus, additional funds are needed to provide for such operational expenses.

In contrast, there is lesser demand leading to both the decline of production and sale of goods during periods of depression. Thus, less amount of working capital is required by the business to carry out its operational activities.

3. Production Cycle

Production cycle, also known as the operating cycle, is the time difference between the conversions of raw materials into final products. This too impacts the working capital requirements of a business to a greater extent.

Businesses with longer production cycles need more working capital to fund its operational activities. Therefore, firms adopt various measures to reduce their production cycle in order to minimize their working capital requirements.

4. Seasonal Fluctuations

There are certain businesses that are seasonal in nature. This means there is a high demand for their goods during a specific period of the year. In such cases, inventory of raw material needs to be purchased during a specific period of time. This is done so that goods are produced and are offered for sale when they are needed.

Thus, the need for inventory increases during this period as compared to the other periods of the year. Therefore, businesses need additional funds to purchase inventories during the specific time of the year. As a result, the seasonality of business impacts the working capital requirements of the business.

5. Operational Efficiency

Various businesses operate on different operational efficiencies. Thus, the operational efficiency of a business depends upon various factors. These include:

- Short production cycles that involve less time to convert raw material into finished goods
- Achieving sales quickly
- The shorter debt collection period

Thus, businesses with increased operational efficiency are required to invest a lesser amount of funds in working capital. In contrast, businesses that have lesser operational efficiency need more funds to be invested in working capital.

Here is an info graphic that explains what is working capital and working capital cycle in an easy to understand way.

CURRENT ASSETS AND LIABILITIES MANAGEMENT

Current Assets Definition:

A current asset is an asset that a company holds and can be easily sold or consumed and further lead to the conversion of liquid cash. For a company, a current asset is an important factor as it gives them a space to use the money on a day-to-day basis and clear the current business expenses. In other words, the meaning of current assets can be explained as an asset that is expected to last only for a year or less is considered as current assets.

Types of Current Assets:

- Cash and cash equivalent
- Inventory
- Ongoing projects
- Pre-paid expenses
- Account receivable
- Marketable securities

The above mentioned are the obvious list of current assets that are taken into consideration to check the operation cycle of a company within one year.

Elements of Current Assets:

Following items are the key elements of Current Assets

1. Trade and other receivables
2. Inventories
3. Cash and cash equivalents
4. Short-term investments

Current Assets Formula

For a company, the current asset in the balance sheet can be calculated as follows.

Current assets=Cash+Cash Equivalents+Inventory+Accounts Receivable+Market Securities+Prepaid Expenses+Other Liquid Assets

Uses of Current Assets:

- Current Assets can be used as clear regular payments and bills.
- It gives an insight into the company's cash and liquid position
- Investors and Creditors analyse the company's current assets closely to understand the risk or benefits involved in the operation.

Examples of Current Assets

- Cash and equivalents
- Short-term investments (marketable securities)
- Accounts receivable
- Inventory
- Prepaid expenses
- Any other liquid assets

Total Current Assets

Total current asset is the aggregate of all cash, prepaid expenses, receivables, and inventory on the company's balance sheet.

Some other formulas that are based on total current assets formula are represented below:

1. Current Ratio = Current Assets ÷ Current Liabilities
2. Quick Ratio = (Current Assets – Inventory + Prepaid Expenses) ÷ Current Liabilities
3. Net Working Capital = Current Assets – Current Liabilities
4. Average Current Assets = (Aggregate Assets for Current Year + Aggregate Assets for Preceding Year) ÷ 2

Definition of Current Liabilities

Current liabilities are an enterprise's obligations or debts that are due within a year or within the normal functioning cycle. Moreover, current liabilities are settled by the use of a current asset, either by creating a new current liability or cash.

Current liabilities appear on an enterprise's Balance Sheet and incorporate accounts payable, accrued liabilities, short-term debt and other similar debts.

The average amount of current liabilities is a vital component of various measures of the short term liquidity of trading concern, comprising of:

List of Current Liabilities Examples:

Following are some current liabilities

- **Accounts Payable:** Accounts payable are nothing but, the money owed to the manufacturers.
- **Accrued Expenses:** They are the bills which are due to a 3rd party but not payable, for instance, wages payable.
- **Accrued Interest:** Accrued Interest incorporates all interest that has been accumulated since previously paid.
- **Bank account overdrafts (BAO):** BAOs are the short term advances that are outlined by the bank for the purpose of overdrafts.
- **Notes payable or Bank loans:** It is the existing principal part of a long term loan.
- **Dividends payable:** They are the dividends stated by the enterprise's BOD (Board of Directors) that are due to be paid to the shareholders.
- **Income Taxes payable:** Income tax is a kind of tax that is owed to the government that is due to be paid.
- **Wages:** Wages is the money that is due to be paid to the employees.

Also Read: How to Calculate Current Liabilities?

Current Liabilities Formula

Current Liabilities = [Notes payable + Accounts payable + Accrued expenses + Unearned revenue

+ Current portion of long term debt + other short term debt.]

REGULATION OF WORKING CAPITAL FINQNCE COMMITTEES

The following points highlight the various committees involved in financing working capital by banks,

1. Dehejia Committee

2. Tandon Committee

3. Chore Committee

4. Marathe Committee

5. Chakravarty Committee

6. Kannan Committee Report

1. Dehejia Committee Report:

National Credit Council constituted a committee under the chairmanship of Shri V.T. Dehejia in 1968 to ‘determine the extent to which credit needs of industry and trade are likely to be inflated and how such trends could be checked’ and to go into establishing some norms for lending operations by commercial banks.

The committee was of the opinion that there was also a tendency to divert short-term credit for long-term assets. Although committee was of the opinion that it was difficult to evolve norms for lending to industrial concerns, the committee recommended that the banks should finance industry on the basis of a study of borrower’s total operations rather than security basis alone.

The Committee further recommended that the total credit requirements of the borrower should be segregated into ‘Hard Core’ and ‘Short-term’ component.

The ‘Hard Core’ component which should represent the minimum level of inventories which the industry was required to hold for maintaining a given level of production should be put on a formal term loan basis and subject to repayment schedule. The committee was also of the opinion that generally a customer should be required to confine his dealings to one bank only.

2. Tandon Committee Report:

Reserve Bank of India set up a committee under the chairmanship of Shri P.L. Tandon in July 1974. The terms of reference of the Committee were:

(1) To suggest guidelines for commercial banks to follow up and supervise credit from the point of view of ensuring proper end use of funds and keeping a watch on the safety of advances.

(2) To suggest the type of operational data and other information that may be obtained by banks periodically from the borrowers and by the Reserve Bank of India from the leading banks;

(3) To make suggestions for prescribing inventory norms for the different industries, both in the private and public sectors and indicate the broad criteria for deviating from these norms ;

(4) To make recommendations regarding resources for financing the minimum working capital requirements;

(5) To suggest criteria regarding satisfactory capital structure and sound financial basis in relation to borrowings;

(6) To make recommendations as to whether the existing pattern of financing working capital requirements by cash credit/overdraft system etc., requires to be modified, if so, to suggest suitable modifications.

The committee was of the opinion that:

(i) Bank credit is extended on the amount of security available and not according to the level of operations of the customer,

(ii) Bank credit instead of being taken as a supplementary to other sources of finance is treated as the first source of finance.

Although the Committee recommended the continuation of the existing cash credit system, it suggested certain modifications so as to control the bank finance. The banks should get the information regarding the operational plans of the customer in advance so as to carry a realistic appraisal of such plans and the banks should also know the end-use of bank credit so that the finances are used only for purposes for which they are lent.

The recommendations of the committee regarding lending norms have been suggested under three alternatives. According to the first method, the borrower will have to contribute a minimum of 25% of the working capital gap from long-term funds, i.e., owned funds and term borrowing; this will give a minimum current ratio of 1.17: 1.

Under the second method the borrower will have to provide a minimum of 25% of the total current assets from long-term funds; this will give a minimum current ratio of 1.33: 1. In the third method, the borrower’s contribution from long-term funds will be to the extent of the entire core current assets and a minimum of 25% of the balance current assets, thus strengthening the current ratio further.

Example:

	₹
Total current assets required	40,000
Current liabilities other than bank borrowings	10,000
Core current assets	5,000
1st Method	
Total current assets required	40,000
Less Current Liabilities	10,000
Working Capital Gap	30,000
Less 25% from Long–term sources	7,500
Maximum permissible bank borrowings	22,500
2nd Method	
Current assets required	40,000
Less 25% to be provided from long–term funds	10,000
	30,000
Less Current Liabilities	10,000
Maximum permissible bank borrowings	20,000
3rd Method	
Current assets	40,000
Less Core Current assets	5,000
	35,000
Less 25% to be provided from long–term funds	8,750
	26,250
Less Current Liabilities	10,000
Maximum permissible bank borrowings	16,250

3. Chore Committee Report:

The Reserve Bank of India in March, 1979 appointed another committee under the chairmanship of Shri K.B. Chore to review the working of cash credit system in recent years with particular reference to the gap between sanctioned limits and the extent of their utilization and also to suggest alternative type of credit facilities which should ensure greater credit discipline.

The important recommendations of the Committee are as follows:

(i) The banks should obtain quarterly statements in the prescribed format from all borrowers having working capital credit limits of Rs 50 lacs and above.

(ii) The banks should undertake a periodical review of limits of Rs 10 lacs and above.

(iii) The banks should not bifurcate cash credit accounts into demand loan and cash credit components.

(iv) If a borrower does not submit the quarterly returns in time the banks may charge penal interest of one per cent on the total amount outstanding for the period of default.

(v) Banks should discourage sanction of temporary limits by charging additional one per cent interest over the normal rate on these limits.

(vi) The banks should fix separate credit limits for peak level and non-peak level, wherever possible.

(vii) Banks should take steps to convert cash credit limits into bill limits for financing sales.

4. Marathe Committee Report:

The Reserve Bank of India, in 1982, appointed a committee under the chairmanship of Marathe to review the working of Credit Authorization Scheme (CAS) and suggest measures for giving meaningful directions to the credit management function of the Reserve Bank. The recommendations of the committee have been accepted by the Reserve Bank of India with minor modifications.

The principal recommendations of the Marathe Committee include:

(i) The committee has declared the Third Method of Lending as suggested by the Tanden Committee to be dropped. Hence, in future, the banks would provide credit for working capital according to the Second Method of Lending.

(ii) The committee has suggested the introduction of the ‘Fast Track Scheme’ to improve the quality of credit appraisal in banks. It recommended that commercial banks can release without prior approval of the Reserve Bank 50% of the additional credit required by the borrowers (75% in case of export oriented manufacturing units) where the following requirements are fulfilled:

(a) The estimates/projections in regard to production, sales, chargeable current assets, other current assets, current liabilities other than bank borrowings, and net working capital are reasonable in terms of the past trends and assumptions regarding most likely trends during the future projected period.

(b) The classification of assets and liabilities as ‘current’ and ‘non-current’ is in conformity with the guidelines issued by the Reserve Bank of India.

(c) The projected current ratio is not below 1.33 : 1.

(d) The borrower has been submitting quarterly information and operating statements (Form I, II and III) for the past six months within the prescribed time and undertakes to do the same in future also.

(e) The borrower undertakes to submit to the bank his annual account regularly and promptly, further, the bank is required to review the borrower’s facilities at least once in a year even if the borrower does not need enhancement in credit facilities.

5. Chakravarty Committee Report:

The Reserve Bank of India appointed another committee under the chairmanship of Sukhamoy Chakravarty to review the working of the monetary system of India. The committee submitted its report in April, 1985.

The committee made two major recommendations in regard to the working capital finance:

(i) Penal Interest for Delayed Payments:

The committee has suggested that the government must insist that all public sector units, large private sector units and government departments must include penal interest payment clause in their contracts for payments delayed beyond a specified period. The penal interest may be fixed at 2 per cent higher than the minimum lending rate of the supplier’s bank.

(ii) Classification of Credit Limit Under Three Different Heads:

The committee further suggested that the total credit limit to be sanctioned to a borrower should be considered under three different heads:

(1) Cash Credit I to include supplies to government,

(2) Cash Credit II to cover special circumstances, and

(3) Normal Working Capital Limit to cover the balance credit facilities.

The interest rates proposed for the three heads are also different. Basic lending rate of the bank should be charged to Cash Credit II, and the Normal Working Capital Limit be charged as below:

(a) For Cash Credit Portion: Maximum prevailing lending rate of the bank.

(b) For Bill Finance Portion: 2% below the basic lending rate of the bank.

(c) For Loan Portion: The rate may vary between the minimum and maximum lending rate of the bank.

 # 6. Kannan Committee Report:

In view of the ongoing liberalization in the financial sector, the Indian Banks Association (IBA) constituted a committee headed by Shri K. Kannan, Chairman and Managing Director of Bank of Baroda to examine all the aspects of working capital finance including assessment of maximum permissible bank finance (MPBF). The Committee submitted its report on 25th February, 1997.

It recommended that the arithmetical rigidities imposed by Tandon Committee (and reinforced by Chore Committee) in the form of MPBF computation so far been in practice, should be scrapped. The Committee further recommended that freedom to each bank be given in regard to evolving its own system of working capital finance for a faster credit delivery so as to serve various borrowers more effectively.

It also suggested that line of credit system (LCS), as prevalent in many advanced countries, should replace the existing system of assessment/fixation of sub-limits within total working capital requirements.

The Committee proposed to shift emphasis from the Liquidity Level Lending (Security Based Lending) to the Cash Deficit Lending called Desirable Bank Finance (DBF). Some of the recommendations of the committee have already been accepted by the Reserve Bank of India with suitable modifications.

The important measures adopted by RBI in this respect are given below:

(i) Assessment of working capital finance based on the concept of MPBF, as recommended by Tandon Committee, has been withdrawn. The banks have been given full freedom to evolve an appropriate system for assessing working capital needs of the borrowers within the guidelines and norms already prescribed by Reserve Bank of India.

(ii) The turnover method may continue to be used as a tool to assess the requirements of small borrowers. For small scale and tiny industries, this method of assessment has been extended up to total credit limits of Rs 2 crore as against existing limit of 1 crore.

(iii) Banks may now adopt Cash Budgeting System for assessing the working capital finance in respect of large borrowers.

(iv) The banks have also been allowed to retain the present method of MPBF with necessary modification or any other system as they deem fit.

(v) Banks should lay down transparent policy and guidelines for credit dispensation in respect of each broad category of economic activity.

(vi) The RBI’s instructions relating to directed credit, quantitative limits on lending and prohibitions of credit shall continue to be in force. The present reporting system to RBI under the Credit Monitoring Arrangement (CMA) shall also continue in force.

UNIT-III EQUITY AND SHARES

LONG TERM CAPITAL

Capital that is held for more than 36 months is a long-term capital.

Sources of long term capital

- Equity Shares
- Preference Shares
- Debebtures
- Retained Earnings
- Long term loans

EQUITY SHARES

Equity Share Meaning

An equity share, normally known as ordinary share is a part ownership where each member is a fractional owner and initiates the maximum entrepreneurial liability related to a trading concern. These types of shareholders in any organization possess the right to vote.

Features of Equity Shares Capital

- Equity share capital remains with the company. It is given back only when the company is closed.
- Equity Shareholders possess voting rights and select the company’s management.
- 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.

Types of Equity Share

- **Authorized Share Capital-**
    - This amount is the highest amount an organization can issue. This amount can be changed time as per the companies recommendation and with the help of few formalities.
- **Issued Share Capital-**
    - This is the approved capital which an organization gives to the investors.
- **Subscribed Share Capital-**
    - This is a portion of the issued capital which an investor accepts and agrees upon.
- **Paid Up Capital-**
    - This is a section of the subscribed capital, that the investors give. Paid-up capital is the money that an organization really invests in the company's operation.
- **Right Share-** T
    - **T**hese are those type of share that an organization issue to their existing stockholders. This type of share is issued by the company to preserve the proprietary rights of old investors.
- **Bonus Share-**
    - When a business split the stock to its stockholders in the dividend form, we call it a bonus share.
- **Sweat Equity Share-**
    - This type of share is allocated only to the outstanding workers or executives of an organization for their excellent work on providing intellectual property rights to an organization.

Merits of Equity Shares Capital

- ES (equity shares) does not create a sense of obligation and accountability to pay a rate of dividend that is fixed
- ES can be circulated even without establishing any extra charges over the assets of an enterprise
- It is a perpetual source of funding, and the enterprise has to pay back; exceptional case – under liquidation
- Equity shareholders are the authentic owners of the enterprise who possess the voting rights

Demerits of Equity Shares Capital

- The enterprise cannot take either the credit or an advantage if trading on equity when only equity shares are issued
- There is a risk, or a liability overcapitalization as equity capital cannot be reclaimed
- The management can face hindrances by the equity shareholders by guidance and systematizing themselves
- When the firm earns more profits, then, higher dividends have to be paid which leads to raising in the value of the shares in the marketplace and its edges to speculation as well

PREFERENCE SHARES

Preference Share Meaning

Preference shares,also known as preferred stock, is an exclusive share option which enables shareholders to receive dividends announced by the company before the equity shareholders.

Preference shares provide the shareholders with the special right to claim dividends during the company lifetime, and also with the option to claim repayment of capital, in case of the wind up of the company.

It is considered as a hybrid security option as it represents the characteristics of both debt and equity investments.

The capital raised by issuing preference shares is known as preference share capital and preference shareholders can be regarded as owners of the company. They however do not enjoy any kind of voting rights, unlike equity shareholders.

Features of Preference Shares

The following are the features of preference shares:

1. Preferential dividend option for shareholders.
2. Preference shareholders do not have the right to vote.
3. Shareholders have a right to claim the assets in case of a wind up of the company.
4. Fixed dividend payout for shareholders, irrespective of profit earned.
5. Acts as a source of hybrid financing.

Types of Preference Shares

The various types of preference share are discussed below:

1. **Cumulative preference share:**

    Cumulative preference shares are a special type of shares that entitles the shareholders to enjoy cumulative dividend payout at times when a company is not making profits. These dividends will be counted as arrears in years when the company is not earning profit and will be paid on a cumulative basis, the next year when the business generates profits.

2. **Non-cumulative preference shares:**

These types of shares do not accumulate dividends in the form of arrears. In the case of non-cumulative preference shares, the dividend payout takes place from the profits made by the company in the current year. If there is a year in which the company doesn't make any profit, then the shareholders are not paid any dividends for that year and they cannot claim for dividends in any future profit year.

3. **Participating preference shares:**

These types of shares allow the shareholders to demand a part in the surplus profit of the company at the event of liquidation of the company after the dividends have been paid to the other shareholders. In other words, these shareholders enjoy fixed dividends and also share a part of the surplus profit of the company along with equity shareholders.

4. **Non-participating preference shares:**

These shares do not yield the shareholders the additional option of earning dividends from the surplus profits earned by the company. In this case, the shareholders receive only the fixed dividend.

5. **Redeemable Preference Shares:**

Redeemable preference shares are shares that can be repurchased or redeemed by the issuing company at a fixed rate and date. These types of shares help the company by providing a cushion during times of inflation.

6. **Non-redeemable Preference Shares:**

Non-redeemable preference shares are those shares that cannot be redeemed during the entire lifetime of the company. In other words, these shares can only be redeemed at the time of winding up of the company.

7. **Convertible Preference Shares:**

Convertible preference shares are a type of shares that enables the shareholders to convert their preference shares into equity shares at a fixed rate, after the expiry of a specified period as mentioned in the memorandum.

8. **Non-convertible Preference Shares:**

These type of preference shares cannot be converted into equity shares. These shares will only get fixed dividend payout and also enjoy preferential dividend payout during the dissolution of a company.

Difference between Equity Shares and Preference Shares

Equity share and Preference share are the two types of share that a company issues. Equity share is an ordinary share. Preference share experience the perquisites of the dividend distribution first. The equity stockholders get the opportunity to cast their vote in major business decisions.

The company preference share receives the dividend at a fixed rate. Whenever there is an issue with the company, the preference share gets the right to return of the capital before the equity share.

Parameters	**Preference Share**	**Equity Share**
Dividend Rate	Has a fixed rate	Fluctuates

Vote Rights	No voting rights	Have voting rights
Participation in Management	Has no right to participate in management decision	Has the right to participate in management decision
Preferences	Get the first preference, before equity share	Gets second preference, after preference share

RETAINED EARNINDS

Retained earnings refer to the portion of the **earnings** left with the company after the distribution of dividend to its shareholders. **Retention** of **earnings** is from the **profits** of the business for a financial year. A company cannot pay dividends or retain **earnings** in the case of net loss in any financial year.

Features of Retained Earnings:

The important features of retained earnings as a source of internal financing have been summarized below:

1. **Cost of Financing:**

It is the general belief that retained earnings have no cost to the company.

2. **Floatation Cost:**

Unlike other sources of financing, the use of retained earnings helps avoid issue- related costs.

3. **Control:**

Use of retained earnings avoids the possibility of change/dilution of the control of existing shareholders that results from issue of new issues.

4. Legal Formalities:

Use of retained earnings does not require compliance of any legal formalities. It just requires a resolution to be passed in the annual general meeting of the company.

Advantages of Retained Earnings:

The advantages or benefits of retained earnings may be stated as under:

i. Cheaper Source of Financing:

The use of retained earnings does not involve any acquisition cost. The company has no obligation to pay anything in respect of retained earnings.

ii. Financial Stability:

Retained earnings strengthen the financial position of a business and thereby give financial stability to the business.

iii. Stable Dividend:

Shareholders may get stable dividend even if the company does not earn enough profit.

iv. Market Value:

Retained earnings strengthen the financial position of a company and appreciate the capital which ultimately increases the market value of shares.

Disadvantages of Retained Earnings:

Retained earnings are the result of conservative dividend policy of the company and are associated with following demerits:

i. Improper Utilization of Funds:

If the purpose for utilization of retained earnings is not clearly stated, it may lead to careless spending of funds.

ii. Over-capitalization:

observative dividend policy leads to huge accumulation of retained earnings leading to over-capitalization.

iii. Lower Rate of Dividend:

Retained earnings do not allow shareholders to enjoy full benefit of the actual earnings of the company. This creates not only dissatisfaction among the shareholders but also adversely affect the market value of shares.
