1 PROJECT PLANNING AND CAPITAL BUDGETING

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1.1 PROJECT PLANNING:

Define Project Planning

It refers to the plan of an undertaking to:

a. build up productive capacities,
b. diversify its business, or
c. extend its existing capacities

1.2 PROJECT REPORT

What do you mean by Project Report? Give the objectives?

1.2.1 Meaning:

It is a pre-investment and comprehensive study of investment proposals of an organization. It encompasses a thorough investigation relating to economic, technical, financial, social, managerial and commercial aspects.

A. project report deals with:

a. Location of the project
b. The size and capacity level
c. The technological aspects, e.g., production process, availability of raw materials, requirements of labour and machines.
d. Government laws and regulations, etc.,

1.2.2 Objectives of Project Report:

a. To compare different investment opportunities
b. To obtain financial assistance from a financial institutions and banks.

Enumerate the Advantage of a Project Report

1.2.3 Advantages of a Project Report:

a. It lays down objectives in various spheres of business.
b. It evaluates the objectives in right perspective.
c. It identifies constraints on resources, viz., manpower, equipment, financial and technological etc.,
d. It paves the way for management to seek financial assistance from financial institutions and bank.
e. Financial intermediaries like merchant bankers and underwriters also require project report to evaluate project viability to revise funds from capital market.
f. Successful implementation of a project depends upon the line of action as suggested in the project report.

List out the contents of a Project Report

1.2.4 Contents of a Project Report

1. Information about industry and its status in the economy, present production and demand pattern, government policies, export potential, licensed and installed capacity.
2. Broad market trend of the product and by-products within and outside the states / country for 5 years.
3. Specifications and quality of raw materials required and their sources of availability.
4. Production process.
5. Availability of technical know-how within and outside country.
6. Location of plant, its advantages and justification.
7. Requirement of water, sources of water availability, etc.
8. Total power requirements for the factory.
9. Requirement for steam raising or processing, source and price.
10. Implementing programme in the form of CPM / PERT and flow charts indicating critical path and schedules.
11. Cost of project-. It consists of cost incurred on land, building, plant and machinery, equipment, off-site facilities, utilities and auxiliary facilities, preliminary expenses, contingencies, cost of spare, repairs and maintenance during trial run, pre-commissioning and commissioning expenses, working capital margin, etc.
12. Details of capital structure.
13. Cost of production Break-even point of production cost should be given; effect or variation of cost of raw materials, utilities, selling price, etc. should be indicated.
14. Projected profitability for 5 years after commission.
15. Cash flow statement and payback period.
16. Technical feasibility and financial viability
17. Organisation and management-description of corporate management, promoters experience, organizational chart key personnel, power and responsibility structure.

Write a note on CPM / PERT as a technique of Project Planning

1.2.5 TECHNIQUES OF PROJECT PLANNING AND SCHEDULING (CPM / PERT)

Following steps should be taken for using CPM and PERT for planning and Scheduling-

a. Each project should be divided into a number of several independent jobs or activities. These jobs or activities must be separately listed.
b. The order of preference for different jobs should be determined.
c. There will be certain jobs which have to be completed before others can be started while some jobs may be done simultaneously. The jobs, therefore, are to be programmed and synchronized in a manner that no bottlenecks are created.
d. A graph or a picture may be drawn portraying each of the jobs and showing the predecessor and successor relationships amongst them. Such a chart shows which job has to come first and which has to come later. It also shows the time required for completion of various jobs.

Determination of critical path – The minimum time required to complete a project is shown by critical path. Critical path is the longest path in the project diagram. This helps in determining the date on which the project is completed. In order to make sure that the project is completed in time, attention has to be given to this path since any increase in time or activity / job will delay the completion of the project.

What is meant by capital Budgeting?

1.3 CAPITAL BUDGETING:

Capital Investment involves a cash outflow in the immediate future in anticipation of returns at future date. The investment of funds requires a number of decisions to be taken in which funds are invested and benefits are expected over a long period. A capital investment decision involves a largely irreversible commitment of resources that is generally subject to significant degree of risk. The finance manager therefore is required to do a proper planning of project to know in advance technical and financial feasibility of the project.

1.3.1 Meaning of Capital Budgeting:

- Capital budgeting refers to the long term planning of expenditure whose returns stretch over future period

- It is the process of deciding whether or not to commit the resources to a project whose benefits would be spread over several time periods.
- It considers proposed capital outlay and its financing. Thus, it includes both raising of long term funds as well as their utilization.

Elaborate on the nature of Capital Budgeting

1.3.2 Nature of Capital Budgeting:

- Involves Huge Cash Outlays
- Intended to receive benefits over a longer period.
- Irreversible decisions are involved.
- Capital assets once acquired cannot be disposed off except at a substantial loss.
- Wrong decisions may lead to liquidation
- If there are no increased earnings from the purc hase of the additional capital assets, the ability of the company to discharge its financial obligations may be affected adversely.
- Expansion of capital facilities by means of the issue of shares may dilute holdings in the company and if not carefully planned and controlled, it can result in the loss of control by the management.
- In this context the forecasting and budgeting of capital expenditure becomes a vital part of policy making and management function. It influences long-term prospects and future earning capacity of the firm.

What are the types of Investment Proposal?

1.3.3 Types of Investment Proposal:

A firm may have several proposals for its consideration. It may adopt one of them, some of them or all of them depending upon whether they are independent, contingent or dependent or mutually exclusive.

1. Independent proposals:
These are the proposals, which do not compete with one another. In case of such proposals the firm may straight away accept or reject on the basis of a minimum return on investment required.

2. Contingent or dependent proposals:
These are the proposals, whose acceptance depends on the acceptance of one or more other proposal. When a contingent investment proposal is made, it should also contain the proposal on which it is dependent in order to have better perspective of the situation.

3. Mutually Exclusive Proposals:
These are proposals which compete with each other in such a way that the acceptance of one precludes the acceptance of other(s). Thus in case of two or more mutually exclusive proposals, only one of the proposal can be accepted.

What factors affect Capital Investment Decisions?

1.3.4 FACTORS AFFECTING CAPITAL INVESTMENT DECISIONS:

1) Amount of investment
2) Operating cash inflows
3) Choice of horizons

Risk and Uncertainty involved in appraisal:

Evaluation of capital expenditure proposal involves projects of the future. Future is always uncertain. Nobody can say with certainty about the quantum and frequency of the future cash flows. There are too many unknown and uncertain factors which influence cash flows and therefore, it is important to recognise that each cash inflow or outflow is only a probable figure. It is necessary to consider risk and uncertainty while carrying out the capital budgeting exercise. Risk and return have a direct relationship. Higher the return from the project, higher would be the risk normally and vice versa. It is, therefore, necessary that the capital budgeting exercise should attempt to optimise both, the return and risk factors. The Hiller's or Hertz's models of risk analysis may be used. (For any inquiry or admission to kalpesh classes dial 2382 0676)

1.3.5 Techniques of Capital Budgeting:

Briefly explain about Payback period as a Capital Budgeting technique. Give its Merits & Demerits.

1. PAYBACK PERIOD:

Meaning: Payback period refers to the period in which the project will generate the necessary cash to recoup the initial investment (i.e., Capital Recovery Period) Give its Merits & Demerits

Formula: Payback period = $\frac{\text{Initial investment}}{\text{Annual Cash inflow}}$

Annual cash flows = Estimated cash inflow resulting from the proposed investment
(i. e. net income on account of investment before depreciation but after taxation)
In case of uneven cash inflows, by calculating cumulative cash inflows, the pay-back period can be calculated.

Accept or reject criterion: A project whose actual pay-back period is more than what has been predetermined by the management will be straightaway rejected. The fixation of maximum acceptable pay-back period is generally done by taking into account the reciprocal of the cost of capital (i.e. maximum acceptable pay-back period = 100 divided by desired rate of return)

The payback period can also be used **in case of mutually exclusive projects.** The projects are then arranged in ascending order according to the length of their pay back periods.

It may be said that pay-back period is a measure of liquidity of investments rather than their profitability. It should more appropriately be treated as a constraint to be satisfied rather than as a profitability measure to be maximized.

Sometimes payback period is calculated after discounting the cash flows by a predetermined rate. The payback period so calculated is called **"Discounted Payback Period".**

Merits:
1. The method is very useful in evaluating those projects which involve high uncertainty
2. The use of pay-back method is preferred on the ground that returns beyond 3 or 4 years are so uncertain as to disregard them altogether in a planning decision.
3. A firm which is short of cash, must necessarily place a premium on quick return of its funds.
4. The method is easy to understand and simple to operate
5. The method reduces the possibility of losses through obsolescence.

Demerits:

1. The method ignores the returns beyond pay-back period, so that a project of long gestation period with merit is likely to be rejected. Thus the method ignores the 'Bigger the Better Principle'.
2. The method fails to take into account the period of time over which an investment is likely to yield savings.

PAYBACK RECIPROCAL:

Meaning: It is a reciprocal of payback period. It is calculated as follows:

Formula: $\frac{\text{Annual Cash Inflow}}{\text{Initial Investment}}$

Payback period method does not indicate any cut off period for the purpose of investment decision. The reciprocal of payback is a close approximation of the internal rate of return, if the life of the project is at least twice the payback period and project generates equal amount of the annual cash inflows.

What do you understand by ARR? Explain Discuss the Merits & Demerits

2. ACCOUNTING OR AVERAGE RATE OF RETURN (ARR):

According to this method, the capital investment proposals are judged on the basis of their relative profitability. For this purpose, capital employed and expected income are determined according to commonly accepted accounting principles and practices over the entire economic life of the project and then the average yield is calculated. Such a rate is termed as Accounting rate of return. It may be calculated, according to either of the following formulae –

i. $\frac{\text{Average annual net earnings}}{\text{Original investment}} \times 100$

ii. $\frac{\text{Annual average net earnings}}{\text{Average Investment}} \times 100$

The term "Average annual net earnings" is the average of the earnings (after depreciation and tax) over the whole of the economic life. One may calculate "Average annual net earnings "before tax. Such rate is known as **pre – tax accounting rate of return.**

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The amount of "Average Investment" is calculated as follows –

$$\frac{\text{Original investment} - \text{Scrap value}}{2} + \text{Additional Net Working Capital} + \text{Scrap Value}$$

Accept / Reject Criterion – Any project expected to give a return below minimum desired rate of return will be straightaway rejected. In case of several projects, where a choice has to be made, the different projects may be ranked in the descending order on the basis of their rate of return.

Merits:

1. The method is superior to pay-back period as it takes into account savings over the entire economic life, even though estimates of distant future may be subject to wide margins or errors.
2. The projects differing widely in character can be compared properly.
3. The method embodies the concept of 'Net earnings' after allowing for depreciation as it is of vital importance in the appraisal of a proposal.

Demerits:

1. The method suffers from the fundamental weakness as that of pay-back method i.e. it ignores the fact that receipts occur at different time intervals i.e. it ignores time value of money.

   If earnings from different investments accrue at the same time, this method can be safely used.
2. The method has different variants, each of which emerge different rate of return for one proposal. This situation arises due to diverse concept of investments as well as earnings.
3. Some analysts are of the opinion that as the, method takes into account earnings after depreciation, it is gross error because it is only the cash flows, occurring subsequent to the sinking fund investments, that are relevant for the decision making purpose.

Write a brief note on DCF method used in Capital Budgeting Decision.

3. DISCOUNTED CASH FLOW (DCF) METHOD:
An investment is an essential outlay of funds in anticipation of future returns. The presence of time as a factor in investment is fundamental rather than incidental for the purpose of evaluation of investments. Time is always a crucial for the investor, so that a sum received today is worth more than the sum to be received tomorrow. Thus in evaluating investment projects, it is important to consider the timings of return on investments.

Assumptions of Discounting Factor Table:
1. Opportunity for investment is available at any time for any amount.
2. Interest will accrue at the same rate.
3. Interest will be received at the end of the year.
4. Interest will be reinvested at the same opportunity rate
5. Price level remains the same.

DCF methods for evaluating capital expenditure proposals are of two types –
i. Present Value Method (PV) / Net Present Value Method (NPV)
ii. Internal Rate of Return Method (IRR)

I. PRESENT VALUE METHOD / NET PRESENT VALUE METHOD / PROFITABILITY INDEX:

a. Present Value Method :

Explain:
a. Present Value Method (PVM)
b. Net Present Value Method (NPVM)
c. Profitability Index

This method is also know as discounted cost-benefit ratio method. It takes into account the entire income whenever received and to this extent it complies with "The Bigger the Better" Principle. Moreover, introduction of compound interest into the calculations gives more weight to the early receipts than the late ones. Thus this method gives effect to both the principles.

Under the present value method, present value of cash inflows is calculated at the rate of return acceptable to the management, which is compared with the original investment to determine prospective profitability. This method is not suitable in case of projects having different size of Investment. (To know more about us visit KalpeshClasses.com)

Accept / Reject Criterion:
An investment proposal should be accepted, other things remaining the same, if the present value of its cash inflows, discounted at a specified rate of return, equals or exceeds the amount of the investment required. The discounting rate or factor is also referred to as the required earning rate.

PV	>	C	accept the proposal
PV	=	C	accept the proposal
PV	<	C	reject the proposal

Where,

PV	=	Present value of Cash in flow
C	=	Present value of cash out flow

b. Net Present Value Method :

The net present value is the difference between present value of benefits and present value of costs. If the net present value is positive, the conclusion is favourable to the decision to go ahead with the project but if it is negative, the project is rejected. The analyst who uses this method feels that it gives desired indication with the least confusion.

Accept / Reject Criterion:

NPV	>	Zero	accept the proposal
NPV	=	Zero	accept the proposal
NPV	<	Zero	reject the proposal

Where,

NPV	=	Net Present Value

c. Profitability Index / Desirability Factor :

If the present value method is used, the present value of the earnings of one project cannot be compared directly with the present value of earnings of another, unless the investments are of the same size. In order to compare proposals of different size, the flows to investment must be related. This is done by dividing the present value of earnings by the amount of investment, to give a ratio i. e. called the profitability index / ratio or desirability factor.

$$\text{Profitability Index} = \frac{\text{Discounted Cash in flow}}{\text{Discounted Cash Outflow}}$$

Or

$$\text{Profitability Ratio} = \frac{\text{Discounted Cash Inflow}}{\text{Discounted Cash Outflow}} \times 100$$

Higher the index number, the better the project. This is also called **benefit cost ratio.**

Accept / Reject Criterion –

PI	>	1	accept the proposal
PI	=	1	accept the proposal
PI	<	1	reject the proposal

Where,
PI = Profitability Index

What do you understand by IRR?

II. TIME ADJUSTED RATE OF RETURN OR INTERNAL RATE OF RETURN (IRR):

In the net present value method, the required earnings rate is selected in advance. There is an alternative method which finds the earnings rate at which the present value of the earnings equals the amount of the investment. This rate is called the **time – adjusted rate of return, DCF rate of return, internal rate of return, yield rate, marginal efficiency of capital etc.**, IRR is the rate which brings the sum of the future cash flows to the same level as the original investment. Thus IRR is the rate of return at which the sum of discounted cash inflows equals the sum of discounted cash outflows.

Accept / Reject Criterion:

IRR	>	Cut-off-rate	accept the proposal
IRR	=	Cut-off-rate	accept the proposal
IRR	<	Cut-off-rate	reject the proposal

Where,
IRR = Interest Rate of Return

Under this method it is presumed that cash inflows can be reinvested at internal rate of return.

Discuss the Merits & Demerits of DCF Technique

Merits of DCF Technique:

1. Conceptually DCF techniques are superior to other methods. It is more objective because its conclusion is not directly influenced by decisions regarding depreciation methods, capitalization v/s expense decisions etc.,

2. Erratic flow of revenues and expenses over the project's life are directly considered under this method while they are averaged out under other methods.
3. DCF method automatically gives more weight to the units of money which are nearer, than to those which are distant, while, under other methods, distinct units of money are unrealistically treated with the same weight as present units.
4. The method enables a ready comparison to be made between projects having different lives and different timings of cash inflows because discounting process allows comparison to be made at the same point of time.
5. It is strictly comparable to cost of capital ratios so that decisions can be made quickly and safely by comparing rate of return and value of money to the firm.

Demerits of DCF Technique:

1. It is pointed that other methods of ranking investment proposals are easier to understand and simple to apply than DCF methods. The supporters of this method argue that the difficulty is over estimated and reluctance in using this method is more on account of unfamiliarity than its complexity.
2. The method does not correspond to accounting concepts for recording costs and revenue with a consequence that special analyst is necessary for the study of a capital investment.
3. Though the method is an advanced one over the other methods, it is not a dependable ranking method in as much as it does not reflect the firm's cost of capital. As a matter of fact the profitability of a capital proposal can be judged only when net income on account of operations is considered.
4. The method is based on the presumption that the cash inflow can be invested at the discounting rate in the new projects. However this assumption does not always hold good especially when IRR is much higher than normal opportunity rate say Bank Rate. This also depends upon available investment opportunities.

Compare & Contrast the three approaches or methods viz., PI, PV, NPV methods.

1.3.6 COMPARISON OF THE PROFITABILITY INDEX Vs. INTERNAL RATE RETURN Vs. PRESENT VALUE APPROACH

In case an undertaking has two or more projects competing for the same funds at its disposal the question of ranking the projects arises. For a given project, desirability factor and net present value methods give the same accept and reject signals. However, if we have to select one project out of two mutually exclusive projects, the net present value method should be preferred. It is because of the fact that the net present value indicates the economic contribution of the project in absolute terms. As such a project which gives higher economic contribution should be preferred.

As regard net present value method versus internal rate of return method one has to consider the basic presumption behind the two. In the case of internal rate of return method, the presumption is that intermediate cash inflows will be reinvested at the same rate, i.e., IRR. Whereas in the case of net present value method intermediate cash inflows are presumed to be reinvested at the cut-off rate.

It is obvious that re-investment of funds at the cut-off rate is more possible than at the internal rate of return which at times may be very high. Hence, the net present values being obtained from discounting at a fixed cut off rate is more reliable in ranking two or more projects than the internal rate of return.

1.5. INFLATION AND CAPITAL BUDGETING:

The impact of inflation is erosion of the purchasing power of money over a period of time, financial management is basically concerned with proper management of finance. The finance manager has to measure the impact of inflation on his decisions so as to re-orient various financial policies according to fast changing circumstances. **Some of the prominent areas which are affected by inflation and are required to be re-oriented are dividend pay-out policy, capital restructuring, depreciation policy, profit planning, working capital and Tax planning.**

State the relevance of inflation in Financial Statements.

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1.5.1. RELEVANCE OF INFLATION:

The income statement and the balance-sheet prepared according to historical cost accounting systems have been the subject of several criticisms on account of the following reasons:

a. It fails to disclose the current worth of the enterprise
b. The financial statements contain items which are not comparable since they are usually a composite of historical and current costs. For e.g., it is not logical to add the rupee cost of a building constructed in 1985 for Rs. 5 lacs to the rupee cost of building constructed in 2002 for Rs. 20 lacs.
c. It results in exaggerating the figure of net profit during inflation.
d. It creates problems of replacement of fixed assets as the depreciation is charged on historical cost of asset whereas larger funds are required for replacement of assets due to inflationary conditions.

On account of these factors, the interest in inflation accounting is widespread.

In what way inflation affects Financial Analysis.

1.5.2 INFLATION AND FINANCIAL ANALYSIS:

The financial performance of a firm as reflected in conventionally prepared financial statements, based on historical costs, is influenced partly by managerial decision and partly by external influences, particularly inflation, which are beyond the control of management. As a result, the performance shown by financial statements may cloud the economic performance.

In the face of different rates of inflation, financial ratios based on such rates are also vitiated. The vagaries of inflation may create the impression of changes in profitability even though the underlying economic profit may remain unchanged.

Inflation may lead to distortion in inter-firm comparison as well. In an inflationary environment, when historical data are used, a firm with older assets, other things being equal, will show a higher return on assets.

Recognizing that both time series and cross section comparisons can be distorted by the effects of inflation, the financial analyst should employ replacement cost data, if possible.

What guidelines have to be followed in case of Project Appraisal under inflationary conditions and Why?

1.5.3 PROJECT APPRAISAL UNDER INFLATIONARY CONDITIONS:

The timing of project appraisal is significant from the viewpoint of appraisers. A project is subjected to inflationary pressure from time to time ranging from 6 months to more than one or two years. During this period, it will be difficult to predict when the trade cycle sets in and upturn in economy is generated. In such a situation, inflation is bound to affect the project appraisal and implementation process.

Following guidelines should be observed while doing project appraisal:

a. Make provision for cost escalation on all heads of cost, keeping in view the likely inflation rate during project implementation.
b. The various sources of finance should be scrutinized with reference to probable revision in the interest rates by the lenders and revision which could be effected in the interest bearing securities to be issued.
c. Adjustment should be made in profitability and cash flow projection to take care of inflationary pressures.
d. Assess the financial viability of the project at the revised rate and assess the same with reference to economic justification of the project. The rate of return should include the rate of inflation per annum.
e. Projects having early payback period should be preferred being less risky.

Problems in investment decisions due to inflation:

a. Difficulty in forecasting the future rates of inflation
b. Difficulty in predicting demand and other factors which may be affected by level of inflation.
c. Problems with carrying out the analysis, whether to express forecast cash flows in 'real' terms or 'nominal' terms.

Write a note on Real, Nominal Cash flows

Real cash flow – It refers to expression of future cash flows in terms of rupees of today's purchasing power.

Nominal Cash flow – It means the number of rupees which are forecasted to be paid and received at various future times. Also called money cash flow.

Money cash flow must be discounted using a money (nominal) discount rate, real cash flow must be discounted using a real discount rate.

1+m	=	(1+r) (1+i)
m	=	(1+r)(1+i)-1
r	=	(1+m)/(1+i) – 1
i	=	(1+m)/ (1+r) - 1

Where
m - stands for money or nominal discount rate, r stands for real discount rate and i stands for inflation rate.

The cost of finance, which we observe in the market, e.g., bank lending rate includes an allowance for the rate of inflation which lenders expect. Interest rates are usually quoted in nominal (money) rather than real terms. Nominal rate is certain but real rate is only expected. Actual real rate can't be calculated until period of investment is over and the inflation rate is known. (To know more about us visit KalpeshClasses.com)

Write a note on impact of inflation on Capital Budgeting decisions on Investors on Inventory Management.

Impact of inflation on capital budgeting decisions – An inflationary economy distorts capital budgeting decisions. The depreciation charge is based on historical costs and the tax benefit arising from depreciation charge does not keep pace with inflation. Also, the cost of capital used for capital budgeting contains a premium for the anticipated inflation.

Impact of Inflation on Investors: The investors are also concerned with inflation, as they consider it at the time of making investment decision. In inflationary situation, the real rate of return on a security will be less than its nominal rate of return.

Effect of inflation on inventory management – Moderate inflation, upto 3% p.a. may be ignored for purposes of inventory management. If the inflation rate in the type of goods, the firm stocks tend to be relatively constant, it can be dealt with easily. One simply deducts the expected annual rate of inflation from the carrying cost percentage and used this modified version in the EOQ model to establish the working stock. The reason for making this deduction is that inflation causes the value of inventory to rise, thus offsetting somewhat the effects of depreciation and other carrying cost factors. Since carrying cost will now be smaller, the calculated EOQ and hence the average inventory will increase. However, the higher the rate of inflation, the interest rate will be higher, and this will cause carrying cost to increase and thus lower to the EOQ and average inventories.

What are the steps involved in cash flow analysis?

1.4 ESTIMATION OF FUTURE CASH FLOW:

It is very essential to have data regarding the cash flows from the project to use any technique of financial evaluation. This implies that costs of operation and returns from the project for a considerable period in future should be estimated. However, future is uncertain and estimation of cash flows can, at best, be a probability.

Steps in developing relevant information for cash flow analysis –

a. Estimation of costs – It requires data regarding cost of new equipment, cost of removal and disposal of old equipment less scrap value, cost of preparing the site and mounting the new equipment, cost of ancillary services, etc. The basis of estimation of these costs would be capital expenditure budget and payment pattern associated with capital equipment purchases.

b. Estimation of additional working capital requirement – Every capital project involves additional working capital to finance the increase in level of activity. The increase in the working capital requirement arises due to the need for maintaining higher sundry debtors, stock-in-hand, prepaid expenses etc.

c. Estimation of production and sales – The cash flows are highly dependent upon the estimate of sales and production levels. On the basis of the additional production units that can be sold and the price at which they can be sold, the gross revenue from a project can be worked out.

d. Estimation of cash expenses – It involves estimation of wages and salaries, manufacturing expenses, general administration and selling expenses, etc.

e. Working out cash inflows – Cash inflow would be revenue minus cash expenses and liability for taxation.

Note – If the discounting rate (if DCF technique is used) is itself based on the cost of capital, there should not be any deduction for interest on long term funds and dividends to equity or preference shareholders while working out the cash inflows.

1.6 RISK AND UNCERTAINTY IN APPRAISING CAPITAL INVESTMENT PROPOSALS

Evaluation of capital expenditure involves projections of future. Future is always uncertain. The estimate of cash flows can, at best, be a probabilistic estimate. The uncertainty about future leads to variation in results. Risk is perceived to be variability of actual returns from the estimated returns. If the risk and uncertainty factors are not taken into account there is always a danger that the capital expenditure would be evaluation may produce misleading results. Risk and return have a direct relationship. Higher the return, higher would be the risk and vice-versa. Therefore, capital budgeting exercise should attempt to optimise both-the return and risk factors.

Explain in brief Hillier's Model & Hertz's Model.

1.6.1 MODELS OF RISK ANALYSIS –

a. **Hillier's Model –** In view of Hillier, uncertainty or risk associated with the capital investment decisions is determined by the variation (standard deviation) of the expected cash flows. There will be lesser deviation in cash flow from the mean cash flow if the capital invest ment and its cash flows are less vulnerable to risk and uncertainty. He further argues that, working out the standard deviation of the various levels of cash flow will take into account the uncertainty factor of cash flows of a project. Hillier has developed a model to evaluate the various alternative cash flows that may arise from a capital expenditure proposal. He takes into account the mean of present value of the cash flows, which may be determined with the help of following Formulae –

$$\overline{M} = \sum_{i=0}^{n} (1+r)^{-i} Mi \qquad 6^2 = \sum_{i=0}^{n} (1+r)^{-2i} 6i^2$$

Where,

Mi is the cash flow in the ith period
r is the discounting factor
i^2 is the variance of cash flows

This model is very useful in taking up the capital budgeting decision if we take up two projects giving somewhat similar mean cash flows. However, the standard deviation of two projects differ. A project which has lower standard deviation will be preferred.
By this analysis, we can evaluate as to which of the two projects has a higher probability of generating a range of cash flows.

b. Hertz's Model – Hertz has suggested the following:
1. Simulation technique which is a highly flexible tool for operational research may be used in capital budgeting exercises.
2. Simulation model may be developed for the investment decision making

Explain the three methods of accounting for risk in capital budgeting decisions.

1.6.2 METHODS OF ACCOUNTING FOR RISK

a. **Application of various possible probabilities to cash flows** – Under this method, the management has to work out the various possible cash flows in different years and estimate the probabilities attached to each cash flow. From this, the expected cash flows can be calculated as illustrated below-
Suppose there are two projects A and B each requiring an initial investment of Rs. 15 lakhs and having 5 year's life, cash flows and their probabilities are as below:

Project A

Probability Weights	**0.20**	**0.20**	**0.40**	**0.10**	**0.10**
Year			(Rs. Lakhs)		
1	3.0	5.0	6.5	7.5	8.0
2	3.0	4.0	5.5	7.0	8.0
3	3.0	4.0	4.5	5.0	6.0
4	1.0	2.0	3.2	4.0	5.0
5	1.0	2.0	3.2	4.0	5.0

Project B

Probability	**Cash flows in each of the five years (Rs. Lakhs)**
0.10	3.0
0.20	3.5
0.40	4.5
0.20	5.5
0.10	6.0

Expected cash flows in each of the five years for

Project A- shall be computed as follows:

For the first years its like this
(0.2x3 + 0.2x5+0.4x6.5+01x7.5+0.1x8) = 5.75 Lakhs and similarly for the other years.

Similarly, the expected cash flows for Project B will be –

(0.10 x 3) + (0.20x3.5) + (0.40 X 4.5) + (0.20 x 5.5) + (0.10 x 6) = Rs. 4.50 lakhs

If we calculate IRR on the basis of expected cash flow, IRR for project A would be 14% and for project B, it will be 15%. On the other hand, if we calculate IRR on the basis of most likely cash flows, without applying probability weights, they would be 17.3% and 15.2% for project A and B respectively. (For any inquiry or admission to kalpesh classes dial 2382 0676)

Since expected cash flows take into account all the cash flows and their probabilities, they better indicate the risk involved.

b. **Varying the discounting rate –** Under this method, higher rate of discount is adopted for projects which are considered more risky, and, lower discount rate is adopted for less risky projects.

The discount rate to be applied takes into consideration the risk profile of the project.

Risk adjusted discounted rate (K) = Risk free rate + Risk premium for normal risk of the firm + Risk premium for covering the risk of project in excess of the firm's normal risk.

c. **Adjusting the cash flows (Certainty Equivalent approach) or (CE Approach) –** According to this method, the estimated cash flows are reduced to conservative level by applying a correction factor termed as certainty equivalent co-efficient. The correction factor which is the ratio of riskless (or certain) cash flows to risky cash flows.

$$\text{Certainty equivalent coefficient} = \frac{\text{Riskless Cash flow}}{\text{Risky Cash flow}}$$

Riskless cash flow means the cash flow which the management is prepared to accept in case there is no risk involved. For example, a project is expected to generate a cash flow of Rs. 20,000. The project is risky, but the management feels that it will get at least a cash flow of Rs. 12,000. The certainty equivalent coefficient is 0.6 (i.e. 12,000 / 20,000).

Certainty equivalent co-efficient can be calculated for estimated cash flows of each year. They are then multiplied with the cash flows to ascertain cash flows which may be used for the purpose of determining IRR or NPV for capital budgeting decisions.

Give an over view of the process involved in developing of a capital project.

Process of control of capital project –

a. Developing an overall plan
b. Preparation of capital expenditure budget, broken up according to the time at which it is likely to be incurred.
c. Proper records should be kept to monitor the progress of each capital project.
d. Periodically, total actual expenditure incurred should be compared with budget estimates.
e. Supplementary sanction should be sought where the cost of project is expected to go beyond the initial estimate.
f. Proper forms and procedures should be adopted.

Define "Social Cost Benefit Analysis"? Why the need felt for SCBA?

1.7 SOCIAL COST BENEFIT ANALYSIS:

An increasing awareness in our society in recent times is that business managers are made increasingly responsible for consequential social and environmental impact. Changing environment and social parameters have compelled them to revalue their social as well as economic obligations towards the needs of the society since society provides the requisite working infrastructure and facilities. Hence, the organization has to present the accounting system which will reflect the social and economic benefits created by it as well as the costs incurred with which to appraise its contribution towards solving the problems of society.

'Social Costs' are sacrifices of the society for which the business firm is responsible like air pollution, water pollution, deficiency due to bankruptcy, soil erosion, deforestation, production of dangerous products, explosives, etc. 'Social benefits' are the compensation made to the society as the form of increase in per capita income, employment opportunities, etc.

Need for Social Cost Benefit Analysis (SCBA)-

a. Market prices which are used to measure costs and benefits in project analysis do not represent social value due to imperfections in market.
b. Monetary cost and benefit analysis fails to consider the external effects of projects.
c. Taxes and subsidies are monetary costs and gains, but these are only transfer payments from social point of view and therefore irrelevant.
d. It is essential for measuring the redistribution effects of benefits of a project as benefits going to poorer section are more important than those going to economically better off sections.
e. Projects manufacturing liquor and cigarattes are not distinguished from those generating electricity or producing necessities of life.

Indicators of social desirability of a project

a. **Employment potential** – A project with high employment potential is considered highly desirable.
b. **Value addition per unit of capital employed** – A project with high value addition per unit of capital employed is given priority.
c. **Foreign exchange earnings** – A project with potential to earn foreign exchange to the country or an import substitution project which saves the country's foreign exchange reserves is highly desirable.
d. **Social cost-benefit analysis** – A project with net benefits to the society over the costs to the society is preferred.
e. **Capital – output ratio** – If the value of expected output in relation to the capital employed is high, the project is given priority over others.

Discuss the steps involved in SCBA

Steps in working out social costs and benefits –

a. All financial costs of a project during the construction period and the operational stage should be ascertained.
b. All financial costs so ascertained will have to be converted into social costs. For this purpose, the financial costs, as determined above, should be segregated between cost incurred in terms of foreign currency and local currency.
c. The financial cost incurred in foreign currency will be considered as social cost of equivalent amount without any adjustment.

d. The local currency cost will be divided into three categories, viz. tradeable, labour and residual.

e. Tradeables are the items which are dealt in international market. These items include most of the commodities except water and electricity, which can be theoretically traded in the international market. The social cost of tradeable items is determined on the basis of international prices of the commodities concerned.

f. The social cost of the labour payment involved in project is obtained by dividing the labour force into three categories – skilled, semi – skilled and unskilled. The social cost of each of these three categories is worked out separately by adopting the shadow pricing techniques. The term shadow price refers to rate attached to a factor which is not normal or actual price paid for it. The social costs of labour are lower than the total amount of wages paid due to the following reasons.
    i. A part of payments is returned to the society in the form of taxes.
    ii. Wages paid to labour will generate demand for goods.
    iii. By working, human skills are developed.
    iv. The cost incurred on social security and welfare amenities like housing, medical services, etc. are offset by resulting social benefits.
    v. Employment generation helps in fulfilling the broad social objective of providing a wider base of employment.

g. Residuals are other than tradeables or labour charges. The opportunity cost of these residuals are worked out depending upon the nature of each item of cost.

h. The total social costs are compiled on the basis of capital and operating costs adjusted on the basis of their opportunity costs and shadow prices.

i. The total value of social benefits from a project is determined on the basis of total tradeable value of finished products.

j. The social cost benefit ratio can be determined on the basis of the social costs and social benefits worked out as per the above methodology. Since various social benefits would arise at different points of time, the internal rate of return (IRR) can be computed by applying the discounted cash flow technique. (DCP).

2 TYPES OF FINANCING

An Overview

Preliminary

Why Business firms need finance?

Classification of Financing needs

A. Classification
- *Long term*
- *Medium term*
- *Short term*

B. Basic Principle of Financing

Classification of Financial Sources of a Business

According to
- *Period*
- *Ownership*
- *Sources of Generation*
- *mode of acquisition*

Long Term Sources of Finance
- ***Equity***
- ***Preference***
- ***Debentures / Bonds***
- ***Term Loans From Fin. Instns.***
- ***Term Loans from Banks***

Term Loan Procedure

Submit the Loan Application
Processing of the Application
Appraisal of the proposed project
Issue of Letter of Sanction
Borrowing unit to accept the terms & conditions
Execution of the loan agreement
Disbursement of the funds
Creation of security
Monitoring of the project

During Implementation
During Operation of the project

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Appraisal of TermLoan Proposal

Market
Technical
Financial
Economic
Managerial

Important Financial Institutions

a. IFCI *f. LIC*
b. NIDC *g. UTI*
c. ICICI *h. GIC*
d. IDBI *i. RCTFC*
e. IRBI *j. EXIM Bank*

Loan Syndication:(Recommended By Narasimhan Committee)

Role of Commercial Banks

i. Loans *v. Letter of Credit*
ii. Cash Credit *vi. Limit of Credit*
iii. Bank Overdrafts *vii. Hypothecation*
iv. Bills discounting *ix. Pledge*

Bridge Loans

New Financial Instruments

a. Deep Discount Bonds *k. Junk Bonds*
b. Secured Premium Notes (SPM) *l. Cumulative Conv. Bonds*
c. Zero Interest fully conv. deb. *m. Stock Invest*
d. Zero Coupon Bonds *n. Index-linked Gilts*
e. Double Option Bonds *o. Variable Rate Instruments*
f. Option Bonds *p. Warrants.*
g. Inflation Bonds
h. Floating Rate Bonds
i. Callable Bonds
j. Option Tender Bonds

Short Term Sources of Finance

Trade Credit
Advances from customers
Accrued Expenses
Bank Advances
Commercial papers
Inter-Corporate Deposits

Certificate of Deposit
Public Deposits
Short term unsecured Debentures

Financing of Export Trade by Banks

Pre-shipment Packing Credit Finance

Clean Packing credit
Against hypothecation of goods
Against Pledge
E.C.G.C. Guarantee
Forward Exchange Contract

Post- shipment Packing Credit Finance

- *By Purchase of bills*
- *By Discounting of bills*
- *Against Bills sent for collection*

Venture Capital Financing

Methods of venture capital financing:

Equity
Conditional term
Income Note
Participating Debentures

Other Sources of Financing

1. *Capital Subsidy/Incentives*
2. *Seed Capital Assistance*
3. *Asset/Debt Securitisation*
4. *Factoring*
5. *Interest free sales tax loan*
6. *Deferred Payment Guarantee*
7. *Forfeiting*

BRIEF TIME TABLE FOR NOVEMBER 2005 C.A. FINAL EXAMINATION.
SUBJECT : DIRECT TAX

EXAMINATION	BRANCH	COMMENCING	ADMISSION STATUS
NOV 2005 (A.Y. 2005-2006)	ANDHERI	19-07-2005	In Progress
NOV 2005 (A.Y. 2005-2006)	CHARNI ROAD	24-05-2005	In Progress
NOV 2005 (A.Y. 2005-2006)	GHATKOPAR	17-07-2005	In Progress

Course Coverage for all the branches is the same.

I. PRELIMINARY:

Why business firms need Finance?

Business firms need finance mainly for two purposes –

a. To fund the long term decisions – for setting up of firms, expansion, diversification, modernization, etc.
b. Involve huge investment, the benefits of which will be usually seen only in the long term. In addition to this, they are also irreversible in nature.
c. To meet the working capital requirements – to support smooth functioning normal business toper of a company.

Classify the Financing of needs based on period & state the principle of financing:-

II. CLASSIFICATION OF FINANCING NEEDS -

a. **Long term financial needs –** Required for a period exceeding 5-10 years. All fixed investments in plant, machinery, land, buildings are considered as long term financial needs.
b. **Medium term financial needs –** Required for a period between 1 to 5 years. Identification of medium term financial needs is arbitrary. Sometimes, long term requirements for which long term funds can not be arranged immediately may be financed from medium – term sources, thus generating medium term financial needs.
c. **Short term financial needs –** They are usually required for a period upto one year. It is related to investment in current assets such as stock, debtors, cash, etc. Investment in these assets is called working capital. The requirement of working capital depends upon a number of factors and may differ from industry to industry.

Basic principle of Financing

Short-term financial needs should be met from short term sources, medium term financial needs from medium term sources and long term financial needs from long term sources. Fund required to finance permanent or hard core working capital should also be procured from long term sources.

Classify the sources of Finance for a Business

III. FINANCIAL SOURCES OF A BUSINESS –

a. **According to period –**
   i. Long term sources e.g. shares, debentures, long term loan etc.
   ii. Medium term sources, e.g. debentures, public deposits, bank loan / overdraft.
   iii. Short term sources e.g. trade credit, advance from commercial banks, advances from customers etc.

b. **According to ownership**
   i. Owned share capital, retained earnings, etc.
   ii. Borrowed capital, e.g. debentures, public deposits, etc.

c. **According to sources of generation**

i. Internal sources, e.g., retained earnings, depreciation funds, etc.
ii. External sources, e.g., debentures, loans etc.

d. **According to mode of acquisition**
i. Spontaneous Financing
ii. Negotiated Financing

Explain Equity Capital as a Long term source of Finance

IV. LONG TERM SOURCES OF FINANCE

a. Equity capital

A public limited company may raise funds by issuing equity shares. Equity shareholders are the owners of the company holding a determinate share.

Salient Features

1. Private Limited Company raises funds from promoters, their relatives and friends.
2. Public Limited Company raises funds from promoters as well as from public.
3. It is a **Permanent** source of funds.
4. Equity share holders being **owners** of company undertake the **risks** of business.
5. They have right to **elect** Board of Directors and have the **control** over the management of company.
   As per recent Amendment to the Companies Act, Equity shares with different voting rights can be issued as per SEBI Guidelines.
6. They are **Redeemed** only in case of **liquidation**, hence least risk involved

   Exceptions:
   i. Buy-back of shares
   ii. Redemption of excess capital

7. Share holders are entitled for **dividend** which depends upon:
   i. Profitability position
   ii. Liquidity position
   iii. Financial needs of company.
   There is no mandatory payment of dividend to equity shareholders.

8. Dividend being an appropriation of profit is not deductible, while computing taxable profits of business. [On the contrary under Income Tax Act, domestic companies were required to pay tax on dividend under section 115 O @ 10% (plus Surcharge) on the amount of dividend paid / distributed. Such dividend was tax free in the hands of equity shareholders. This was applicable upto 31.5.2002.]Returns from the sale of shares in the form of capital gains are subject to capital gain tax.

9. **Costliest** but less risky capital.
10. Equity capital provides **security** to the lenders of fund.
11. The company can make further issue of share capital by making a rights issue.
12. The company can issue **bonus shares** by way of capitalization of reserves.
13. Hold share in the free reserves of the company.

Advantages –

i. It represent permanent capital. There is no liability for repayment
ii. It does not involve any fixed obligation for payment of dividends.
iii. Transfer of ownership is easier.
iv. The issue of new equity shares increases flexibility of the company.
v. The company can make further issue of share capital by making a right issue.

Disadvantages

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i. The cost of equity capital is highest.
ii. Equity dividends are non-tax deductible payments.
iii. The cost of issuing equity stock is generally higher than the cost of issuing other types of securities.
iv. Sale of equity stock to outsiders may dilute the control of existing shareholders.

Explain Preference share capital as a LT source of Finance

b. Preference Share Capital:

It partakes some characteristics of equity and some of debt capital. It's twin qualities resemble equity because preference dividend is paid only out of distributable profits and preference dividend is non-tax deductible payment. It is similar to debt capital as the dividend rate is usually fixed, the claim of preference shareholders is prior to the claim of equity shareholders and preference shareholders do not normally enjoy voting rights.

Types
- Dividend Payment
  - Aim
  - Non-cumulative
- Surplus Participation
  - Participation
  - Non-Participation

Salient Features

a. Preference share is a **hybrid security** because it has features of both ordinary shares and bonds.
b. There are **no voting rights** offered to preference shareholders, except in certain special circumstances
c. The holders of such shares enjoy **priority** over equity shareholders both as regards to fixed dividend and redemption in case of winding up.
d. A public company may issue **Redeemable Preference Shares** to be redeemed after a fixed period. The companies Act prohibits to issue irredeemable preference shares of shares redeemable after expiry of twenty years of issue. For redemption of preference shares, a company has to comply with legal requirements of Sec. 80 of the Companies Act.
e. It is a Medium or Long Term Source of funds.
f. Preference shares enable the company to **avoid dilution of equity capital.**
g. Preference dividend, being an appropriation of profit is non tax deductible.
h. Though company creates financial leverage, as there is a fixed dividend, cost of preference share capital is far greater than cost of debentures / borrowed funds, thereby risk is higher generally.
i. If Debt-equity ratio is high or cost of equity financing is relatively high, the case for using preference shares will be strengthened.
j. Cumulative Convertible Preference shares (CCPs) may also be offered, under which the shares would carry a cumulative dividend and specifies a limit for a period of say three years which the shares are converted into equity shares.
k. For normal preference shares, the maximum permissible rate of dividend is 14%

Types:

a. There are two types of preference shares viz. **Cumulative and Non-cumulative preference shares**. In cumulative preference shares unpaid dividend gets accumulated. All arrears of dividend must be paid before any dividend can be paid to equity shareholders. The non cumulative preference shares carry a right to fixed dividend out of profits for that year only. In case of non availability of profits, the holders of non cumulative preference shares are not entitled to arrears of dividend. **Unless otherwise specified,** preference shares are cumulative preference shares.

b. Further there are two types of preference shares viz. **Participating and Non-participating preference shares.** Participating preference shares carry a right to participate in surplus profits along with equity shareholders after dividend at a certain rate has been paid to equity shareholders in addition to entitlement of fixed dividend. Again in case of wind up, if there remains surplus after paying both the preference and equity shareholders, then the holders get additional share in the surplus assets. The right to participate is given in the Memorandum or Articles or by virtue of terms of Issue.

Advantages:

- There is no legal obligation to pay preference dividend. A company does not face bankruptcy, or legal action if it skips preference dividend.
- There is no dilution of control as preference shares do not generally carry the voting right.
- There is no dilution in earning per share (EPS) on enlarged capital base.
- Preference capital is generally regarded as part of net worth. It enhances the credit worthiness of the firm.
- No collateral is pledged in favour of preference shareholders.
- Financing through preference share is cheaper as compared to financing through equity shares.
- The company can take advantage of leverage as preference shares are entitled to a fixed rate of dividend.
- It can be redeemed after a specified period.

Disadvantages:

- Compared to debt, it is an expensive source of financing.
- It is not a tax-deductible payment.
- It dilutes the claim of the equity shareholders over the assets of the company.
- Though there is no legal obligation to pay preference dividend, skipping them adversely affect the image of the firm in the capital market.

Explain the role of Debentures/Bonds as a Longterm Source of Finance

c. Debentures/bonds -

Debentures / bonds are instruments for raising long term debt capital. It is identified as 'a document issued by a company as an evidence of a debt due from the company with or without a charge on the assets of the company. Debentures are issued on the basis of a debenture trust deed which lists the terms and conditions on which the debentures are floated. Debentures are normally secured against the assets of the company. Interest payable on debentures are tax-deductible. Interest is payable at fixed rate, however rate of interest may be linked with inflation.

Salient Features:

1) Debenture holders are the creditors of the company and hence no voting rights are enjoyed by them.
2) Debenture are redeemable according to the items of their issue.
3) Interest on debentures must be paid irrespective of profitability of the company. It is a charge against profits.

4) In case of liquidation, debenture holders being creditors have prior claim over the shareholders.
5) Raising funds by way of debentures has advantage of financial leverage or trading on equity.
6) Interest on debentures is tax deductible. Thus there is a tax shield and the source of finance becomes cheaper.
7) Debentures are usually secured on the assets of the company and therefore carry lesser risk and assured return to the investors.
8) As it is obligatory to pay interest at regular intervals and repayment of principal sum on scheduled dates any failure in obligations may paralyse the company's operations.
9) Financing through debentures is associated with financial risk to the company. This increases the cost of equity capital
10) Higher risks bring higher capitalization rates on equity earnings. Thus even though gearing is favorable and raises EPS, the higher capitalization rate attributable to gearing may drive down the market price of equity shares.,
11) There is flexibility in Debenture funds. Surplus funds with the company may be utilized for buying own debentures from the market and making cancellation thereof even before maturity date.
12) A company may issue convertible debentures (CDs) in which, option may or may not be given to debenture holders to convert them into equity or preference shares at stated issue price, after a certain period. CDs may be fully or partly convertible.
13) In a period of rising prices, debenture issue is advantageous. The fixed monetary outgo decreases in real terms as the price level increases.
14) Debentures are classified into -

    From Security point of view – Secured Debentures, Unsecured Debentures
    From Registration point of view – Registered Debentures, Bearer Debentures
    From Priority point of view – First Debentures, Second Debentures etc.
    From Enlisting point of view – Listed Debentures, Unlisted Debentures
    From Conversion point of view – Convertible Debentures, Non – convertible Debentures
    From Redemption point of view – Redeemable Debentures, Irredeemable Debentures

These days many companies are issuing convertible debentures or bonds with number of schemes / incentives like warrants / option etc., These debentures or bonds are exchangeable at the option of the holder for equity shares under specified terms and conditions. Debentures / Bonds are issued subject to SEBI guidelines. Public issue of debentures and private placement to mutual funds now require that the issue be rated by credit rating agency like CRISIL [Credit Rating and Information services of India Ltd.]. Credit rating is given after evaluating factors like track record of the company profitability, debt-service coverage, creditworthiness and perceived risk of lending.

Advantages:

i. The cost of debentures / bonds is lower than the cost of preference or equity capital as the interest on debentures is tax-deductible.
ii. It does not result in dilution of control.
iii. It enables the company to take advantage of leverage.
iv. The fixed interest burden associated with debentures / bonds, irrespective of changes in price level, has appeal to many companies.

v. It is suitable for investors who prefer a stable rate of return with little or no risk

Disadvantages:

i. Debenture interest and capital repayment are obligatory payments
ii. Not suitable for companies whose earnings fluctuate considerably, it may lead to considerable fluctuations in the rate of dividend payable to the equity shareholders.
iii. The protective covenant associated with a debenture issue may be restrictive.
iv. It enhances the financial risk of the company and may increase the cost of equity capital.
v. Failure to pay interest / principal may lead to the extreme case of filing a winding up petition by the debenture holders.

How do Termloans from Finance Institutions serve as a LT source of Finance?

d. Loan from financial institutions (Term Loans)- Terms loans forms a major source of finance for long – term project. They are generally repayable in more than one year but less than 10 years. Specialised financial institutions like IFCI, LIC, ICICI, IDBI, IRCI, State financial corporations, National Small Industries Corporation ltd., etc. providing long term financial assistance.

The salient features of term loans are:

- **Interest and principal payment –** Interest for term loan in fixed after the financial institution appraises the project and assesses the credit risk. Interest and principal payments are obligatory, and in case of defaults, attracts penalty. The principal amount of a term loan is generally repayable over a period of 6 to 10 years after an initial grace period of 1-2 years, in annual, semiannual or quarterly instalments.
- **Security –** Term loans typically represent secured borrowing. Usually assets financed with the proceeds of the term loan provide the prime security.
- **Restrictive covenant:** The term loans, in many cases, stipulate a number of conditions regarding the management and other financial policies.

The important covenant of the loan agreement includes

1. Amount of loan
2. Rate of interest
3. Additional levy of Interest
4. Commitment Charges
5. Reimbursement of Costs etc.,
6. Last date of Withdrawal
7. Repayment schedule
8. Conversion Right
9. Security for the loans
10. Appointment of Nominee Directors
11. Restriction on payment of Dividends
12. Permission to carry out Expansion or Diversification
13. Inspection of Books and Property
14. Commitment to Investment of Funds
15. Consent for Change in Scheme
16. Appointment of Managing Director

17. Changes in Memorandum and Articles of Association with prior approval affecting institutional interest.
18. Raising Unsecured Loans
19. Raising of Financial Resources
20. Submission of Physical and Financial Progress Reports
21. Review of Project cost
22. Withhold Disbursement in certain cases
23. information about Change in important Contacts
24. Maintenance of Property
25. Merger, Compromise with institutional consent
26. Material Happenings to be informed
27. Creation of Subsidiary with prior permission
28. Promoters Contribution towards the project
29. Lock – in – period for promoters funds

Advantages:

i. The cost of term loan < cost of equity or preference capital (as interest on term loans is tax deductible.)
ii. Term loans do not result in dilution of control.
iii. Leverage advantage.

Disadvantages:

i. The interest and principal payments are obligatory payments. Failure to meet these may threaten the solvency of the firm.
ii. Restrictive covenant may reduce managerial freedom.
iii. Term loan increases the financial risk of the firm which may raise the cost of equity capital.

e. Term Loan from Banks:

Explain the note of Banks in Meeting the Financing needs of a business

The primary role of the commercial bank is to cater to short term requirement of funds, however banks have started term financing of industries, though the formal term loan lending is so far, small and is confined to major banks only. It is argued that term loans do not satisfy the cannon of liquidity, which is a major consideration in all bank operations.

In fact, the degree of liquidity in the amortizations for term loan is more than that in demand loans, which are renewable from year to year. The adoption of formal term loan lending by banks thus will not in any way hamper the criteria of liquidity. As a matter of fact, it will introduce flexibility in the operations of the banking system. All banks are not well equipped to make appraisals of such loan proposals and evaluate an element or risk.

Salient Features:

1. Term loans are secured borrowing as medium / long term source of finance for additions to fixed assets.
2. Rate of interest depends upon credit rating of the borrower, perceived risk of lending and cost of funds to the lender.
3. Term loan is generally repayable over a period of 47 years in quarterly / half yearly instalments.
4. Interest on term loan is tax deductible.
5. Administrative cost of serving the loan is minimal as compared to cost related to Debenture / Bond option.
6. Usually interest on term loan is payable on quarterly basis.

V. TERM LOAN PROCEDURE -

Explain the procedure involved in obtaining a Termloan

The procedure associated with a term loan involves the following principal steps

a. Submission of loan application – The application form seeks comprehensive information about the project. It cover the following aspects: –
   i. Promoters background
   ii. Particulars of the Industrial concern.
   iii. Particulars of the project (capacity, process, technical arrangements, management, location, land and buildings, plant and machinery, raw materials, efficient, labour, and schedule of implementation)
   iv. Cost of the project
   v. Means of financing
   vi. Marketing and selling arrangements
   vii. Profitability and cash flow
   viii. Economic considerations
   ix. Government consents

b. **Initial Processing of loan Application –** On receipt of application, an officer of the financial institution reviews it to ascertain whether it is complete for processing. If it is incomplete, the borrower is asked to provide the required additional information. When the application is considered complete, the financial institution prepares a 'Flash Report' which is essentially a summarization of the loan application. On the basis of the 'Flash Report', it is decided whether the project justifies a detailed appraisal or not.

c. **Appraisal of the proposed project –** The detailed appraisal of the project covers the marketing, technical, financial, managerial and economic aspects.

d. **Issue of the letter of sanction –** If the project is accepted, a financial letter of sanction is issued to the borrower. This communicates to the borrower the assistance sanctioned and the terms and conditions relating thereto.

e. **Acceptance of the terms and conditions by the borrowing unit –** On receiving the letter of sanction from the financial institution, the borrowing unit convenes its board meeting at which the terms and condition; associated with the letter of sanction are accepted and an appropriate resolution is passed to that effect.

f. **Execution of loan agreement –** The financial institution after receiving the letter of acceptance from the borrower, sends the draft agreement to the borrower to be executed by authorized person and properly stamped as per the Indian Stamp Act, 1899. The agreement, properly executed and stamped, along with other documents as required by the financial institution must be returned to it. Once the financial Institution also signs the agreement, it becomes effective.

g. **Disbursement of loans –** Periodically, the borrower is required to submit information on the physical progress of the projects, financial status, arrangements made for financing the projects, contributions made by the promoters, projected funds flow statements, compliance with various statutory requirements, and fulfillment of the pre-disbursement conditions. Based on the information provided by the borrower, the financial institutions will determine the amount of term loan to be disbursed from time to time. Before the entire term loan is disbursed, the borrower must fully comply with the terms and conditions of the loan agreement.

h. **Creation of security –** The term loan provided by financial institution are secured through the first mortgage, by way of deposit of title deeds of immovable properties and hypothecation of movable properties.

i. **Monitoring –** Monitoring of the project is done at the implementation stage as well as at the operational stage.

- **During implementation,** the project is monitored through-
    i. Regular reports furnished by promoters, which provide information about placement of orders, construction of buildings, installation of plant and machinery, trial production, etc.,
    ii. Periodic plant visit,
    iii. Discussion with promoters, bankers suppliers, creditors, etc.,
    iv. Progress report submitted by nominee directors and

v. Audited accounts of the Company

- **During the operation stage,** the project is monitored with the help of
  i. Quarterly progress report on the project
  ii. Site inspection
  iii. Reports of nominee directors, and
  iv. Comparison of performance with promise

The most important aspect of monitoring is recovery of dues represented by interest and principal repayment.

How do FIS appraise a project? Proposal?

VI. APPRAISAL OF TERM LOAN PROPOSAL

Financial institutions appraise a project from the marketing, technical, financial, economic and managerial angles.

a. Market appraisal – Efforts are made to

i. Examine the reasonableness of the demand projections by utilizing the findings of available surveys, industry association projections, planning commission projections, and independent market surveys. Planning commission projections, and independent market surveys.

ii. Assess the adequacy of the marketing infrastructure in terms of promotional effort, distribution network, transport facilities, stock level, etc.,

b. Technical appraisal – it involves following aspects –

- Product mix
- Capacity
- Process of manufacture
- Engineering know-how and technical collaboration
- Raw materials and consumables
- Location and site
- Building
- Plant and equipment
- Manpower requirements
- Break-even point

Technical review is done by qualified and experienced personnel.

c. Financial Appraisal

i. **Reasonableness of the Estimate of Capital cost –** While assessing the capital cost estimates, efforts are made to ensure that under estimation of cost is avoided, specification of machinery is proper, quotations are obtained from potential suppliers, contingencies are provided and inflation factors are considered.

ii. **Reasonableness of the Estimate of working results –** The estimate of working result is sought to be based on a realistic market demand forecast, an appropriate time schedule for capacity utilization, and cost projections that distinguish between fixed and variable costs.

iii. **Adequacy of Rate of Return –** The general norms for financial desirability are as follows.
   - Internal rate of return – 15%
   - Return on Investment – 20 – 25% after tax
   - Debt-service Coverage Ratio – 1.5 to 2.0

iv. **Appropriateness of the financing pattern –** The institutions consider the following in assessing the financial pattern-
   - A debt equity ratio norm of 1.5 : 1.
   - A requirement that promoters should contribute a certain percentage of the project cost
   - The means of the promoter and his capacity to contribute a reasonable share of the project finance.

d. Economic appraisal – The economic review looks at the project from the larger social point of view. Some of the issues considered are-

i. Impact of the project on the distribution of income in the society.
ii. Impact of the project on the level of savings and investment in the society.
iii. Contribution of the project towards socially desirable objective like self sufficiency, employment etc.,

e. Managerial Appraisal – In order to judge the managerial capability, the following questions are asked -

i. How resourceful are the promoters? This is judged in terms of the experience of the promoters, progress achieved in organizing various aspects of the project and skill of the promoters.

ii. How sound is the understanding of the project by the promoter? This is assessed in terms of the credibility of the project plan and the details furnished to the financial institutions.

iii. How committed are the promoters? This is assessed by the resources applied to the project and the zeal with which the objectives of the project are pursued.

BRIEF TIME TABLE FOR NOVEMBER 2005 C.A. FINAL EXAMINATION.
SUBJECT : DIRECT TAX

EXAMINATION	BRANCH	COMMENCING	ADMISSION STATUS
NOV 2005 (A.Y. 2005-2006)	ANDHERI	19-07-2005	In Progress
NOV 2005 (A.Y. 2005-2006)	CHARNI ROAD	24-05-2005	In Progress
NOV 2005 (A.Y. 2005-2006)	GHATKOPAR	17-07-2005	In Progress

Course Coverage for all the branches is the same.
All lectures are conducted by Professor Mr.Kalpesh Sanghavi Only.

VII. IMPORTANT FINANCIAL INSTITUTIONS

List down a few FIS & State in brief the role in meeting Financing needs of Business firms

a. Industrial Finance Corporation of Indian (IFCI) (Set up in 1948)-

Objective
To provide medium and long term finance to industry.

Assistance Provided –
i. Project financing
ii. Financial services
iii. Comprehensive corporate advisory services.

b. National Industrial Development Corporation (NIDC) (Setup in 1954)

Objective
Development of industries, particularly those which are to fill the gaps in the industrial structure.

Assistance Provided –
i. Financing of Industries, priority to manufacturing industries.
ii. Study and investigation of industrial schemes and implementing them.
iii. Assistance in the form of capital, credit, machinery or any other type of facility.

c. Industrial credit and Investment Corporation Ltd. (ICICI) (Set up in 1955)

Objectives – To carry on the business of assisting industrial enterprises within the private sector in India by–
i. assisting in the creation, expansion and modernization of such enterprises
ii. encouraging and promoting the participation of private capital
iii. encouraging and promoting ownership of industrial investments and the expansion of investment markets.

Assistance Provided:
i. Medium and long term project and equipment finance

ii. Underwriting and subscription to share capital of companies
iii. Assistance in the form of rupee and foreign exchange loans
iv. Comprehensive corporate advisory services

d. Industrial Development Bank of India (IDBI) (Set up in July 1964):

Objectives:
To serve as a principal financial institution for co-ordinating the working of other financial institutions engaged in promoting, financing and developing industries.

Assistance provided –

i. Promoting the establishment of new enterprises especially in key industries.
ii. Lending and underwriting
iii. Direct subscription
iv. Refinance facility to SFCs, SIDCs and commercial banks in their lending activities to the industry
v. Short-term accommodation in the form of discounting / rediscounting commercial paper, bills of Exchange etc.,
vi. Guaranteeing deferred payments
vii. Arranging technical or administrative assistance for industries
viii. Undertaking research and surveys for evaluating and dealing with marketing of assistance

e. Industrial Reconstruction Bank of India (IRBI) (Set up in 1984) –

Objectives – To revive and revitalize the sick and closed industrial units.

Assistance provided –

i. Lending and reconstruction of industries
ii. Restructuring of management by providing technical and managerial guidance.
iii. Acting as a catalyst in securing assistance from banks, financial institutions and government agencies.

f. Life Insurance Corporation of India (LIC) (Set up in 1956)

Objective – To carry on life insurance business and providing substantial support to industry.

Assistance provided –

1. Subscription and / or underwriting shares, debentures and bonds of public limited companies
2. Providing financial assistance to industrial units in participation with other financial institutions.
3. Supporting new issue market and secondary market.

g Unit trust of India (UTI) (Set up in 1964)

Objective

To mobilize public savings and to channelise them into productive corporate investments with a view to promote growth and diversification of the country's economy and to provide regular and growing dividend income to units holders with safety and security of their capital.

Assistance Provided –

i. Subscribing to industrial securities and also purchasing securities in secondary market.
ii. Underwriting of new capital issues and direct subscription to shares and debentures of companies.
iii. Providing short term finance assistance by way of bridge finance.
iv. Project Finance

h. General Insurance Corporation (GIC) (Set up in 1973)

Objective
To undertake general insurance business in India and to invest in capital intensive and socially oriented projects.
Assistance provided –
i. providing assistance to industrial projects
ii. Subscription to equity shares and debentures
iii. Underwriting of securities

i. Risk capital and Technology Finance Corporation Ltd. (RCTFC) (Set up in 975).

Objective
To encourage new entrepreneurs, particularly technologists and professionals by providing seed capital (To know more about us visit KalpeshClasses.com)

Assistance provided –
i. Providing cheap personal loans to such professionals and technologists who have reasonable industry and business experience.
ii. Helping in setting up of a number of medium scale projects by first generation professional entrepreneurs
iii. Assisting by way of venture capital, risk capital etc.

j. State Financial corporations (SFCs) – Established in various started under Financial Corporation Act, 1951-

Objective – To serve the medium and small sized industries on a regional basis.

Assistance Provided
i. Granting loans to corporate and non-corporate units
ii. Project financing

k. Export – Import Bank of India (EXIM) (Set up in 1982)

Objective – To provide loans in foreign currency for meeting project expenditure relating to input of capital goods, raw materials, components, technology as well as local rupee costs of projects.

Assistance Provided –
i. Offering foreign currency loans under the new facility at LIBOR plus a reasonable spread.
ii. Enabling export-oriented enterprises with good export performance and sound financial, to access foreign currency funding even for the domestic cost of their projects.
iii. Undertaking research and analysis.

What do you meant by Loan Syndication?

VIII. LOAN SYNDICATION: [RECOMMENDED BY NARASIMHAM COMMITTEE]

Loan syndication involves commitments for term loans from the financial institutions and banks for financing a particular project. In other words, in loan syndication, two or more financial institutions / banks agree to finance a particular project. One of the institutions may become a lead institution and bring about coordination in the financing arrangements of different financial institutions / banks. Loan syndicate may be of two type. – 1. Direct lending 2. Participatory lending.

In a loan syndication, a financial institutions will take up the responsibility of appraising the project and tying up the entire loan within a specified time frame. This can be done by taking a part of the exposure and offering the remainder to other financial institutions and banks.

The advantage of loan syndication would be that borrower would not have to approach different financial institution. (For any inquiry or admission to kalpesh classes dial 2382 0676)

All the discussions on Financial Institutions have been concluded.

What are the forms of advances provided by Commercial Banks?

IX. ROLE OF COMMERCIAL BANKS:

Commercial banks mostly provide only short term credit to the business. They have started taking interest in term financing of industries in several ways. Commercial banks made advance to the customers in the following forms –

i. **Loans**
ii. **Cash Credit**
iii. **Bank overdrafts –** Under this, the customer of the bank is allowed to overdraw his current account, with or without security if he requires temporary accommodation.
iv. **Bills Discounting –** Under this, the banks provides funds to customer either by outright purchase or discounting bills arising out of sale of finished goods.
v. **Letter of credit –** Letter of credit is opened by a bank in favour of its customer undertaking the responsibility to pay to the supplier (or to the supplier's bank) in case its customer fails to make payment to the supplier with in the stipulated time.
vi. **Limit of credit –** It is a commitment by a bank to lend a certain amount of funds on demand specifying the maximum amount of unsecured credit the bank will permit the customer to lend at any point of time.
vii. **Hypothecation –** Hypothecation is in case of movable properties, where the goods hypothecated will be in the possession of the borrower. The bank is given access to goods whenever it desires.
viii. **Pledge –** In case of pledge, the goods are placed in the custody of the bank as security.

What do you mean by Bridge Loans?

X. BRIDGE LOANS -

It refers to loan taken by firms, generally, from commercial banks or financial institutions, pending disbursement of term loans from financial institutions. It may be noted that there is always a gap between the date of sanctioning of a loan and its disbursement by financial institution to the concerned borrowing firm. In order to prevent delay in starting their projects, the firms arrange from the commercial banks short-term loans which are later on repaid as and when loan disbursements are received from financial institutions.

Bridge loans are normally secured by hypothecating movable assets, personal guarantees and demand promissory notes. The rate of interest on bridge loan is usually higher than that on term loan.

Rate of interest on bridge loans is generally higher than that of the term loans. RBI has issued guidelines to banks regarding bridge loans to curb malpractices.

Explain in brief about the New Financial Instruments?

XI. NEW FINANCIAL INSTRUMENTS-

a. **Deep Discount Bonds –** It is a form of zero interest bonds. These are sold at a discounted value and on maturity, face value is paid to the investors. In such bonds there is no interest pay-out during lock in period. The main advantage of DDB is that the difference between the sale price and original cost of acquisition will be treated as capital gain, if the investor sells the bond on stock exchange.

b. **Secured Premium Notes (SPN) –** SPN is issued along with a detachable warrant. It is redeemable after a notified period of say 4 to 7 years. The warrant attached to the SPN gives the holder the right to convert the warrant into equity shares with in the period notified by the company.

c. **Zero interest fully convertible debentures –** These instruments do not carry any interest. They are compulsorily and automatically converted into new equity share of the company at predetermined price after a specified period. The company is benefited as it does not have to pay interest. The investor will be benefited if the share price of the company in the market is very high. For this instrument to work, the debenture must be offered at a rate lower than the prevailing market rate of its equality shares.

d. **Zero Coupon Bonds (Z C B) –** It does not carry any interest, but it is sold by the issuing company at a discount. The difference between the discounted value and maturing or face value represent the interest to be earned by the investor on such bonds.

Advantages of Zero Coupon Bonds (Z C B) –

a. To issuers

i. The issuer escapes the periodic payments that too in the gestation period of the project (In the initial few years), yet is allowed to deduct the implied interest from the taxable income.

ii. The marketability of the issue will become significantly better and issue expenses can be expected to come down with the amounts raised becoming more.

b. To Investors

i. This is especially good for individuals since the amount of initial investment is lesser as compared to PCD/FCD/NCD.

ii. Investors are normally looking for capital gains in the form of additional feature of Zero Coupon Convertibles where they can convert the Bond at maturity into equity shares at are apparently lesser premium as compared to a convertible debenture.

iii. This instrument is beneficial for higher tax bracket long term investors as compared to Convertible Debentures. They save on taxes as the implied interest is paid as capital gain in the form of appreciation of Bond Price.

iv. The investment is secured against the assets of the company as against Company Fixed Deposits which are unsecured.

v. This can be especially beneficial when long-term interest rates are expected to fall.

Disadvantages of (Z C B)

a. To Issuers –

i. The issuer carries an interest rate risk in the sense that a particular rate of interest is looked in at the time of issue for the life of the instrument and if long term interest rate falls, the issuer stands to lose.

ii. The number of securities issued (and possibly the investor base) for the same funds raised will be larger as compared to other instruments, thereby increasing the administrative and servicing costs.

b. To Investors –

i. The Z C B – holders do not have an option regarding conversion.

e. **Double Option Bonds –** In this, each bond has two parts in the form of two separate certificates, one for principal and other for interest (including redemption premium). These certificates are listed on stock exchange. The investor has the facility to sell either one or both parts anytime he likes.

f. **Option Bonds –** These are cumulative and non-cumulative bonds where interest is payable on maturity or payable periodically. Redemption premium is also offered to attract investors. These were recently issued by IDBI, ICICI etc.

g. **Inflation bonds –** In these bonds, interest rate is adjusted for inflation. Thus, the investors get an interest free from the effects of inflation.

h. **Floating Rate Bonds –** The interest paid to the floating rate bond holders changes periodically depending on the market rate of interest payable on the gilt-edged securities. These bonds are also called adjustable interest bonds or variable rate bonds.

i. **Callable Bonds:** A callable bond is a bond, which the issuer has the right to call and pay off at a price stipulated in a bond contract. The price at which bond is repaid is called "call price". The issuer has advantage to call their existing bonds, if current rate of interest in the market is sufficiently lower than the bond coupon rate. Usually the issuer cannot call the bond for a certain period after issue.

j. **Option Tender Bonds:** The option tender bonds are bonds with put option, which give the right to sell back their bonds to the issuer normally at par. (The opposite of callable bonds.)

k. **Junk Bonds:** Junk bonds are high yield securities which are widely used source of finance in takeovers and buyouts. Firms with low credit rating are willing to pay 3 to 5 percent more than the high grade corporate debt to compensate for the greater risk.

l. **Cumulative Convertible Preference Shares (CCPs) –** The Government has issued guidelines to companies proposing to issue CCPs. **The salient features are:** - The entire issue of CCP would be convertible into equity shares between the end of 3 years and 5 years, as may be decided by the company.

- The conversion of CCP into equity would be deemed as being the one resulting from the process of redemption of the preference shares out of the proceeds of the fresh shares made for the purposes of redemption.
- The rate of preference dividend payable on CCP would be 10%
- The preference shares would have voting rights as per Companies Act, 1956.
- The face value of the aforesaid shares will ordinarily be Rs. 100 each.

It appears that this scheme was not found favorable by the investors.

ISSUERS:

Advantages:

1. The 10% dividend on CCP shares is < the rate of interest in case of debentures (pre-tax only). The effective cost of debentures to the company depends on its tax rate. Therefore, for new companies with no tax liability, CCPs may offer a cost advantage.
2. The CCP shares are deemed as equity and so assure a large equity base for substantial borrowing for financing the same project or further investments.
3. In the initial years, CCP shareholders are not entitled to voting rights and so the management can retain full control over the company with a small capital contribution of its own.
4. The instrument is ideal for capital – intensive projects having long gestation period like steel fertilizers and power.
5. The planning of capital structure is facilitated since there is no uncertainty regarding conversion, unlike Optionally Convertible Debentures.

INVESTORS:

Advantages:
1. CCP shares give an assured return of 10% p.a. even during the gestation period, which may not be available in the case of equity shares. Even if the profits are inadequate in the initial stage, the dividend payable accumulates and the entire amount is paid before any dividend is paid to the equity shareholders.
2. There is a possibility of significant capital gain due to appreciation in the share price on conversion, if the project is economically viable and the company starts paying dividend.

Disadvantages:
1. CCP shareholders, u/s 87 (2) (a) of the Companies Act, will have right to vote only on resolutions which directly affect their rights and u/s 87 (2)(b)(i) on every resolution, if the dividend has remained unpaid for an aggregate period of not less than two years preceding the date of the meeting.
   This limits the extent to which CCP shareholders can influence the working of the company.
2. The CCP shareholder does not have an option regarding conversion.
3. The investment is not secured against the assets of the company as against the debt instruments like Optionally Convertible Debentures which are secured.

m. Stock Invest

In case of oversubscription of issue, there have been long delays in refunds of excess application money and large amounts of investors's funds remain locked up in companies for long periods affecting the liquidity of the investing public. To overcome this problem, a new instrument called "STOCKINVEST" is introduced.

The "stockinvest" is non-negotiable bank instrument issued by bank in different denominations. The investor who has a saving or current account with the bank will obtain the stockinvest in required denominations and will have to enclose it with the share / debenture application. The face of the instrument provides for space for the investor to indicate the name of the issue, the number and amount of shares / debentures applied for and the signature of the investor.

The stockinvest will be signed by the bank and the date of issue will also be indicated on the instruments. Simultaneously, with the issue of stockinvest, the bank will mark a lien for the amounts of stockinvest issued in the deposit account of the investor. On full or partial allotment of shares to the investor, the Registrar to issue will fill the columns of stockinvest indicating the entitlement of allotment of shares/ debentures, in terms of number, amount and application number and send it for cleaning.

The investor's bank account will get debited only after the shares / debentures are allotted. In respect of unsuccessful applicants, the funds continue to remain in the account and earn interest in case of savings bank or a term deposit. The stockinvest is intended to be utilized only by the account holders and the stockinvest should not be handed over to any third party for use.

This scheme is temporarily suspended as investors raised apprehensions in the transparency of the system.

n. Index-Linked Gilts -

Currently, the dated securities issued by the Central Government offer a coupon rate varying from 10 to 11.5% p.a. (recently hiked to 12% p.a. on new issues), depending upon the term of maturity. Given an average annual inflation rate of 12% p.a. The inflation adjusted rate of return (real rate of return) earned on these securities is just marginally positive and can be negative in those periods, where the inflation rate exceeds the coupon (nominal) rate. To protect the institutional investor (a significant part of which gets channelised into Government securities) from the purchasing power risk or inflation risk, we can consider the introduction of "Index-Linked Gills," These Index-linked gilts are inflation-proof over their terms of maturity.

The Government can issue index-linked gilts along the following lines:

- The base for index-linking can be the Consumer Price Index (CPI) and the base date for index linking can be the CPI value.
- Each Intervening coupon payment and the maturity proceeds are to be increased in the ratio of the CPI value.

Index-Linked Gilts were Introduced in U.K. in 1981 and have been growing in importance over the last ten years. Given the fact that an index-linked gilt-edged stock is a low income-high capital gains stock, the stock has also attracted considerable amounts of investment form individual investors in the higher tax brackets.

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o. Variable Rate Instrument -

In this, the coupon rate of interest is not fixed but varies in accordance with some predetermined formula. For example, the instrument may provide for the coupon being determined at six monthly intervals at a margin above the six-month inter-bank rate. This instrument helps the borrower as he does not have to commit to a fixed interest loans at rates which are temporarily very high.

Warrants -
Warrants are another popular source of finance in other countries. In India, it is currently being used only as a sweetener with NCDs, for e.g., forthcoming P & G Rights issue. Warrants are also traded in the secondary market in U.S.A., but pricing is very difficult, so it will take some time before it becomes popular in India and people appreciate its potential as an instrument in itself. It needs a very mature market as a prerequisite along with a high level of investor education otherwise it might be misused by the issuers.

Issuers:

Advantages:

1. Of late, the companies have been becoming dependent on Mutual Funds for privately placing their NCDs. This may create problems in future as these Mutual funds might start interfering with the working of the companies. With the use of warrants, NCDs could be sold to the public, thereby reducing issuers' dependence on Mutual funds.
2. Given the sweetener effect of the warrants, the front end discount on private placement of the NCDs could be reduced.
3. Warrants provide a mechanism for controlling future holdings of the promoters in the company and act as a deferrent against raiders. This is a better mechanism as compared to PCDs/straight equity since the cash outflow happened only when control is threatened. So, funds are not blocked unlike other options.

Disadvantage:
The long term capital structure planning becomes more difficult due to the uncertainties associated with conversion warrants.

Investors:

Advantages:
1. The warrants act as a sweetener because it is detachable and tradeable in the stock exchanges. Thus, it provides an additional benefit to the investors at zero cost.
2. Warrants and NCDs put together is a better combination as compared to convertible debentures because the investor continues getting interest on whole of his investment throughout the life of the instrument i.e. NCD,
3. The investor has an option regarding the taking up of shares against warrants unlike FCDs/PCDs, thereby, giving flexibility.

Disadvantage:
Given the complex structure of a warrant, the pricing is very difficult for the common investor to understand.

XII. SHORT TERM SOURCES OF FINANCE

What are the short term sources of Finance?

A. **Trade Credit** – It is a spontaneous source of finance which is normally extended to business organization depends on the custom of the trade and competition prevailing in the industry and relationship of suppliers and buyers. The dependence on this source of working capital finance is higher due to negligible cost of finance as compared to negotiated finances. It is a facility whereby business firms are allowed by the suppliers of raw materials, services, components, end products to defer the immediate payment to a future period. This form of credit is more helpful to small enterprises who find it difficult to acquire capital from banks and other sources in capital markets.

B. Advances from customers – Manufacturers and contractors engaged in producing costly goods involving considerable length of manufacturing or construction time usually demand advance money from their customers at the time of accepting their orders for executing their contracts or supplying the goods. This is **a cost free source of finance** and is very useful.

C. Accrued Expenses – It is another source of short term financing that arises from normal conduct of business. One of largest accrued expenses is employee's accrued wages. For large firms, the accrued wages held by the firm constitute an important source of financing.

D. Bank Advances – Refer 'Role of Commercial Bank' (Para IX)

SECURITY ARRANGEMENT FOR BANK ADVANCES

Loans are provided by banks against some security. Security may be personal or tangible as well as primary or collateral. In India security arrangements are regulated by the RBI.

a. **Personal and tangible security –** The personal right of action of the bank against the borrower exists in all types of advances; Still, banker takes a demand promissory note, a bond or a bill of exchange from borrower.
Tangible security is one that can be realized by sale or transfer, e.g., stocks, shares, goods, immovable property etc.

b. **Primary and collateral security** – Primary security is the principal security and is furnished to secure the repayment of advance.
Collateral security is the additional or supporting security i.e., when the security runs parallel to demand promissory note.

c. **Margin** – A bank keeps a margin on securities as a cushion against changes in the value of securities. The difference in the value of security and the amount up to which the borrower can withdraw is called margin.

Appraisal of a proposal by banks

The banker's appraisal of the borrower is designed to determine the suitability of the loan proposal from the standpoint of two objectives-
a. Value and soundness of security offered, and
b. Safety of the loan - The safety depends on the 'ability' and 'willingness' of the borrower to pay back.

An appraisal of the borrower by the banker is carried out to assess and determine how good a risk the borrower is likely to be. A whole set of tools and techniques of financial analysis is used by the banker in arriving at some rational judgement about the credit worthiness of the borrower.

The banker needs to go beyond financial statements and statistical data presented to him by the borrower. This will help the banker to ascertain the willingness of the borrower to pay back. While examining a loan proposal, the banker should not merely look into technical, economic and financial feasibility of the project, but also the 'person' or managerial competence.

Some bankers have grouped the points of appraisal as –

a. **Prospects** – What is the possibility of growth of the unit or the industry?
b. **Purpose** – What is the purpose of the loan? Is it for acquiring fixed assets or for liquid assets?
c. **Payment** – What is the possibility of loan being repaid within the time stipulated?
d. **People** – What is the character and caliber of the person to whom advance is being grated?
e. **Protection –** What is the security available?

Facilities offered by banks to small scale units (SSUs) –

1. Meeting the working capital requirements by -
    a. Granting cash credit, loan facilities against pledge, hypothecation of raw materials and finished goods, etc.
    b. Granting bills discounting and bills purchasing facilities.
    c. Factoring arrangement.
2. Meeting fixed capital requirements for acquisition of fixed assets against security of the assets.
3. Financing the requirements of technically qualified and experienced entrepreneurs.
4. Financing export trade of small units.
5. Charging concessional rate of interest on advance.

Appraisal of small borrowers by bankers – Small borrowers can't satisfy the traditional norms required for obtaining finance. The following points should be taken into consideration while appraising small borrower's proposal –

a. The prospective borrower must be properly introduced.
b. He must have a good reputation, possess character and capacity.
c. He should posses the necessary skill and technical know-how.
d. The borrower should be asked to furnish the latest statements of his assets and liabilities, statements of income and expenditure for the previous years, if he is already in business.
e. If the borrower is heavily indebted, the proposal should not be entertained as the loan may be utilised to repay old borrowings.
f. Ascertain the purpose for which advance is required.
g. Project should be carefully studied as to its economic and technical feasibility.
h. The borrower should be in a position to generate sufficient income from the advance to enable him to repay the loan as per the schedule.
i. The bank may ask for a tangible security by way of pledge, hypothecation and / or a guarantee.
j. An insurance policy on the borrower's life assigned in bank's favour should preferably be obtained.

e. Commercial Papers:

Commercial Paper (CP) is an unsecured promissory note issued as a debt instrument, that enables highly – rated corporate borrowers to raise funds for a short period. The maturity period may vary from 90 days to 180 days. The amount raised by CP is also large. Interest rates of CP are negotiable.

The firm or the dealers in CP sell these to the short term lenders, who use it as interest earning investments of temporary surplus operating funds. The maturity term of CP is fixed.

The CPs are issued with face value but the issue price is less than face value. The difference is discount on the issue price which works as a return to the lender at the time of maturity. Discount on CP depends upon the amount involved, maturity period and prime lending rate of commercial banks.

The main advantage of CP is that the cost involved is lower than the prime lending rates. In addition to this cost, the borrower has to bear another cost in the form of stamp duty and placement fees payable to the dealer of CP.

The main risk concerning CP is the lack of security.

CP comes under the purview of RBI which has issued guidelines in 1990 on the basis of recommendations of the Vaghul Committee.

Guidelines for issue of CP in India:

1. CP should be in the form of Usance Promissory Note negotiable by endorsement and delivery. It is issued at a discount to the face value as may be decided by issuing company
2. Amount to be raised by CP is not restricted by the company's cash credit component of the maximum Permissible Bank Finance. Cps can be issued upto 100% of the fund based working capital limit enjoyed with the bankers.
3. CP is issued in denomination of Rs. 5,00,000, but the maximum lot or investment is Rs. 25,00,000 per investor.
4. CPs should be issued for a minimum period of **30 days** and maximum of **6 months. No grace period** is allowed for repayment.
5. CPs can be issued by a company whose –
    i. Tangible net worth is not less than Rs. 5 crores.
    ii. Fund based working capital limit is not less than Rs. 4 crores.
    iii. Shares are listed on the stock exchange.
    iv. Specified credit rating is obtained from CRISIL or ICRA
    v. The current ratio is 1.33 : 1.00
6. All expenses (such as dealers fees, rating agency fees, other relevant costs) should be borne by the issuing company.
7. CPs can be issued to any person, bank or company. The issue of CP to **NRIs can only be on non-repatriable** basis and is not transferable.
8. Deposits by the issue of CP have been exempted from the provisions of Sec. 58 A of the Companies Act, 1956.

f. Inter Corporate Deposits (ICD):

Sometimes the companies borrow funds for a short term period, say upto six months, from other companies which have surplus liquidity for the time being. The ICDs are generally unsecured and are arranged by a financier. The ICDs are very common and popular in practice as these are not subject to legal hassles. Convenience is the basic virtue of this method of financing. There is no regulation at present in India to regulate these ICDs. The rate of interest on ICD varies depending upon the amount involved and time period. The entire working of ICD market is based upon the personal connection of the lenders, borrowers and financers. Rate of interest on ICDs is negotiable but generally higher than bank rates.

g. Certificate of Deposit (CD):

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

h. Public Deposits:
Public deposits are tapped as a source of short term or medium term finance. This had become an important source of finance during the period of credit squeeze by RBI. A public company can accept public deposits, [subject to provisions of The Companies Act 1956, upto a maximum of 35% of its paid up capital and reserves from the public and shareholders.] These are unsecured deposits and may be accepted for a period ranging from six months to three years. As the deposits are available for a period of not more than three years, they are used for financing working capital requirements. Of course, the public deposits are renewable on maturity.

i. Short term Unsecured Debentures:
Recently many companies have raised short term funds by the issue of unsecured debentures for periods upto 17 months and 29 days. The rate of interest on these debentures may be higher than the rate of secured long term debentures. It may be noted that no credit rating is required for the issue of these debentures. As per SEBI guidelines, the credit rating is required for debentures having maturity period of 18 months or more. The use of unsecured debentures as a source of short term financing, however, depends upon the state of capital market in the economy.

XIII. FINANCING OF EXPORT TRADE BY BANKS:

Types

Clean | **Hypothecation** | **Pledge** | **E.C.G.C** | **Forward Contract**

What do you mean by Pre-shipment Finance?

1. Pre – Shipment or Packing Credit Finance:
Packing credit is an advance extended by banks to an exporter for the purpose of buying, manufacturing or processing, packing and shipping the goods to overseas buyers.

An exporter having a firm order in hand placed with him by a foreign buyer or irrecoverable letter of credit opened in his favour, can approach bank for availing credit. An advance so taken is required to be liquidated within 180 days from the date of its commencement by negotiation of export bills or receipt of export proceeds in an approved manner. Packing credit in the case of customers of long standing, may also be allowed against firm contracts entered into by them with overseas buyers.

Types of Packing Credit –

i. **Clean Packing Credit:** It is a clean type of export advance. Each proposal is weighed according to requirement of trade and creditworthiness of the exporter. Export credit Guarantee Corporation [ECGC] cover is obtained by the bank.

ii. **Packing credit against hypothecation of goods:** Export finance is made available on certain terms and conditions, where the goods are hypothecated to the bank as security with stipulated margin. In this case borrower is required to submit periodical stock statement to bank.

iii. **Packing credit against pledge of goods:** Export finance is made available on certain terms and conditions, where the exportable finished goods are pledged to the bank with approved clearing agents who will ship the goods from time to time as required by the exporter. The possession of the goods so pledged lies with the bank and kept under lock and key.

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

v. **Forward Exchange Contract** – Another requirement of packing credit facility is that if the export bill is to be drawn in a foreign currency, the exporter should enter into a forward exchange contract with the bank, thereby avoiding Forex risk.

Explain Banks meet post shipment financing needs.

2. Post – Shipment Packing Credit Finance:
Bank provides finance to exporters by purchasing export bills drawn payable at sight or by discounting usance export bills covered by confirmed sales and backed by documents of title to

the goods such as bill of lading, air/ship consignment notes. It is necessary that exporter should obtain a shipment or contract risk policy of ECGC.

Finance may also be provided by banks to exporters by way of advance against bill forwarded through them for collection, taking into account creditworthiness of the party, nature of goods exported, usance etc.

XIV. VENTURE CAPITAL FINANCING:

What do you mean by venture capital Financing?

Technically competent entrepreneurs, who lack experience and funds required as promoters contribution is financed under venture capital financing. Venture capital financing refers to financing new highly risky ventures promoted by qualified entrepreneurs with a potential for success.

Venture Capital industry is a recent introduction. It is a national priority especially in the areas of telecommunication, Non-conventional energy, Quality upgrading, Bio-technology, Information Technology, Induction of new technologies etc.,

The Government of India issued guidelines for venture capital companies in 1988 and offered a number of tax concessions. In 1999 the existing guidelines were relaxed to increase the attractiveness of the venture schemes and induce high net worth investors to commit their funds to "sunrise" sectors, particularly the Information Technology Sector. Initially the contribution to the funds available for the venture was only from all India financial institutions, state development corporations, commercial banks and companies in private sector. In the last couple of years, many off shore funds have been started in the country and maximum contribution is from foreign institutional investors.

Some methods of Venture capital financing are as follows:

Methods

Equity Financing | **Conditional Loan** | **Income Note** | **Participating Debenture**

1. Equity Financing:

As venture capital undertaking generally requires funds for a longer period but may not be able to provide returns to the investors during initial stages, the venture finance is normally Equity Financing > 49% Equity Capital, So the control remains with the enterprises.

2. Conditional Term:

A conditional loan is repayable in the form of royalty after the venture enterprise is able to generate sales. No interest is payable on such loans. A royalty charge may range from 2 to 15%, actual rate depends on factors like gestation period, cash flow pattern, risk and other related factors. Some capital financers give a choice to enterprise for paying high rate of interest (say above 20%) instead of royalty on sales once it becomes commercially sound.

3. Income Note:

It is a hybrid security which combines the features of both conventional loan and conditional loan. The entrepreneur has to **pay both interest on loan and royalty on sales** but at substantially low rates.

4. Participating Debentures:

Such a security carries charges in three phases:

Start a phase	:	No interest
Next phase	:	Low rate of interest upto a particular level of operation.
Subsequent phase	:	High rate of interest.

XV. OTHER SOURCES OF FINANCING:

Other Sources

- **Capital Subsidy**
- **Interest Free**
- **Seed Capital Assistance**
- **DPG**
- **Asset / Debt Securitisation**
- **Forfaiting**
- **Factoring**

Write a note on capital subsidy?

1. Capital Subsidy / Incentives:

In order to encourage the dispersal of industries in the less developed areas, Government has been giving a package of incentives to New / Expanding units set up in the developing region.

The Package scheme of incentives introduced in 1964 were amended from time to time e.g. Government of Maharashtra introduced a new scheme viz., Package Scheme of Incentives 2001, for accelerating the process of dispersal of industries to the less developed regions and for promoting high-tech industries in developed areas of the state coupled with the object of generating mass employment opportunities.

The following categories of industrial and other units will be considered for incentives:

1. Industries listed in the first schedule of Industrial (Developed and Regulation) Act, 1951.
2. Small scale Industries, Coir, Silk, Handicraft and Khadi Industries.
3. Information Technology
4. Hotels.
5. Poultry and Agro Industries.
6. Bio – Technology.
7. Non-Conventional energy.

The Incentives may be in the form of:

1. Special Capital incentives as a grant computed on the basis of certain percent of fixed capital investment, with a ceiling.
2. Interest Subsidy
3. Refund of Octroi / Entry Tax
4. Exemption of Electricity Duty.
5. Exemption of Sales Tax or Deferment of Sales Tax.

The Capital incentives form a part of long term finance. However one must not be dependent on the availability of incentives for economic viability of the project.

The incentives are sanctioned and released to the units only after they have complied with initial effective steps and final effective steps respectively. The release of incentives by the concerned State Government generally takes one to three years. The promoters therefore find it convenient to avail bridge finance against the sanctioned capital incentives.

However bridge finance is normally made available to the extent of only 85% of the sanctioned incentives.

2. **Interest free sales tax loan –** State Government as a package of incentives sanction interest free sales tax loan either by way of deferment of sales tax liability of a new unit or disbursing sales tax loan on the basis of sales tax paid by existing units in the past. The loan is repayable after 10 / 12 / 14 years. Thus it serves as a long term loan without any interest.

3. **Seed Capital Assistance –** This scheme is designed by IDBI for professionally or technically qualified entrepreneurs and / or persons possessing relevant experience, skills and entrepreneurial traits. All the projects eligible for financial assistance from IDBI, directly or indirectly, through refinance are eligible under the scheme. This scheme is interest free but carries a service charge of 1% p.a. for the first 5 years and 10% p.a. thereafter. The repayment schedule is fixed depending upon the repaying capacity of the unit with an initial moratorium upto 5 years.

4. **Deferred Payment Guarantee (DPG) –** Assistance in the nature of DPG is available for purchase of indigenous as well as imported plant and machinery. Under this scheme, guarantee is given by concerned bank/financial institutions about the repayment of the principal along with interest and deferred instalments. This is a very important type of assistance particularly useful for existing profit-making companies, who can acquire additional plant and machinery without much loss of time.

5. **Asset / Debt Securitisation -** The term securitization 'refers to both switching away from bank intermediation to direct financing via capital market and / or money market, and the transformation of illiquid assets like automobile loans, mortgage loans, trade receivables into marketable securities.
   "Securitisation is a process of transformation of illiquid assets into a security, which may be traded later in the open market".

It is method of recycling of funds. It is especially beneficial to financial intermediaries to support lending volumes. Assets generating steady cash flows are packaged together and against this asset pool, market securities can be issued.

Securitisation Process:

i. The Origination Function:
A borrower seeks a loan from finance company, housing company or lease from leasing company. The creditworthiness of the borrower is evaluated and contract is entered into in a normal manner with repayment schedule.

ii. The pooling Function:
The originated assets viz. trade receivable, lease rentals, housing loans, automobile loans etc., according to maturity pattern and interest rate risk are clubbed together to create a pool. This pool is transferred, in favour of Special Purpose Vehicle (SPV), which acts as a trustee for the investor. Once the assets are transferred they are held in the investor's portfolio.

iii. The Securitisation Function -

It is the SPV's job now to structure and issue the securities on the basis of asset pool. The securities carry a coupon and on expected maturity which can be asset based or mortgage based. They are generally sold to investor through a merchant banker. The investors interested in these types of securities are generally institutional investors like mutual fund, insurance companies etc. (For any inquiry or admission to kalpesh classes dial 2382 0676)

The originator usually keeps a spread available between yield from secured assets and interest paid to investors.

Thus trustees act as receiving and paying agent. Thus good quality loans will be eligible for securitization. The repayment pattern of assets in particular will be the deciding factor to structure the instrument.

The process of securitization is generally without recourse i.e. investor bears the credit risk or risk of default and issuer is under an obligation to pay to the investors only if the cash flows are received by him from the collateral. The issuer however, has a right to legal recourse in the event of default. This risk run by the investor can be further reduced by obtaining insurance cover, often provided by a pool insurance policy.

Benefits to the originator:-

a. The additional source of capital can be tapped through securitization relieving trade receivable, deposit collection process.
b. Without disturbing the liabilities side of the Balance Sheet, the funds can be raised and enhance activity of lending, which increases the profitability.
c. Reduce the existing debtors and its related risks.
d. Conversion of illiquid asset into liquid portfolio.
e. The assets are shifted off the Balance – Sheet, thus giving the originator recourse to off Balance – Sheet funding.
f. It facilitates better Balance Sheet management, as assets are transferred off – Balance Sheet facilitating satisfaction of Capital Adequacy Norms.
g. Enhancement of credit rating.
h. Improvement of income to asset ratio.

Benefits to the investor:-

1. He gets security which is backed by adequate collateral and has credit enhancement

2. Securities are rated by credit rating agencies. It becomes easier for an investor to compare the risk – return profile of asset backed securities with other investible instruments and make an informed choice.
3. It opens up new investment avenue.

For a developed securitization market, high quality assets with low default rate is essential with standardized loan documentation and stable interest rate structure. Well developed secondary debt market is very essential for this route. In Indian context debt securitization has began to take off.

6. Forfaiting – Meaning – It is a technique to help the exporter

1. To sell his goods on credit and
2. Yet receive the cash before the due date. Forfaiting, in the field of exports, implies surrender by an exporter of the rights to claim payments, (which he could have received in future) in lieu of immediate cash payments.

Mechanism – The exporter generally takes bill/promissory notes to the forfaiter (generally a bank) buys the instruments at a discount from their face value. The importer's bank has already guaranteed payment unconditionally and irrevocably, and exporter's bank (the forfaiter) now takes full responsibility for collection. It has no recourse to the exporter i.e. the forfaiter cannot go back to the exporter for the recovery of money, which the importer may not have paid him. The forfaiter charges certain commission on the face value of receivables for bearing risk and servicing the receivables.

Advantages –
1. It eliminates virtually all **credit risks.**
2. It protects against the possible fluctuation **in interest rates** before the bills or notes are paid off.
3. Fluctuations in **exchange rates** do not matter during commitments period.
4. Administering the sales ledger and collection of payments are taken over by forfeiter.

Disadvantages –
1. The exporter's bank may not like to commit funds for the length of the period that the exporter may desire.
2. The importer's bank may refuse to guarantee payment.
3. The exporter's bank may not agree to forfait deal involving importer from financial'y weak country.

i. **Factoring :**

It is not just a single service, rather a portfolio of complementary financial services available to clients i.e., sellers, relating to credit investigation, sales ledger management, purchase and collection of debts.

Key Features –

a. The factor selects the accounts of the client that would be handled by it and establishes, the credit limits applicable to the selected accounts.
b. The factor assumes responsibility for collecting the debts of accounts handled by it.
c. For each account, the factor pays to the client, at the end of the credit period, or when the account is collected, whichever comes earlier, against not yet collected and not yet due debts. The credit is usually extended upto 70 % to 80 % of the face value of the debts and carries interest rates which may be => the lending rate of commercial banks.

Advantages –
1. Conversion of Accounts Receivables to cash without botheration of repayment.
2. Ensuring definite pattern of cash flow from credit sales.
3. Continuous factoring may eliminate the need of Credit and Collection Department.

Limitations –
1. Cost of factoring tends to be higher than the cost of other forms of short term borrowing.
2. Factoring of debt may be perceived as a sign of financial weakness.

Chapter 3

3 SPECIAL PROBLEMS RELATING TO FINANCING AND MANAGEMENT OF SMALL AND MEDIUM ENTERPRISES

An Overview

Introduction

Rationale of Small Scale Enterprises

Government Policies and Programmes for Development of Small Scale Industry Sector

Problems And Deficiencies of Small Scale Industries

Big Industrial Units- Financial Bodies Nexus Scuttling Small Enterprises

Remedial Measures For Development of Small Scale Industries

Secretarial Audit for Small Companies

Role of Small Industries Development Bank of India (SIDBI) in the Development of SSI units

Innovation And Small Units in India

Finance of Khadi and Village Industries

KVI Sector- Opportunities and Challenges

New Policy for Small Scale Industries, 1991

I. Introduction

What do you mean by SSIs?

How do they differ from Large and Cottage Industries?
Small-scale industrial units are those which operate with
- a modest investment in fixed capital,
- relatively small-scale workforce and
- a relatively small volume of output of goods / services.

As per the present Industrial policy of the Indian Government, a small scale industrial unit is one having investment upto Rs. 1 crore in plant and machinery. In case of ancillary industrial unit also, the limit is Rs. 1 crore.

- The small scale sector plays an important role in Indian Industry and economy. It has made rapid strides in India proving one of the reasons for the pace of development.
- It has graduated from producing basic consumer goods like detergents, soaps, paints, etc. to evolving sophisticated control systems, electro-medical equipment, drugs and pharmaceuticals.
- They differ from large scale Industries with respect to size of capital, employment, production and management, flow of input and output and so on.
- They differ from cottage industries with respect to the degree of mechanization, ratio of hired labour to family labour, geographical size of market, capital employed and so on.

II. RATIONAL OF SMALL SCALE AND COTTAGE INDUSTRIES:

Outline the rational of Small & Cottage Industries?

1. **Employment Generation** – The employment creation potential per unit of investment is higher than that of large industries.
2. **Decentralised Regional Development** – They are broad based and dispersed than large industrial units, thus resulting in balanced regional development.
3. **Creation of wide entrepreneurial base** – They result in diffusion of economic power among a large number of small entrepreneurs.
4. **Mopping up and mobilization** of small savings, scarce capital and local materials, human resources and skills.
5. **Modest capital requirement** – There are suitable for capital scarce countries like India.
6. **Contribution to industrial production** and industrial growth.
7. **Low capital output ratio** as compared to large industries.
8. **Support to large industries** – by meeting their requirements of raw materials, intermediate goods, spare parts etc.
9. **Export orientation** – They contribute nearly 50% of the total exports of the country.
10. **Production of wide range** of producers's and consumer goods.
11. **Quality of Gradation**

III. PROBLEMS AND DEFICIENCIES OF SMALL SCALE INDUSTRIES:

State the deficiencies in SSIs

1. **Concentration in industrialized states –** Most SSI units are clustered in industrialized states and around urban conglomerates along with large units rather than decentralize into semi-urban and rural areas. Reason: SSI units depends on large scale units and on large cities as source of their markets. This had led to increased congestion of large metropolitan areas.
2. **Bogus and Fictitious Units –** A large number of SSI units exists only on paper to take advantage of concessional and liberalized allocation of import licenses, scarce raw materials and finance only to divert them in the market to the highest bidder.
3. **Exploitation of labour –** Employees and workers in SSI units are less organized and united and hence are exploited by ownership groups.
4. **Lack of entrepreneurial spirit –** Small industry entrepreneurs are said to show more anxiety in availing of the liberal credit and other facilities offered by the government than in developing self reliance and building up their own resources.
5. **Industrial Sickness –** Industrial sickness is far more chronic in SSI units than in large industries.
6. **Under – utilization of capacity –** Proliferation of units in the same industry, because of easy conditions, create more capacity as compared to demand. Further, unhealthy competition among SSI units lead to underutilization.
7. **Tendency to avoid compliance with laws –** In order to avoid compliance with a plethora of factor and labour laws, the SSI units tend to replace labour by capital and become more capital intensive. Also, they refuse to grow, once they reach the plant and machinery ceiling fixed for small scale units.
8. **Influence of Big Business Houses –** Few big business houses have indirectly taken the concessions and facilities offered by the government to the SSI units.
9. **Problems in getting scarce raw materials, adequate credit etc.** – Although several protective and promotional measures have been taken, the SSI units still face problems in getting scarce raw materials, adequate credit, technical assistance, marketing avenues, etc.
10. **Poor quality of products –** SSI units lack technical sophistication to make quality products. So products manufactured by SSI units are not upto the desired standards.
11. **Lack of Technical upgradation –** The SSI units have not technically upgraded themselves because of permissible investment limit of Rs. One crore, which is extremely unreasonable in present situation.
12. **Inadequacy of working capital –** This arises due to delay in receiving payment for their supplies.

IV. GOVERNMENT POLICIES AND PROGRAMMES FOR DEVELOPMENT OF SMALL-SCALE INDUSTRY SECTOR:

1. **Underlining the significance of SSI in Industrial Policy:** The Government underlined the significance of small-scale and cottage industries for overall economic development in all the Industrial Policies.

2. **Special Institutions** – Special institutions have been established to promote and co-ordinate the development of small and village industries to meet the diverse needs of small-small sector are as follows-
   a. Small Industries Development Corporation (SIDC) to formulate policies, co-ordinate and monitor development of SSIs.
   b. National Small Industries Corporation (NSIC) – to support hire purchase of machinery and equipment, marketing and export promotion.
   c. Handloom Board
   d. Khadi and Village Industries Commission
   e. Central Handloom and Handicraft Corporation
   f. All India Handicraft Board
   g. Central Silk Board and Coir Board
   h. State level Directorates and Development Corporations
3. **Exemption** from obtaining industrial licenses for a wide range of items.
4. **Reservation** – A number of items have been exclusively reserved for SSI units.
5. **Exclusive procurement by Government** – About 410 items manufactured by SSI units have been exclusively reserved for procurement by the government.
6. **Setting up of Industrial Estates** for setting up SSI units
7. **District Industries Centre** – To facilitate single window clearance of a package of assistance and facilities such as credit, guidance, raw materials, training etc.
8. **Financial Assistance** – Long term and short term financial assistance by specialized institutions, banks at concessional rates of interest.
9. **Fiscal and other concessions** – e.g.concessional excise duty, exemption of excise duty upto Rs. One crore for SSI units, capital subsidy in backward areas, tax holiday, allocation of scare and essential indigenous / imported materials and so on.

Special schemes –

a. Small Industries Development Funds, 1986
b. National Equity Funds, 1987
c. Single Window scheme, 1988
d. Small Industries Development Bank of India as an Apex Bank to provide financial assistance to SSI units.
e. Scheme of Integrated Infrastructural Development, 1994
f. Quality certificate scheme to improve SSI product quality
g. Seven point action plan to improve credit flow to SSI sector
h. Technology development and modernization fund.
i. Credit Insurance Scheme, 1999-2000, to improve flow of investment credit.
j. A National programme for Rural Industrialisation to set up 100 rural clusters every year.
k. Comprehensive policy package, 2000 – This policy raised the exemption limit for excise duty for SSI units, encouraged the small units to develop testing laboratories, raised the limit for composite loans, increased the coverage of integrated infrastructure Development Scheme, and so on.

V. BIG INDUSTRIAL UNITS – FINANCIAL BODIES NEXUS SCUTTLING SMALL UNITS: Explain how the nexus between

Between the big industrial units and financial institutions is causing growing incidence of sickness among SSI units?

1. A major portion of outstanding bank credit (about 74%) is locked in big units. So, SSI units suffer resource crunch (both short-term and long term).
2. By starving off credit to SSI sector, the big units make them subservient to their needs or reduce their status to supplier industries. The big units also prevent meaningful regional dispersal of industries.
3. The growth of organized sector employment has been negligible and its ability to absorb job seekers is limited. This would adversely affect unemployment situation.
4. SSI units suffer from inadequacy of working capital caused by delays in receiving payment for their supplies from bi units, Banks and financial institutions do not give due credence to working capital requirements of SSI units.
5. Actual amounts given are much lower. Even these lower amounts are delayed.
6. Borrower's working capital limits are not raised by banks even in the event of rise in excise and custom duties or in prices of basic raw materials. This added to cost making SSI units uncompetitive.

VI. REMEDIAL MEASURES

State the measures to be taken to develop SSIs.

1. **Co-ordination** among various government agencies associated with meeting the needs of SSI units.
2. Separate **public agency** at State levels to issue licenses for establishment of SSI units .This is to ensure that the basic objectives of development of SSIs are achieved. Licensing should be simple and hassle free.
3. Separate and **sound institutional arrangement** for :

a. monitoring the functioning of SSI units
b. identifying at an early stage the likely sickness among the units.
c. Initiating quick measures to remove the basic sources of sickness.
d. Rehabilitation.

4. **Management Development Institutes** – to provide management education and training on how to manage small industrial units.
5. **Identification of sectors with high export potential** and setting up commercial parks for exports. Also, special credit schemes targeted at SSI exporters should be balanced.
6. **Export factoring services** – to be introduced as a new trade financing instrument for SSI units.
7. **Adequate and timely finance** – by banks / financial institutions need to be improved.
8. **Venture capital fund** – may be set up for new entrepreneurs for providing assistance to project involving new and untried process and technologies which have scope for commercial applications.
9. **Extending non-financial services** – to the SSI units for technological upgradation, skills upgradation, quality improvement environment management and information about markets, regulation, clients, etc.

VII. SECRETARIAL AUDIT FOR SMALL COMPANIES -

Write a note on secretarial audit?

According to Section 383 A of the Companies Act, 1956, every company which is not required to employ a whole time secretary and having a paid up share capital of Rs. 10 lacs or more, shall file with the Register, a certificate from a Company Secretary in whole time practice as to whether the company has complied with all the provisions of this Act and a copy of the compliance certificate shall be attached with Board's report.

The objective of introducing compliance Certificate is to improve the standards of corporate records. This is expected to bring about greater self regulation in the corporate sector.

In case of smaller companies, which can not afford or which do not require the services of a whole time Company Secretary, the need for introducing compliance report by a Company Secretary in whole time practice was greatly felt. The Company Secretary, would relieve them from filing various returns with the Registrar of Companies. He is expected to play a vital role to guide the company with regard to compliance of the Companies Act and the procedures prescribed therein. He can also guide the company in compliance with several other laws like IDRA, MRTP, FEMA, Direct Tax Act, etc. (To know more about us visit KalpeshClasses.com)

VII. ROLE OF SMALL INDUSTRIES DEVELOPMENT BANK OF INDIA (SIDBI) IN THE DEVELOPMENT OF SSI UNITS

SIDBI has been set up under the Small Industries Development Bank of India Act, 1990 passed by parliament. It is intended to work as a principal financial institution for the promotion, financing and development of industries in small scale sector. It is also expected to co-ordinate the functions of the financial institutions, viz., State Financial Corporation, State Small Industrial Development Corporations, Scheduled Banks and State Co-operative Banks, etc., engaged in promotion, financing and developing the small scale industries.

SIDBI has set up a Technology Development and modernization Fund to help SSI units in technology upgradation.

SIDBI will participate in venture capital fund set up by public sector institutions as well as private sector companies upto 50% of the total corpus of the funds, provided such funds are dedicated to the financing of small scale industrial sector.

The measures taken by SIDBI will help a large number of SSI units in obtaining their credit requirement as well as technology upgradation and modernization.

What were the institutional measures taken to develop SSIs?

VIII. INNOVATION AND SMALL UNITS IN INDIA

Small units lack technical sophistication to make high quality products. Inspite of several protective and promotional measures adopted by Central and State Governments, nothing much was done to change and update the outdated process and equipment. In order to assist the SSI units in modernization and upgradation of technology, both the Central and State Government has a number of institutions, e.g.

a. Small industries Development Organisation (SIDO)
b. National Small Industries Corporation (NSIC)
c. Small Industries Service Institute (SISI)
d. Council for Scientific and Industrial Research (CSIR)
e. Indian Standards Institute (ISI)
f. Research, Design and Development Committee
g. The Technical Consultancy Organisation of IDBI
h. Office of the Development Commissioner (DC) of SSI, New Delhi

In spite of these efforts, very little progress is made in the upgradation of small units.

Suggestion for Technology Improvement in SSI units –

1. The changes in technology should be implemented in a phased and planned manner.
2. The entire process of strategies adopted for development and growth of the SSI units including the programme of technology upgradation and modernization should be time bound.
3. Research laboratories, universities, banking institutions and large firms have to come together to devise new mechanism suitable for the small sectors.
4. The government should keep track of the new innovations and technological improvements in different product lines and prepare a list of them. Data base technological information systems may be set up by the Government, by active contact with technological plants.

Write a note on KVIC?

IX. FINANCING OF KHADI AND VILLAGE INDUSTRIES (KVI) UNITS:

Khadi Village and Industries Commission (KVIC) - KVIC has been established to develop Khadi and Village Industries by providing finance, training, technical man-power, technology, raw materials etc.,

KVIC appraises projects and decides the quantum of capital expenditure and working capital loans. It also renders technical and marketing support so that the institutions can come up and perform their role of employment generation and value addition. KVIC gets its funds from Planning Commission, through Ministry of Industry, Government of India. These funds are earmarked to various industries under its purview. On this basis, KVIC prepare a plan for allocating funds to its various implementing agencies, viz., State KVI Boards, Registered institution and departmental units.

Pattern of Assistance by KVIC –

1. Assistance in the form of a package and cover provision of finance right from the procurement of raw materials to the disposal of finished goods.
2. Financing implementing agencies in the form of capital expenditure loans to purchase tools, equipment, etc.
3. Assistance to set up retail outlets.
4. Concessional rate of interest for Khadi and village industries.

Institutional Finance – A comprehensive interest subsidy scheme of bank finance is formulated to supplement financial resources available from the government. Under this scheme, the borrowing institution is required to bear interest at 4% p.a., and the difference between the actual rate of interest and 4% is paid to the bank by the KVIC as interest subsidy. Under the scheme, the borrowers are KVIC, State KVIC Boards, registered institutions and co-operatives.

X. KVI SECTOR – OPPORTUNITIES AND CHALLENGES - Discuss

Any industry set up in a rural area with an investment not more than Rs. 15,000/- per head can come under the purview of KVIC. Khadi and village industries play a vital role in the development of rural areas. The importance of KVI sector can be highlighted as follows –

1. The traditional industries like Khadi village industries, handicrafts, handlooms, etc., provide about two-third employment in the country.
2. KVI are less capital intensive and more labour intensive.
3. KVI play an important role in balanced regional growth.
4. KVI cause least disturbances to ecology and no pollution.
5. Of the total employment in KVI programmes, 48% are women and 32% SC/ST, which is higher compared to national average.
6. KVIs have favourable incremental capital – output ratio.

Shortcomings of KVI sector

1. KVI products are often costlier due to high content of wages in unit cost and small scale operation.
2. Wage profile in various KVI are very low.
3. Lack of quality consciousness, absence of proper processing, packing, marketing etc.
4. Lack of Research and development activities which can create technological improvements.

5. Lack of co-ordination between various agencies.
6. Lack of co-ordination at state, District and Block Levels.

XI. NEW POLICY FOR SMALL SCALE INDUSTRIES, 1991

Write a note on New policy on SSIs?

A joint package of policy measures for small, tiny, handloom, handicraft and village industries was announced in 1991, with the objective of imparting more vitality and growth impetus. The main features of the policy are as follows:

i. The investment limit in the smaller sector, was not changed in the New Policy, 1991. But later on it was increased to Rs. 1 crore and the investment limit for tiny units was raised to Rs. 25 lakhs.

ii. The most important feature of the policy was the four-point scheme to provide financial support to the SSI sector.

   While promising to set up an agency to monitor and ensure that the credit demands of the SSIs were fully met, it decided to allow equity participation by other industrial undertakings in the SSI, not exceeding 24 per cent of the total shareholding. This was being done to provide small units access to the capital market and to encourage modernization, technical upgradation, ancillarisation and sub-contracting.

   It also decided to widen the scope of the National Equity Fund Scheme to cover the projects upto Rs. 10 lakhs for equity support (up to 15 per cent). The single window scheme was also enlarged.

   In addition, a limited partnership Act was proposed to be introduced to enhance the supply of risk capital to the SSI sector. The proposed Act would limit the financial liability of the new and non-active partners/entrepreneurs to the capital invested.

   While introducing factoring services through the SIDBI the policy proposed to set up a net-work of such services throughout the country to be operated through commercial banks. This would to a great extent solve the problems of the delayed payments to small sector by the large units. In addition, a suitable legislation was also proposed to be introduced to ensure prompt payment of small industries bills.

iii. The tiny sector would be accorded priority in the government purchase programme. Though not specified, the policy also provides relaxation to the tiny sector from certain provisions of labour laws. The tiny sector would also be eligible for additional support in terms of land and power allocation and access to facilities for technology upgradation on a continuing basis, including easier access to institutional finance.

iv. The policy envisaged market promotion of small and tiny sector products to be undertaken by co-operatives, public sector institutions, other professional agencies by adopting a consortium approach. The National Small Industries Corporation (NSIC) would concentrate on marketing of mass consumption items under a common brand name in association with the State Small Industries Development Corporations.

v. The small and tiny sector would be accorded priority in allocation of indigenous raw materials. Adequate and equitable distribution of indigenous and imported raw materials would be ensured do the small sector, particularly the tiny sub-sector. The policies would be so designed that they do not militate against entry of new units.

vi. With a view to widen and deepen complementary in production programmes of large, medium and small sectors, the policy would encourage production of parts, components, sub-assemblies, etc. required by the large public and private sector in a techno-economically viable manner through small scale ancillary units.

vii. To facilitate location of industries in rural and backward areas and to promote stronger co-ordination between industry and agriculture, a new scheme of integrated infrastructural development for small industries was proposed to be implemented with the active participation of State Government and financial institutions.

viii. Emphasis would be laid on improving the quality and marketability of the products of the handlooms and handicrafts sector pari passu with consumer preference instead of merely depending on rebates and subsidies. The policy promised to initiate measures will encourage R&D activities, strengthen activities of Khadi and Village Industries Commission and ensure better flow of credit facilities from the financial institutions.

ix. The SIDO had been recognized as the nodal agency to support SSI in export promotion. An export development centre would be set up in SIDO to serve the SSIs through its network offield offices to further augment export activities of this sector.

Dereservation of Items for SSI unit in phases

The policy of reservation started in 1968. In 1998, the number of items reserved for SSI units was 836. The policy was started with the objective of generating more employment as well as keeping in view that output growth is SSI units was higher as compared to large sector. It was observed that nearly 68 of the 836 items account for more than 80% of the total value of the output produced by all the reserved items. Besides, many of these are capital intensive rather than labour intensive.,

Since 1991, 24% of the equity of the SSI units can be acquired by large scale units. More importantly, in the post reform period, the reserved items may find it very difficult to enhance their capacity, improve economies of scale, improve technology because the negative protection means there is no compulsion for them to compete. The issue becomes much more important with the dismantling of quantitative restriction (QR) on all the imported items. It has created a peculiar situation where the reserved items are to compete with the imported items, yet domestic large scale industries are no permitted to manufacture those items.

The Abid Hussain Committee recommended total dereservation and replacement of the policy of dereservation with a policy of promotion and strengthening those units which account for a bulk of the volume of output of reserved items.

While the government has not accepted the policy of total dereservation, it has gone about selective dereservation of such items which are directly affected immediately by opening up of the economy, e.g., agricultural machinery, tools, toys, garments, leather products, etc.

It is felt that the negative protection enjoyed by SSI units as a result of policy of reservation should give way to positive policy of strengthening these units, opening them to competition, technology upgradation and infrastructure development.

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EVALUATION OF POLICY FOR SMALL SCALE INDUSTRIES, 1991

Evaluate the New Policy for SSIs

1. The new policy for small industries had been announced to make the SSI units cost efficient and competitive by taking measures such as assistance in procurement of credit for raw materials etc., development of markets and training centres, etc.
2. The policy emphasized timely finance rather than cheap finance and targeted oriented schemes rather than general promotional activities for small units.
3. The specific attention given to tiny sector is welcome because till now only small scale units and modern units enjoyed the benefits given by government.
4. The policy provided for equity participation by other industrial units in the small industrial units not exceeding 24% of the total shareholding. This provision would help small units by taking care of working capital and quality problems of small units.

   At the same time, equity participation legitimizes the practice of indirect ownership of small units by large corporate entities. Many large units try to own a number of small units and circumvent the reservation policy and enjoy the benefits accruing to small units with respect to taxation and subsidies, etc. The new policy will encourage this practice.

5. The idea of limited partnership is also welcome. It will attract equity capital from friends and relatives of the entrepreneurs of small units, on the other hand, small units short of fund but wishing to avoid sharing of decision-making will welcome augmentation of risk capital from such partners.
6. It is not clear as to how the objective of timely availability of the credit to the small units will be achieved. The setting up of a special monitoring agency with no additional power of directing commercial banks to issue additional credit is of no help.
7. Regarding transfer of technology by the large units to the small units, it is doubtful whether the large units will ever like this to take place.
8. The policy do not make any mention of medium sector.
9. The policy is economically unviable and technically obsolete for small enterprises. It has still continued the cumbersome policy of registration of small units.

Chapter 4

4

INTRODUCTION TO CAPITAL MARKETSIN INDIA INCLUDING DEPOSITORIES

An Overview

Preliminery

1.RBI
2.SEBI

Capital Markets

- *Role*
- *Methods of raising finance*
- *pricing*

Primary Market/New Issue Market/IPO Market

1. *First Issue by New Companies*
2. *First Issue by Existing Private Companies*
3. *Public Issue by Listed Companies – Guidelines for book-building*
4. *E-IPO*

Secondary Markets/Stock Markets/ Stock Exchange

The organized Stockexchanges
OTCEI
Primary vs. Secondary Markets
Functions

Working of Stock Exchange

1. *BSE*
2. *NSE*

Stock Exchanges Abroad

1. *NYSE*
2. *NASDAQ*
3. *LSE*

Reforms in Stock Exchanges

Depositories

- *Introduction*
- *Depository System in India*
- *Functions*
- *Advantages*
- *Disadvantages*
- *NSDL*
- *CDSL*
- *DP – Features, Constituents, Legal Framework, Operation Procedure, Demat*

Rematerialisation

- *Process*
- *Accounts with DP*
  - *Checklist for Trading*
  - *Checklist for Clearing and*
  - *Checklist for Settlement of Dematerialised Securities*

Code of Ethics for Participants

General Principles *Operational Principles*

TEAM OF PROFESSORS AT KALPESH CLASSES

PROF. KALPESH SANGHAVI (C.A.)

PROF. L.MURALIDHARAN (C.A.)

PROF. SOWMYNARAYANAN (C.A.)

PROF. RAJAGOPALAN (C.A.)

PROF. JAISON (C.A.)

NOW LIVING ~~WORKING~~ TOGETHER.

I. PRELIMINARY:

Indian financial markets consist of Capital Market, Money Market and the Debt Market. From the point of view of regulatory authorities, the organized part of the Indian financial system can be classified as-

1. **Reserve Bank of India (RBI) –** It regulates commercial banks, Foreign Exchange Markets, financial Institutions and primary dealers. Financial institutions consist of all India Institutions like IDBI, IFCI, ICICI, NABARD or sectoral financial institutions like EXIM, TFCIL etc., Primary Dealers are registered participants of the wholesale debt market and bid at auctions for Government Debt, Treasury bills,etc.,

2. **Securities and Exchange Board of India (SEBI)** – It regulates Primary market, secondary market, derivatives market and market intermediaries like mutual funds, brokers, merchant banks, depositories.

II. CAPITAL MARKETS / SECURITIES MARKET:

A. Elaborate on the role of Capital Markets.
Capital markets are markets for financial instrument (e.g.. bonds and stocks) with maturities of more than one year i.e. they are markets for long-term securities.

Role of Capital Market
1. The capital market is the indicator of the inherent strength of the economy.
2. It is the largest source for long term funds for companies.
3. It offers a number of investment avenues to investors.
4. It helps in channelling the saving pool in the economy towards optimal allocation of capital in the country.

B. What are the Methods of Raising Capital (Issue Mechanism)?
Methods of Raising Capital (Issue Mechanism)
1. Public Issue – It includes sale of securities to the members of the public through
   (a) Prospectus
   (b) Tender / Book Building
   (c) Offer for sale
2. Rights Issue
3. Private Placement

C. Explain guidelines relating to free pricing
Pricing by Companies Issuing Securities-
The companies eligible to make public issue can freely price their equity shares or convertible securities in following cases-

1. **Public / Rights issue by listed companies –** A listed company can freely price its equity shares and any other convertible security/ securities offered through a public / right issue.
2. **Public issue by unlisted companies –** They can freely price their equity shares or any convertible securities subject to fulfilling certain criteria.

3. **Public issue by an infrastructure company –** It is free to price its equity shares subject to compliance with the disclosure norms as specified by SEBI.
4. **Initial public issue by Banks –** They can freely price their equity shares or any convertible securities subject to approval by RBI.

D. What is Differential Pricing?
Differential Pricing:

When differential pricing allowed?

a) Any unlisted company or a listed company making a public issue of equity shares or any convertible securities may issue such shares to applicants in the firm allotment category at a price different from the price at which the net offer to the public is made. The price offered to applicant in the firm allotment category should be higher than the price at which securities are offered to the public.

b) The differential price will also be applicable to public issue which is a part of a composite issue.
Justification of price – The offer document should give justification for price difference in case of firm allotment and public offer.

Denomination of shares for Public / Rights Issue:
A company can make public or rights issue of equity shares in any denomination determined in accordance with -

1. Section 13 (4) of the Companies Act, 1956 i.e. shares of a fixed amount, and
2. The norms specified by SEBI. Some of such norms are
   a. Shares should not be issued in decimal of a rupee,
   b. Denomination of existing shares should not be altered to a denomination of decimal of a rupee,
   c. Companies should adhere to disclosure and accounting norms as may be specified from time to time.
   d. At any time, there should be only one denomination for the shares of a company.
   e. Companies may change standard denomination by splitting or consolidating existing shares after amending MOA and AOA.

Classification of Capital Market

1. Primary Market
2. Secondary Market

III. PRIMARY MARKET / NEW ISSUE MARKET / IPO MARKET:

Primary market is one in which new issues of common stock, bonds etc. are sold by Companies, Government, Local Authorities, Corporation, etc. to acquire new capital. It also includes issue of further capital by companies whose shares are already listed on a stock exchange. It is also called new Issue Market or IPO market.

Explain the guidelines relating to IPO by new companies & existing

1. **First Issue of New Companies**

Meaning of new Company – A company which has not completed 12 months of commercial operation and its audited operative results are not available. Such companies may be set up by

i) Promoters without track record
ii) Existing private or closely held or unlisted companies with five year track record of consistent profits in terms of PAT in five out of seven preceding years, with profits during two years prior to the issue.

Companies without Track Record – Guidelines –

i. Can issue capital at par only
ii. Issue to foreign investors at price determined by shareholders by special resolution.
iii. Promoter's contribution – 20% of the total issued capital.

b. Backing by companies with a Track Record – Guidelines

i. Free to price their issues (at premium)
ii. Promoting Company(ies) / Promoter(s) Contribution – 50% equity of new company.
iii. Price is applicable to all new investors uniformly including promoters
iv. Promoter's contribution subject to lock in period of 3 years.
v. Justification for price to be given in prospectus / offer document.

2. First Issue by Existing Private / Closely Held Unlisted Companies – Guidelines –

i. Track record of distributable profits in terms of section 205 of the Companies Act, for at least 3 out of immediately preceding 5 years.
ii. Pre-issue net worth of not less than Rs. One crore, in 3 out of preceding 5 years, with the minimum net worth to be met during immediately preceding 2 years.
iii. Should not have outstanding financial instrument or any other right, which would entitle the existing promoters / shareholders any option to receive equity share capital after the Initial Public offering.
iv. Issue size does not exceed 5 times its pre-Issue networth as per latest audited accounts.

Note –

1. An unlisted company which does not fulfil any of these eligibility criteria can make a public issue only through book building process.
2. In case of an unlisted company, formed out of division of an existing company, track record of distributable profits of the division spun off will be considered for the purpose of eligibility criteria.

3. Public Issue by Listed Companies – Guidelines

i. Free to price their issues
ii. Issue price to be determined in consultation with lead manager
iii. Issue size must not exceed 5 times its pre-issue networth as per latest audited accounts.

Note –

1. If condition (iii) is not complied with, a public issue can be made only through book-building process.
2. A listed company which has changed its name to indicate that it is a company in the information technology sector during a period of 3 years prior to filing of offer document with SEBI, should comply with requirements for public issue by unlisted companies before

making public issue. If it does not fulfil the conditions it can make a public issue only through book-building process.

3. Every listed company making an IPO for a sum of Rs. 10 crores or more, shall issue the same only in dematerialised form.

GUIDELINES FOR BOOK – BUILDING: Briefly give the Guidelines for Book building.

Book building is a price discovery mechanism and is becoming increasingly popular as a method of issuing capital. Here the Lead Manager known as Book Runner determines the level of interest from investors at various price levels and obtains commitments. The issue is then made and applications are received. Allotments are made to investors based on the price offers received.

An issuer company proposing to issue capital through book building should comply with the following:

A. 75% Book-Building Process

In an issue of securities to the public through a prospectus, the option for 75% of net public offer through book building should be available to the issuer company subject to the following:

1. The option of book building should be available to all body corporates, which are otherwise eligible to make an issue of capital to the public.
2. The book building facility should be made available as an alternative to, and to the extent of a percentage of the issue, the issuer company should have an option of either reserving the securities or going through book building process.

A company proposing to make public issue through the book-building should -

- Disclose either the issue size or the No. of securities to be offered in the offer document (subject to compliance with the requirement of Rule 19 (2) (b) of the Securities Contracts (Regulation) Rules,) 1957 on minimum public holding.
- Make additional disclosures in the offer document with respect to the arrangements made to meet the deficit in the means of financing and the pattern of deployment of excess funds.
- Be permitted to fix a minimum bid size for the book-built portion.

A company availing the optional facility may:

i. graphically display the demand at the end of each day of the bidding period at the terminals for the information of the syndicate members as well as the investors.
ii. Use electronically linked facilities for bidding
iii. Decide the number of bidding centres.
iv. Fix a minimum bid size for the book-built portio.

3. The issue of securities through book-building should be separately indicated as ‘placement portion category’ in the prospectus.

4. a. The securities available to the public should be separately identified as 'net offer to the public' and should be made at the fixed price determined by the book-building exercise;
   b. The requirement of a minimum of 25% of the securities to be offered to the public should also be applicable.

5. In case the book-building option is availed of, underwriting should be mandatory to the extent of the net offer to the public.
6. The draft prospectus containing all the information, except that regarding the offer price should be filed with SEBI.
7. The issue company should nominate one of the lead merchant bankers as a Book Runner and his name mentioned in the prospectus.
8. a. The copy of the draft prospectus filed with SEBI may be circulated by the Book Runner to the institutional buyers who are eligible for firm allotment and to intermediaries eligible to act as underwriters inviting subscriptions to the securities.
   b. The draft prospectus should indicate the price band within which the securities are being offered for subscription.

9. The Book Runner on receipt of the offers should maintain a record of the names and number of securities ordered and the price at which the institutional buyer or underwriter is willing to subscribe to the securities under the placement portion.

10. The underwriter(s) should maintain a record of the orders received.

11. a. The underwriter(s) should aggregate the offers so received for and intimate to the Book Runner the aggregate amount of the orders received by him.
    b. The institutional investor should also forward the orders, if any, to the book runner.

12. On receipt of the information, the Book Runner and the issuer company should determine the price offer.

13. The issue price for the placement portion and offer to the public **should be the same.**

14. On determination of the price the underwriter should enter into an underwriting agreement with the issuer indicating the No. of securities as well as the subscription price.

    Provided the Book Runner should have an option of requiring the underwriters to the net offer to the public to pay in advance all monies required to be paid in respect of their underwriting commitment.

15. On determination of the issue price, within two days thereafter, the prospectus should be filed with the ROC.

16. The issuer company should open two different a/cs for collection of application moneys, one for the private placement portion and the other for the public subscription.

17. One day prior to the opening of the issue, Book Runner should collect from the institutional buyers and the underwriters, the application forms along with the application money to the extent of the securities proposed to be allotted to them / subscribed by them.

18. a) Allotments for the private placement portion should be made on the second day from the closure of the issue.
    b) However, to ensure that the securities allotted under placement and public portions are Pari Passu in all respects, the issuer may have one date of allotment which shall be the deemed date of allotment for the issue through book-building.

    The Company shall have the option to fix a date of allotment for book-built portion, which may be prior to the date of allotment for fixed price portion,

    Provided, the date of allotment for book-built portion should be deemed to be the date of allotment for fixed price portion for the purpose of dividend and other Corporate benefits and the same should be disclosed in the offer document.

19. In case the Book Runner has exercised the option mentioned in pt. No. 14 for payment by the eleventh day of the closure of the issue, the shares allotted as per the private placement category should be eligible to be listed.

B. 100% Book-Building Process

In an issue through a prospectus, option for 100% Book-Building should be available to any issuer company subject to the following:

i. Issue of capital should be Rs. 25 crores and above.
ii. Reservation or firm allotment to the extent of a % specified in these Guidelines should be made only to categories mentioned in sub-clause (iii) below.
iii. Book-Building shall be for the portion other than the promoters contribution and the allocation made to the following:
   - Permanent employees of the issuer company and in the case of a new company the permanent employees of the promoting companies.
   - Shareholders of the promoting companies in the case of a new company and shareholders of group companies in the case of an existing company either on a 'competitive basis' or on a firm allotment basis.

iv. The issuer company should appoint an eligible Merchant Banker(s) as book runner(s) and their name(s) shall be mentioned in the draft prospectus.
v. The Lead Merchant Banker shall act, as Lead Book Runner and other eligible Merchant Banker(s), shall be termed as Co-Book Runner(s).
vi. The primary responsibility of building the book shall be that of the Lead Book Runner.
vii. The Book Runner(s) may appoint those intermediaries who are registered with SEBI and who are permitted to carry on activity as an 'Underwriter" as **syndicate members**.
viii. The draft prospectus containing all the disclosures as laid down in SEBI Guidelines, 2000 except that of price and the No. of securities to be offered to the public shall be filed by the Lead Merchant Banker with SEBI.
   - The total size of the issue should be mentioned in the draft prospectus.
ix. a) In case of appointment of more than one Book Runner, the rights, obligations and responsibilities of each should be delineated.

b) In case of an under subscription in an issue, the shortfall shall have to be made good by the Book Runner(s) to the issue and the same should be incorporated in the inter se allocation of responsibility given in Schedule II.

x. a) SEBI within 21 days of the receipt of the draft prospectus may suggest modifications to it.

b) The Lead Merchant Banker shall be responsible for ensuring that the same are incorporated in the prospectus.

xi. a) The issuer company, after receiving the final observations, from SEBI shall make an advertisement in an English National daily, one Hindi National newspaper and a Regional language newspaper with wide circulation at the place where the registered office of the Issuer Company is situated.

b) The advertisement so issued should contain the salient features of the final offer document as specified in Form 2A of the Companies Act circulated along with the application form.

xii. The issuer company should compulsorily offer an additional 10% of the issue size offered to the public through the prospectus.

xiii. The pre-issue obligations and disclosure requirements as specified in Chapters V and VI respectively of SEBI Guidelines, 2000 shall be applicable to the issue of securities through book-building unless stated otherwise in this Chapter.

xiv. The Book Runner(s) and the issuer company determine the issue price based on the bids received through the 'syndicate members'

xv. On determination of price, the number of securities to be offered should be determined (issue size the determined price.)

xvi. Once the final price (cut-off price) is determined all those bidders whose bids have been found to be successful (i.e. at and above cut-off price) shall become entitled for allotment.

xviii. On determination of the entitlement as above, the information regarding the same (i.e., the no. of securities to which the investor becomes entitled) should be intimated immediately to the investors.

xix. The final prospectus containing all disclosures as per these Guidelines including the price and the number of securities proposed should be filed with the Registrar of Companies.

xx. Arrangement should be made by the issuer for collection of the applications by appointing mandatory collection centres as per these Guidelines.

xxi. The investors who had not participated in the bidding process or have not received intimation of entitlement of securities may also make an application.

Write short notes on OTCEI?

OVER THE COUNTER EXCHANGE OF INDIA (OTCEI)-

The OTCEI has been set up to help small companies to list their shares.

- It provides a cost effective and convenient platform to the smaller companies to raise finance from the Capital Market.
- OTCEI was promoted by a consortium of financial institutions.
- It is a, nationwide stock exchange committed to provide entrepreneurs with a smooth economical vehicle for going public,
- and investors with a fair, stable and efficient market. Thus the OTCEI brings investors and promoters close together.

FEATURES OF OTCEI:-

1. Nationwide listing
2. Listing of small and medium sized companies
3. Ringless and screen-based trading
4. Transparency of transactions
5. Faster delivery and payment
6. Use of state of art technology
7. **Sponsorship**
   The companies which seek listing on the OTCEI have to approach one of the members appointed by the OTCEI for acting as the sponsor to the issue. The sponsor appraises the project. By entering into the sponsorship agreement, the sponsor is committed to making market for that scrip by giving a buy/sell quote for a minimum period of 18 months.
8. **Bought out deals**
   Through the concept of Bought – out deals. OTCEI allows companies to place the equity meant for public, with the sponsor member at a mutually agreed price. This ensures swifter availability of funds to companies for timely completion of projects and a listed status at a later date.
9. **Liquidity through market making**
   The sponsor member is required to give two way quotes (buy and sell) for the scrip for 18 months from the date of commencement of trading. Besides the compulsory market maker, there is an additional market maker and voluntary market makers who give two way quotes. This produces efficient pricing, reduces gap between buy and sell quotations and increases the capacity to absorb large volumes.

Guidelines for listing on the OTCEI:

1. **Eligibility Norms –** Any company proposing to list on OTCEI is exempted from eligibility norms applicable to public issue by SEBI guidelines subject to the fulfilling of the following besides the listing criteria laid down by the OTCEI-
   a. It is sponsored by a member of the OTCEI, and
   b It has appointed at least two market makers, one compulsory and one additional market maker.

2. **Pricing Norms –** In case of Bought out Deal, SEBI's pricing norms applicable to public issue by unlisted companies is exempt subject to the following conditions –
   a. The promoter after such issue should retain at least 20% of the total issued capital for a lock in of 3 years.
   b. At least 2 market makers are appointed in accordance with Market Making Guidelines stipulated by OTCEI.

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IN ASSOCIATION WITH KALPESH CLASSES

INITIAL PUBLIC OFFERS THROUGH THE STOCK EXCHANGE ON LINE SYSTEM – (E-IPO)

The company making public issues would now have the option to issue through the on line system of stock exchange or through the existing banking channel. This will be applicable for fixed price issues as well as price portion of book-built issues. SEBI has formulated guidelines for e-IPO.

IV. SECONDARY MARKETS / STOCK MARKETS / STOCK EXCHANGES -

What are Secondary Markets?

- Securities which are already outstanding and owned by investors, are usually bought and sold through the 'Secondary Market.
- The proceeds from a sale in the secondary market do not go to the issuing organization but to the current owner of the security.
- There are two broad segments of the secondary markets –

i. The organized stock exchanges
ii. The OTCEI

- The primary middlemen in the secondary markets are brokers and dealers.

Two Segment

SES **OTCEI**

What are Stock Exchanges? Give their characteristic

Recognised Stock Exchanges

These stock exchanges are recognized and regulated under the securities contracts (Regulation) Act, 1956. No person is allowed to organise stock exchanges other than the recognised ones. There are 22 recognised stock exchanges in India

Characteristics of Stock Exchanges in India

1. **An association of individual members –** A stock exchange is an association of individual members called brokers, formed for the express purpose of regulating and facilitating the buying and selling of securities by the public and institutions at large for a commission. They also buy securities on their own behalf.

2. **Recognition from Government –** Under the securities and contracts (Regulations) Act, 1956.

3. **Corporate Membership –** Corporate membership of stock exchanges has been introduced recently.

4. **Governing Board –** A stock exchange is governed by a board, consisting of directors. Some members are nominated by the Government. The Board is headed by a President, who is an elected member, usually nominated by the government. The Board is expected to safeguard the interests of investors.

5. **Listing requirement –** All companies wishing to raise capital from the public are required to list their securities on at least one stock exchange.

6. **Regulated by SEBI –** SEBI has been set up in Bombay by the Government to oversee the orderly development of stock exchange in the country.

Compare & Contrast Primary & Secondary Markets.

Primary Markets Vs. Secondary Markets:

1. **Differences:-**

a) Nature of securities:

Primary market deals with new securities and secondary market deals with securities already taken for trading.

b) Type of transaction:

Only purchase transaction is possible in primary market for the new securities whereas both purchases and sales would be possible in the secondary market.

c) Place of business:

Companies having business in a place can raise money throughout the country in primary market whereas the security can be traded in only a particular stock exchange in secondary market.

2. **Similarities:**

a. **Listing –** One aspect of inseparable connection between the too is that the securities issued in the primary market are invariably listed on a recognised stock exchange for dealing in them. The practice of listing securities on the stock market is of immense utility to potential investors who can dispose off the securities any time they are in need of cash.

b. **Control –** The stock exchange exercises considerable control over the organisation of new issues. The new issues of securities which seek listing have to comply with statutory rules as well as regulations framed by the stock exchanges. If not, the stock exchange would refuse listing facilities to them.

List down the functions of SES.

Functions of Stock / Secondary Markets / Exchanges:

1. Economic Health
A developed stock exchange leads to healthy development of capital market and ultimately to the economic development of the country.

2. Channelisation of savings into Investment
The savings of the community are mobilized and channelled by stock exchange for investment into those sectors and units which are favoured by the community at large, on the basis of such criteria as good return, appreciation of capital, and so on. Stock exchanges render this by arranging for the preliminary distribution of new issues of capital, offered through prospectus, as also offers for sale of existing securities, in an orderly and systematic manner.

3. Marketability and Liquidity
The stock exchanges provide a readymade marketability and liquidity to the securities.

4. Continuous price formation
The collective judgement of many people operating simultaneously in the market leads to a continuous price discovery mechanism. This also helps the determination of offer price for a new or a rights issue.

V. WORKING OF STOCK EXCHANGE

Write a short note on BSE?

1. BOMBAY STOCK EXCHANGE: (BSE)

Brief History: It was set up in July 1875 as "Native Share and Stock-Brokers Association" through the presidency of Bombay with the approval of the Central Government. It was recognised by the G.O.I. on August 31, 1957 under the securities contracts (Regulation) Act, 1956.

Objectives:
i. To safeguard the interests of the investing public.
ii. To establish and promote honourable and just practices in securities transactions.
iii. To promote, develop, maintain and regulate the market for dealing in securities.
iv. To promote industrial development in the country through efficient resource mobilisation.

Capital Requirements:

i. For companies already listed on other stock exchanges and seeking listing on BSE – minimum issued equity capital of Rs. 3 crores.
ii. For new companies and delisted companies seeking relisting – minimum post-issued equity capital of Rs. 10 crores.

Trading Procedures – The transactions (i.e. sale and purchase) in securities can be undertaken only through the registered share brokers. The investor who wishes to enter into a transaction has to place an 'order' with the share broker. The BSE computerized its trading system by introducing 'Bombay on Line Trading' (BOLT) on 14.3.1995. Now trading in all scrips takes place through BOLT. In this screen based (on-line) system, the deals are confirmed immediately. This facility also improves the price competitive characteristic of the market. The investor will give delivery of securities (in case of sale) or will make the payment (in case of purchase) to the stock broker. The stock broker will make the payment for the securities sold or deliver the security certificate purchased on the settlement program of the stock exchange.

Trading system in BSE after July 2, 2001: A new system of trading in cash market and forward market has been put in place since July 2, 2001. In cash market, there will be compulsory rolling settlement, which will be done on a daily basis.

Each trading day will be taken as if it is a settlement. When an investor buys a security, he will have to pay for them and when he sells, he will have to give delivery.

Further different exchanges in India had settlement period closing on different days. With this new system, all settlement days of all exchanges will be same. i.e. on daily basis.

In case of forward market, options will be permitted.

Price Indices–

1. The price indices of securities traded at BSE are reflected through the BSE sensitive Index (Sensex) and the BSE National Index (Natex). BSE sensex was introduced on 1.1.1986 with the base year 1978-79. Only 30 scrips are selected from the companies listed on BSE only and selection is based on their market activity i.e. those which are highly sensitive to market fluctuations.
2. BSE introduced two new indices, i.e., the BSE National Index-200 and Dollax with the base year 1989-90 for both the Indices. Dollax represents the current as well as the base year values in dollar terms, which are very useful for foreign investment institutions, overseas corporate bodies, foreign investors etc.,
3. BSE has also introduced BSE-500 index w.e.f. July 8, 1999 with the base year of February 1, 1999.

These scrips are selected taking into account various parameters i.e. market capitalisation, industry representation, trading frequency and number of trades.

Write a note on NSE?

2. NATIONAL STOCK EXCHANGE (NSE) OF INDIA LTD.

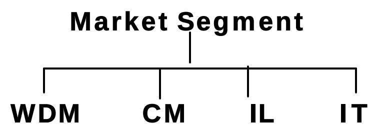
Brief History – The NSE was incorporated in November 1992 by IDBI and other All-India Financial Institutions and became recognised stock exchange from April 26, 1993 to provide nationwide stock trading facilities. The NSE has a fully a automated screen-based trading system. The NSE was setup on the recommendation of a high powered committee called the **Pherwani Committee**.

- the basic idea of setting up of NSE was to establish a nation-wide trading for equities and debt instruments.
- to provide a fair, efficient and transparent securities market and
- to meet the international standards of securities market.

The promoters of NSE are –

i. IDBI
ii. IFC
iii. ICICI
iv. LIC
v. GIC
vi. SBI Capital Markets Ltd.
vii. Stock Holding Corporation of India Ltd.
viii. Infrastructure Leasing and Financial Services Ltd.

Market Segments of NSE –



Initially the NSE set up two segments:

i. **The wholesale Debt Market (WDM) –** This segment deals with pure debt instruments such as Government Securities, treasury bills, public sector bonds, corporate debentures, commercial papers, bank bonds, institutional bonds, certificates of deposits, etc., This segment provides facilities for institutions including subsidiaries of bank engaged in financial services and corporate bodies to enter into high value transactions in debt instruments mentioned above.

ii. **Capital Market (CM) –** This segment deals with equities, convertible debentures, warrants, units of mutual funds, etc., The segment comprises of the securities with nationwide investors base. By virtue of equal access nation wide, such securities can be traded from any part of the country on the same price.

Later on two additional segments were added exclusively for institutions –

i. The Institutional Lot (IL) – Deals with large volume trades
ii. The Trade for Trade (IT) Segment – Facilitates bilateral settlement to as to minimize the exposure.

Capital Requirements – For companies which are already listed on other stock exchanges and seeking listing on the NSE are

i. Minimum issued equity capital of Rs. 10 crores,

ii. Minimum market capitalization of Rs. 25 crores,
iii. A profitability track record of at least three years.

Trading System at NSE – The trading system of NSE is known as National Stock Exchange for Automated Trading (NEAT). It is a fully automated screen based system. It operates on a price time priority. It is order driven and hides the identity of trading parties. Complete market information is available through various inquiry facilities.

Settlement – Trades on WDM segment are settled gross on a trade for trade basis i.e. each transaction is settled individually and no accumulation or netting of transactions is permitted. After July 2, 2001, The NSE is following a daily rolling settlement. In other words, each day is a settlement day for all the securities.

Price Indices – The price index of securities traded on NSE is reflected through NSE-50 index, popularly known as NIFTY. It comprises of 50 scientifically selected scrips having market capitalisation of Rs. 5 billion each. It was introduced on April 22, 1996 with the base year as 1995 with the objectives of reflecting market movements more accurately, providing fund managers a tool for measuring portfolio returns vis-a-vis market returns, etc.,

NSE has introduced other indices also, e.g., Nifty Junior Index (Mid Cap. Index) and the dollar denominated Nifty-(Defty).

Compare BSE & NSE with regard to the performances.

Comparative Analysis of Performances of BSE and NSE

1. **Number of Companies Listed –** In 1999-2000, this number in BSE 8027 against 673 on the NSE.

2. **Returns –** The rate of return generated on the BSE and the NSE has been negative in majority of the quarterly period from 1994-95 to 1999-2000. However, the returns have been better on the BSE as compared to NSE.

3. **Average Daily Turnover –** The average daily turnover on NSE has been higher than BSE since November 1995, however, the difference between the BSE and NSE has been narrowing and the NSE is slowly losing its edge over the BSE.

4. **Market Capitalisation –** Market capitalisation represents the market value of all the companies listed on a stock exchange. The market capitalisation of NSE is more than the BSE. The market capitalisation of the NSE and the BSE has been increasing because of growing investors' confidence in the stock market on account of rationalisation and refinancement of the margin system such as mark to margins, volatility margin and incremental carry forward system, passing of the securities laws (Amendment) Bill 1999 by the Parliament, etc.

5. **Number of Shares Traded –** NSE has registered an edge over BSE when comparison is made on the basis of number of shares traded on the two exchange. This is due to the fact that the NSE is much better equipped technologically as compared to BSE.

VI STOCK EXCHANGES ABROAD:

The prices of securities on Indian stock exchanges are influenced by stock exchanges abroad after liberalisation of Indian economy. Some of the major stock exchanges abroad are –

Write short notes on

1. NYSE
2. NASADAQ
3. LSE

TEAM OF PROFESSORS AT KALPESH CLASSES

PROF. KALPESH SANGHAVI (C.A.)

PROF. L.MURALIDHARAN (C.A.)

PROF. SOWMYNARAYANAN (C.A.)

PROF. RAJAGOPALAN (C.A.)

PROF. JAISON (C.A.)

NOW LIVING ~~WORKING~~ TOGETHER.

1. NEW YORK STOCK EXCHANGE (NYSE) -

History –

NYSE was established more than 200 years ago. It is the world's foremost securities marketplace. Over the years, its commitment to issuers and investors has been unwavering, and its persistent application of the latest technology has allowed it to maintain a high level of market quality and service.

NYSE is registered as a national securities' exchange with the Securities and Exchange Commission. In 1971, it was incorporated as a not for profit corporation. It is managed by 25 member board of Directors comprising a Chairman and CEO, 12 representatives of public and 12 representatives from the securities' industry.

Trading Mechanism

Each day on NYSE trading floor an auction takes place. Open bids and offers are managed on the Trading floor by Exchange members acting on behalf of institutions and individual investors. Buy and sell orders for each listed security meet directly on the trading floor in assigned locations. Prices are determined through supply and demand.

2. NATIONAL ASSOCIATION OF SECURITIES' DEALERS' AUTOMATED QUOTATIONS (NASDAQ)-

It is known for its growth, liquidity, depth of market and the World's most powerful, forward-looking technologies. All these make NASDAQ a choice at the forefront of innovation. NASDAQ National Market lists more than 4,010 securities. To be listed on NASDAQ, a company must satisfy stringent financial, capitalisation, and corporate governance standards. Some of the best known companies in the world are listed on NASDAQ.

Market Structure

It is a screen-based market, operating in an efficient, highly competitive electronic trading environment in contrast to traditional floor-based stock markets. NASDAQ has no single specialist through which transactions pass. NASDAQ's market structure allows multiple market participants to trade through a sophisticated computer network linking buyers and sellers from around the world.

3. LONDON STOCK EXCHANGE (LSE) -

It was set up in 1760. In the year 2000, it became a public limited company under the name London Stock Exchange plc. Dealing in shares is conducted via an off-market trading facility operated by Cazenove and Co.

LSE provides a range of services for companies and investors -

Company Services – It provides a number of markets which allow companies large and small to raise capital, and a range of services to increase the company profile.

Trading services – It gives market users, access to a well-developed trading environment with a proven record of stability and flexibility.

Information Services – It provides high quality real-time price information to market users worldwide, as well as historical and reference data.

LSE also undertakes Share Aware Programme to raise awareness about the opportunities and long term benefits of share investment.

What were the reforms introduced in Stock Exchangees?

VII Reforms of stock exchanges –

After the liberlisation of the economy, many reforms were introduced in the financial sector including stock exchanges. Some of the major reforms introduced in stock exchanges are-

1. **Setting up of NSE in 1994 –** It resulted in keen competition among various stock exchanges in the country. As a result, total daily turnover as well as market capitalisation has risen multifold.
2. **Policy of Free Pricing of Securities –** This was adopted after the repeal of the capital (CIC) Act, 1947 in 1992 and the establishment of SEBI.
3. **Disclosure of Information –** Disclosure norms have been tightened for IPOs as well as for other issues to protect investors interest.
4. **Presence of Authorised rating agencies:** The presence of authorised rating agencies and their role in the entire exercise enhances the confidence of the investors at large.
5. **Book-Building System –** It has resulted in better discovery of prices and reduction in the cost of public subscription.
6. **Reduction in time-lag between closure of issues and listing of securities,** enhancing liquidity in investment in capital market instruments.
7. **Screen-based Trading –** With on-line connectivity virtually throughout the country.
8. **Dematerialisation –** Tremendous progress has been made in replacing physical stock in shares straight away by the Dematerialisation system. All fraudulent practices that existed were all eliminated totally.

Future of Regional Stock Exchanges:

After the rapid expansion of the operations of the NSE and BSE, there has been progressive decline in turnover at the Regional Stock Exchanges. In order to ensure that the valuable services of the members of these stock exchanges are not lost to the securities industry, a new national segment of trading open to all members of these stock exchanges was established in the form of 'Inter-connected Stock-Exchange of India" (ISE). It has been granted recognition by the SEBI. The ISE is a stock exchange of stock exchanges, members of the participating stock exchanges being the only traders on the ISE. The ISE has provided a highly automated trading system open to all the registered traders of the participating exchanges with direct access to national level trading platform on an equal footing regardless of location of participating exchanges and of the status of the exchange in terms of turnover, financial strength etc.

Futures and options on BSE and NSE

Both the BSE and NSE have commenced trading from June 2000 in index futures. Trading in options and index futures and also on individual scrips is expected to start in the near future. However, trading in index futures is still on a low level.

Write note on Rolling & Badla Settlements

Rolling Settlement and Badla –

One of the major reforms in the recent times is the introduction of Rolling settlement. In this, each day will be taken as if it is a settlement. When an investor buys shares, he will have to give delivery. With the introduction of rolling settlement, all settlement days of all exchanges will be the same. Badla system, also called carry-over trading system or forward trading system, has been totally terminated by SEBI. In Badla system, an investor is allowed to carry over his or her transaction of a particular stock to the next settlement cycle without cash settlement in the current settlement cycle. It provides a great deal of liquidity to the securities market. In badla, the buying investor carries forward his or her long position by matching it with a short-position of a bearish investor, or is financed by a financier or badlawala for which he is charged a badla rate for carry forward.

VIII DEPOSITORIES

Briefly explain the development & role of Depositories in India.

A brief Introduction of Depository:

The rapid growth in number volume and value of securities in the Indian Capital Market exposed the limitation of handling and dealing in securities in physical / paper mode. To take care of this, depository system was introduced whereby the transfer of shares could be effected by mere book entry and where no physical movement of securities is involved. It contributes to the speedy settlement of transactions. The transfer of ownership of securities is effected through a book entry on the ledgers of the Depository. Depository system eliminates paper work, facilitates electronic book entry of the transfer of securities, facilitates automated and transparent trading in scrips, allows for reduction in settlement period and ultimately contributes to the liquidity of investment in the securities.

A company formed and registered under Companies Act, 1956 which has been granted a certificate of Registration by SEBI is eligible to provide depository services. In India, the depositories are NSDL and CDS.

Depository System in India:

A depository can be compared with a bank. If an investor wants to utilise the services offered by a depository, he has to open an account with the depository through depository participant, similar to the opening of an account with any of the bank branches.

Depository holds securities in the form of electronic accounts in the same way as a bank holds money. This eliminates the need to deliver physical certificates on sale and transfer. Settlement takes place through Depository. For delivery of securities, the investor can issue a debit note. Similarly, for receipt of delivery of securities, the investor can issue a credit instruction.

Functions Performed by Depository:

1. Dematerialisation and Rematerialisation of securities
2. Provide for disbursement of corporate benefits to the beneficial owners.
3. Effective settlement of securities traded on the exchanges as well as market trades through book entry transfers.
4. Facilitating pledging, hypothecation of eligible securities.
5. Provide for securities lending and borrowing when the legal framework permits.

Advantages of a Depository:

1. It is speedier. Delay in transfer of securities in eliminated.
2. It avoids lot of paper work.
3. Buyer gets exemption from stamp duty on transfer of securities.
4. There are simultaneous payment and delivery instructions.
5. The issuer company can ascertain the principals of shareholding pattern to keep a watch on the take over threats, physical loss etc

6. It helps the company to save substantial amount on printing of certificates, postage expenses and legal compliances.
7. The issuer company is not required to affix stamps for duty on each certificate.

Disadvantages of a Depository:

1. Rare possibility of setting up of a single depository
2. Multiple depository system raises the problem of co-ordination between different accounts of a single individual.
3. It may increase the number of frauds.
4. It may increase the threat of corporate take over as the management may not be knowledgeable of the facts when depositories are dealing.

Write a note on NSDL

National Securities Depository Limited (NSDL) –

NSDL was registered by SEBI on June 7, 1996 as India's first depository to facilitate trading and settlement of securities in the dematerialised from. It is promoted by IDBI, UTI and NSE to provide electronic depository facilities for securities traded in equity and debt markets.

Write a note on CDS

Central Depository Services India Ltd. (CDS) –

CDS was registered by SEBI on February 8, 1999. It has been promoted by BSE and Bank of India (BOI). It was set up with following objectives –

1. Accelerate the growth of scripless trading.
2. Make a major thrust in the individual investors' participation in the depository system.
3. Create a competitive environment and be responsive to users' interest and demand.
4. Enhance liquidity.

Who is a Depository Participant

DEPOSITORY PARTICIPANT (DP):

Features:

1. DP is the agent of the depository and is the interface between the depository and the investor.
2. Financial institutions, banks, custodians, stockbrokers, etc., can become depository / participant.
3. A DP is responsible for maintaining the securities account of the investor and handling it in accordance with the investors' instructions.
4. Each DP has a unique identification number provided by the Depository called the BPID, which is used to identify that DP by the depository and by other DPs.

5. A DP should not, by itself or through any other person(s) on its behalf, publish, supply, show or make available to any other person or reprocess, retransmit, store or use any information provided by the Depository for any purpose other than in the ordinary course of business as a user of the Depository, except with the explicit approval of the Depository.

List the Constituents of Depository System

Constituents of the Depository System:
1. Issuers or Company
2. Issuer Registrar
3. Depository Participant
4. Clearing Members
5. Stock Brokers
6. Clearing Corporations
7. Investors

Legal Framework Governing Depositors:
1. Depositories Act, 1996
2. SEBI (Depositories and Participants) Regulations, 1996
3. Bye-Laws of Depository
4. Business Rules and Depository
5. The Companies Act, 1956
6. The Indian Stamp Act, 1899
7. Securities and Exchange Board of India Act, 1992
8. Securities Contract (Regulation) Act, 1956
9. Benami Transaction (Prohibition) Act, 1988
10. Income – Tax Act, 1961

Explain the operationalities in Depository System

Operational Procedure in the Depository System:

The operational procedure to be followed by the Issuer Registrars and Transfer (R&T) Agent in the Depository Systems are:

6. Dematerialisation
7. Rematerialisation
8. Beneficial owners Reporting
9. Reconciliation of Records.

Dematerialisation

It is the process by which an investor can get physical certificates converted into electronic balances maintained in the account with the participant in the NSDL system; securities held in dematerialised form are fungible i.e. they do not bear any distinguishing features.

IX. REMATERIALISATION

The conversion of dematerialised securities back into physical certificates is called Rematerialisation. Rematerialisation is optional on the part of the investor and can be done on the request of investor any time after the same have been dematerialised.

Process of Rematerialisation

1. Beneficial owner submits Rematerialisation Request form (RRF) to the DP.
2. DP intimates NSDL of the request through the system.
3. DP submits RRF to the registrar.
4. NSDL confirms materialization request through the Registrar.
5. Registrar updates accounts and prints share certificates and intimates NSDL.
6. NSDL updates accounts and downloads details to DP.
7. Registrar dispatches certificates to investor.

Accounts with the Depository Participant (DP)

An investor intending to hold securities in the electronic from in a depository system should open an account with DP. So also all the clearing members who intend to provide settlement function in the depository system.

Categories of Accounts with a DP:

1. **Beneficiary Account –** It is an account held with the DP by a client for the purpose of holding securities.
2. **House Account –** It is the DP's own beneficiary account held in its own system for holding its own securities.
3. **Clearing Account –** It is an account held with DP by a clearing member of a clearing corporation for the purpose of carrying out clearing and settlement function in respect of electronic trades.
4. **Own Clearing Account –** It is the DP's own clearing account held in its own system in case where the DP is also a clearing member of a clearing corporation.

Benefits of opening an Account with DP to the client

1. Dematerialise the existing holdings in securities and receive credit in its account.
2. Purchase any such security in depository segment of the market and receive credit in its account.

CHECK LIST FOR TRADING, CLEARING AND SETTLEMENT OF DEMATERIALISED SECURITIES

Check List for Trading

Trading in dematrialised securities is quite similar to trading in physical securities except that the physical segment follows account period settlement and demat segments follow rolling segment (T+5). (To know more about us visit KalpeshClasses.com)
In rolling segment, all trades executed on particular day (T), netted intra day, will be settled on next working day. This means trades executed on Monday will normally be settled on next Monday (T+5). Both pay in and pay out will be on the same day.

Trades in demant segment are to be settled separately with securities held in dematerialized form. It cannot be substituted with physical securities, **but trades in physical segment can be settled with dematerialized securities**. This means that dematerialized shares can be delivered either in Unified segment or in demat segment. Since 12th June 1998, when CSE commenced trading in demat form, this facility is also available at CSE.

NSE, BSE and CSE intimates daily obligation for each CM at the end of the day for dematerialized segment separately. The final obligation is uploaded by the stock exchanges on the second working day (T+2) after the trading. At, CSE it is on the next working day (T+1)

In case of the electronic rolling segment, short deliveries, if any, will be auctioned on the 6th working day. For example : If 100 shares of RIL sold on Monday are not delivered to the exchange on next Monday (T+5), the auction trading for this short position will take place on Tuesday and pay in and pay out of auction trading for these trades will take place on Thursday.

Pari Passu Shares and Non Pari Passu shares are identified by separate ISIN no: in demat form. In NSE/BSE either Pari Passu or Non Pari Passu Shares can be delivered against delivery obligation for a scrip. In NSE/BSE, the difference in dividend for NPP shares will be adjusted by ClearingCorporation (CC) / Clearing House (CH) in the found obligation. However these shares are traded and settled separately at CSE. This means NPP Shares cannot be delivered against delivery obligation of Parri Passu Shares at CSE.

2. Opening Clearing Accounts for Settlement of Demat Trades:
All the trades executed at exchanges are settled by the Clearing Member (CM), as in the case of securities in the physical form.
To settle trades in demat segment each CM should open one clearing a/c with any of the Depository Participants.

Procedure to open Clearing Account

- Approach a DP
- Fill up an account opening form (received from DP)
- Sign an agreement with the DP
- Application is forwarded to NSDL by DP

NSDL allots a number identified as CM – Business Partner – ID (CM-BP-ID).
DP opens account and an account number (client-ID) is provided along with CM-BP-ID to the CM.

Arrangement of Clearing Account:

The Clearing Account consists of three parts:
Pool A/c, Delivery A/c. Receipt A/c. (CC/CH)
For each settlement in each exchange, there will be one Clearing Account with three parts facilitating easy book keeping.

a. **Pool Account :** It has two roles to play in clearing of securities, viz.,
   i. Before pay in the selling client of the CM transfers securities from his Client Account to the CM Pool Account.
   ii. The CM transfers securities from his Pool Account to the account of the buying client.
b. **Delivery Account –** The CM transfer securities (to the extent of his net obligation to the CC/CH), from the Pool Account to the Delivery Account before pay in. At the time of pay-in, NSDL flushes out the securities in the Delivery Account and transfers the same to the CC/CH.
c. **Receipt Account –** On pay out day, the CC/CH transfers securities to the Pool Account (to the extent of near receipt) through the Receipt in Account.

Check List for Clearing:

- Clearing Account is used only for the purpose mentioned above. If you want to trade in your own securities, you have to open a separate Client Account (Beneficial owner a/c) like any other investor.
- Each CM can have only one clearing a/c for each Clearing House or Clearing Corporation.
- BSE member brokers who participate in Badla transactions have to open a separate Vyaj badla account only at BOM Shareholding. (CH of BSE and DP of NSDL).
- It is possible to shift Clearing Account from one DP to another. CM may operate through old a/c till such time a new a/c is opened.
- It is not essential to have Clearing Account of CM and client account of his clients with the same DP. Clients and CM can open their respective accounts with separate DPs.
- As a CM you can mention your Client ID, CM-BP-ID, DP Name and DP ID on your contract note. This will help your clients in specifying same on their Debit and Credit instructions.
- CM may retain securities in his own CM pool account if the client has not made payment on securities purchased.
- CM has to ensure that before Book Closure or Record Date of any company the securities are moved from CM Pool account to a beneficiary account as holding in Pool account in not entitled for any corporate benefits. Therefore, it is suggested that CM should not keep securities in his pool account for longer period.

- Securities can be moved from the Clients' accounts to CM Pool Accounts and from the CM Pool Accounts to CM Delivery Accounts for a particular settlement at any time before pay-in for that settlement.
- Securities can be moved from the CM Pool Accounts to the buying client accounts any time after receiving credit into CM Pool Accounts.
- CM cannot transfer securities from CM Pool Account of one CC/CH to CM Pool Account with another CC/CH directly. For example, Transfers from NSE CM Pool Account to CSE CM Pool Account and vice versa are not allowed.

3. Settlement:

Market Trades

In the depository system, any trade that is cleared and settled through the Clearing Corporation (CC/CH) is called market trade. Both pay in and pay out of securities and funds (settlement) in AE and BE segments of NSE and demat segment of BSE and CSE will be on the fifth working day (T+5) after the trading.

Off Market Trades

Off Market Trades are those trades, which are not cleared and settled through the CC/CH Pool A/c. The buyer and the seller negotiates the trade with each other. The seller will then give his DP a delivery instruction slip instructing him to debit his account with the transacted securities by giving details for buying client. Similarly the buyer will give his DP an instruction.

X. Code of Ethics for Participants

1. General Principles:

a. **Professionalism –** A participant in the conduct of its business should observe high standards of commercial honour and just and equitable principles of business.

b. **Adherence to Business Rules –** Participants should adhere to the Bylaws and business Rules of the depository.

c. **Honesty and Fairness –** A participant should act honestly and fairly in the best interests of its clients.

d. **Capabilities –** A participant should have and enjoy effectively the resources and procedures which are needed for the proper performance of its business activities.

2. Operational Principles – Participants should ensure

a. That any employee who commits the participant to a transaction has the necessary authority to do so.
b. That employees are adequately trained in operating in the relevant areas, they are assigned to and are aware of their own, and their organisation's responsibilities as well as the relevant statutory acts governing the participant, the Bye Laws and the Business Rules including any addition or amendments thereof.
c. That great care is taken at all times not to misrepresent in any way, the nature of the transaction
d. That improper use of Clients' securities or funds is not made.

Chapter 5

5 INTRODUCTION TO CAPITAL MARKET INSTRUMENTS

An Overview

1. Capital Market Instruments

1. ***Equity Shares***
2. ***Issue Mechanism***
    1. *Public Issue through Prospectus*
    2. *Offer for sale*
    3. *Private Placements*
    4. *Rights Issue*
3. ***Preference Shares***
4. ***Debentures/Bonds***
5. ***ADRs and GDRs***

2. *Forward Contracts – Meaning and Features*

3. *Futures Contracts –*

- *Meaning,*
- *Mechanism,*
- *Pricing and*
- *Valuation*

4. *Types of Orders –*

- *Market,*
- *Market-if-touched(MIT),*
- *Stop loss and*
- *Goods Till Cancelled(GTC)*

5. *The Clearing Mechanism-*

- *Margins,*
- *Marking to market and*
- *SIFs*

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Options

2. Meaning
3. Key terms in Options
4. Strategies/combinations in Options
5. How Options Work?
6. Price of an Option
7. Factors affecting the Price
8. Speculation
9. Futures Vs. Options
10. Futures Vs. Forwards
11. Advantages
12.Disadvantages

Write a note on Capital Market Instruments

CAPITAL MARKET INSTRUMENTS -

The Capital market instruments are the vehicles between the companies and the investors. These instruments are of two types, viz., primary market and secondary market instruments. Apart from derivative instruments, the following are the major mediums of approaching capital markets:

1. Equity Shares
2. Preference Shares
3. Debentures / Bonds
4. Depository Receipts

Write a brief note on Equity Shares.

1. Equity Shares -

The features, advantages and disadvantages of equity shares have already been discussed in Chapter2 ‘Types of Financing’

Explain the four avenues available for issue of equity shares.

2. ISSUE MECHANISM -

i. Public issue through prospectus – features

a. The issuing company itself offers directly to general public a fixed number of shares at a stated price.
b. In case of new companies, issue is invariably made at face value. But, in case of existing companies, it may include a premium.
c. Generally the issues are underwritten to ensure success incase of unsatisfactory public response.
d. The public issue is made through a Prospectus, which contains information about the company and proposed security issue to the investing public. Its contents are governed by Companies Act, 1956. The additional disclosure requirements are also mandated by the SEBI.

Disadvantages:

This method of raising capital is highly expensive. The cost of floatation involves underwriting expenses, brokerage and other administrative expenses.

ii. Offer for Sale -

Under this method, securities are offered through intermediaries like of issue houses / merchant bankers / investment banks or firms of stockbrokers. The sale of securities with an offer for sale is done in two stages.

In the first stage, the issuing company sells the securities enbloe to the issuing houses or stockbrokers at an agreed fixed price and the securities thus acquired by the sponsoring institutions, are resold, in the second stage, by the issuing houses to the ultimate investors. The securities are offered at a price higher than at which they were acquired from the company. The difference, called ‘turn’, represents the remuneration of issuing houses.

Disadvantages:

a. It is an expensive method of raising capital.
b. The premium is pocketed by the issuing houses.

iii. Private Placements

In this method, the companies sell the securities to one or few investors. The distinctive features of private placements are:

a. There no need for a formal prospectus as well as an underwriting arrangement.
b. The terms of the issue are negotiated between the company (issuer) and the investors.

Advantages:

a. It is a relative Cheap source of raising finance – There are no expenses relating to advertisement, underwriting commission, and other administrative expenses.
b. This method is useful for companies which cannot access the general investing community through a public issue in the capital market.
c. This method is generally adopted by small companies with unsatisfactory financial performances.

Disadvantage:

As the securities are issued to only a select group of investors, it may lead to concentration of shares into a few hands who may create artificial scarcity of scrips in times of hectic dealings in such shares in the market.

iv. Rights Issue -

This method of raising capital is used by existing companies who offer securities to the existing security holders. The existing security holders are offered the right to subscribe to new securities in proportion to the number of securities already held.

Advantages:

a. It is an inexpensive method of raising capital.
b. The original proportion of share ownership is maintained.
c. Rights are negotiable – The holder of rights can sell them.

Write a note on preference shares

2. Preference Shares -
Discussed elsewhere in the book

Write a note on Debentures. Explain how to calculation of yields on debentures & Bond prices.

3. Debentures / Bonds -
Discussed elsewhere in the book

Calculation of yields on Debentures / Bonds:-

The most common method to calculate yield is yield to Maturity (YTM). This is another name of IRR. Formula to calculate YTM is as follows –

$$\text{YTM} = \frac{\text{Coupon Rate} + \text{Prorated Discount}}{(\text{Facevalue} + \text{Purchase Price}) / 2}$$

Determinants of Bond Prices –

Bond prices depend on a number of factors such as the ability of the issuer to make interest and principal payments and how the bond is collaterized. An across the board factor that affects bond prices is the level of prevailing interest rates.

What do you understand by the form Depository Receipts?

4. Depository Receipts: (DR)
DR is an instrument in the form of receipt or certificate created by the overseas Depository Bank outside India and issued to the non – resident investors it is a negotiable instrument evidencing a fixed number of equity shares of the issuing company generally denominated in US Dollars.

DRs are commonly used by those companies which sell their securities in international market and expand their shareholdings abroad. These securities are listed and traded in International Stock Exchanges. These are either American Depository Receipts (ADR) or Global Depository Receipts (GDR).

ADRs are issued in case the funds are raised through retail market in United States.

In case of GDRs, the invitation to participate in the issue cannot be extended to retail US investors.

While DRs denominated in freely convertible foreign exchange, are issued by the depository in the international market, the underlying shares denominated in Indian Rupees issued in the domestic market by the issuing company are custodised with local bank called “Custodian”.

An investor has an option to convert GDR into a fixed number of equity shares of issuer company after a cooling period of 45 days. He can do so by advising the depository. The depository, in turn, will instruct the custodian about cancellation of GDR and the release of the corresponding shares in favour of the non-resident investor.

a. For being sold directly on behalf of the non-resident or being transferred in the books of account of the issuing company in the name of non – resident.
b. Once the underlying shares are issued, the same cannot be recustodised. Until such conversion, GDRs are traded in Overseas Stock Exchange entitled for dividend **but carry no voting rights.** On conversion of GDRs into equity shares, the said shares carry voting rights and yield rupee dividend and are tradable on Indian Stock Exchange like any other equity issue.

The issue of FCCBs / GDRs requires the following approvals:
1. Approval of the Board of Directors.
2. Approval of the Shareholders.
3. Two stages approval of Ministry of Finance “In Principal and Final”.
4. Approval of Department of Company Affairs.
5. Approval of Reserve Bank of India.
6. In – principle consent of Stock Exchange for listing underlying shares.
7. In – principle consent of financial institutions

HEDGING INSTRUMENTS:

What are the Derivatives? Explain

1. Derivatives –
Derivatives are most modern financial instruments in hedging risk. The individuals and firms who wish to avoid or reduce risk can deal with the others who are willing to accept the risk for a price. A common place where such transactions take place is called the ‘derivatives market’.

Derivatives are those assets whose value is determined from the value of some underlying assets. The underlying asset may be equity, commodity or currency. The most important derivatives are Futures, Options, forwards, Swaps etc.

Derivative

OTC **Exchange Traded**

Exchange – Traded Derivatives:
Derivatives which are traded on an exchange are called ‘exchange-traded derivatives.’ Trades on an exchange generally take place with anonymity. Generally go through the Clearing Corporation.

OTC Derivatives –
A derivative contract which is privately negotiated is called the OTC derivative. OTC trades have no anonymity and they generally do not go through a clearing corporation. Every derivative product can either Trade OTC or on an exchange. OTC future contracts are called ‘forwards’ (or exchange-traded forwards are called futures).

Define Spot Market

2. Spot Market:

Spot Market is also called ‘cash market’ where the sale and purchase of commodity takes place for immediate delivery. The price at which the exchange takes place is called the ‘spot price’. The spot market involves both the transfer of ownership and the delivery of the commodity or instrument on the spot.

Define forward contract. What are the points for negotiation?

3. FORWARD CONTRACTS:

A forward contract is an agreement made today between a buyer and seller to exchange a commodity or an instrument for cash at a predetermined future date at a price agreed upon today. The agreed upon price is called the forward price; with a forward market the transfer of ownership occurs on the spot, but delivery of the commodity or instrument does not occur until some future date. Also no money changes at the time the deal is signed.

In a forward contract, no part of the contract is standardised and the two parties sit across and work out each and every detail of the contract before signing it. For example, in case of a gold bullion forward contract, the parties would negotiate the following features of the contract.

a. The weight of the gold bullion to be delivered,
b. The fineness of the metal to be delivered.
c. The place at which the delivery is to be made,
d. The period after which the delivery is to be made, and
e. The price which the buyer would pay.

Define futures. Explain the mechanism involved

4. Future Contracts:

A futures contract is a financial instrument, issued by an organised exchange to buy or sell a commodity, security or currency on a predetermined future date at a price agreed upon today. The agreed upon price is called the 'futures' price.

Futures markets are exactly like forward markets in terms of basic economics.

1. However, contracts are highly liquid.
2. There is no counterparty risk. (In futures market, unlike in forward markets, increasing the time to expiration does not increase the counterparty risk.)
3. A futures contract provides both a right and an obligation to buy or sell a standard amount of a commodity, security or currency on a specified future date at a price agreed, with the characteristic of standardization; it is this element which makes the agreement tradable – i.e. traded for itself. The only negotiable, chargeable element must be the price agreed when entering into the contract.

Mechanism in Future Contracts - The selling and buying of future contracts is a way of describing commitments, a seller of a future can sell without previously having bought. In the commodities futures market, the following conventions apply.

a. Buy a future to agree to take delivery of a commodity. This will protect against a rise in price in the spot market as it produces a gain if spot prices rise Buying a future is said to be going long.
b. Sell a future to agree to make delivery of a commodity. This will protect against at all in price in the spot market as it produces a gain if spot prices fall. Selling a future is said to be going short.

In a future contract, at the end of the trading session each day, both the parties to the contract carry forward the transaction to the next day by closing out the previous day's transaction. The party, whose account falls short of the specified amount, makes up the short fall by paying variation margin, technically at the end of the day. The parties to the contract then enter into a new forward contract with the same maturity date as existed in the original contract but at a new forward price. Through this process, known as 'marking to market', the clearing house replaces each existing future contracts with a new one.

How to Determine Futures Price

Determination of futures Price:

The futures price is determined as follows:
Futures price = Spot Price + Costs of carrying

The spot price is the current price of the commodity. The cost of carrying is aggregate of storage, insurance, transport costs involved in delivery of commodity at an agreed price, finance cost i.e. interest forgone on funds used for the purchase of the commodity.

Prices, exclusive of commission, are determined by supply and demand. The future price is the market's expectation of what the spot price will be on the delivery date of a particular contract.

On the delivery date itself, the settlement price is determined by the spot price, but prior to this, the future price could be above or below the spot. This difference is called 'Basis'.

Basis = Futures Price – Spot Price

If the future price is greater than the spot, it is called 'contango'. Here, 'basis' is decided solely by costs of carrying.
If the spot price is greater than the futures price, it is called 'backwardation'. Here, 'basis' is affected by factors other than the cost of carrying.

The 'basis' will approach zero towards the expiry of the contract i.e. the spot and future price converge as the expiry of the contract approaches. This process of the 'basis' approaching zero is called 'convergence'.

Cost of carry Model in Financial Futures
Future Price = Spot price + carrying cost – Returns (dividends, etc.)

Explain the valuation of Futures

VALUATION OF FORWARD / FUTURE CONTRACTS

In derivative securities, continuous compoundings are used.

1. In terms of the annual compoundings, the forward price can be computed through the following formula -

$$A = \left(P + \frac{r}{100}\right)^t$$

$$A = P\,((1 + R) / 100)^t$$

Where, A = Terminal value of an amount
P = Amount invested
r = Rate of interest per annum
t = Years

2. In case of multiple compounding, e.g. n times, the formula is

$$A = P\left(1 + \frac{r}{n}\right)^{nt}$$

3. In case the compounding becomes continuous, i.e. more than daily compounding, the formula is

$$\mathbf{A = Pe^{rn}}$$

Where,
e = epsilon, a mathematical constant having a value of 2.72.

4. In case, there is cash income accruing to security like dividends, the following formula is used

$$\mathbf{A = (P-I)\ e^{rn}}$$

Where, I = present value of the income flow during the tenure of the contract.

5. In case the income accretion to the securities is in the form of percentage yield, y, as in the case of stock indices arising on account of dividend accruals to individual stocks constituting the index the formula is -

$$\mathbf{A=Pe^{n(r-y)}}$$

Correlation between forward and future prices

1. For contracts of the same maturity, the forward and future contracts tend to have the same value subject to the interest rates remaining fixed.

2. In case of changing interest rates, the value of future contract would differ from that of a forward contract because the cash flows generated from 'marking to market' in the ease of the former would be available for reinvestment at various rates on day-to-day basis.

Give the Purposes of futures market

Purposes of futures market

1. **Hedging** – Future contracts provide a hedging facility to counter the adverse movements in prices, interest rates, foreign exchange rates, etc.,
2. **Speculation** – Future contracts provide arbitrage opportunity to the speculators.
3. **Price discovery** – Price discovery is the use of future price to predict spot price that will prevail in the future. These predictions are useful for production decisions involving the various commodities.

Types

Market **Limit** **MIT** **Stop Loss** **GTC**

5. TYPES OF ORDERS

Market Order:

When a trader places a buy or sell order at the price which prevails in the futures pit at the time the order is given, it is called a market order.

Limit Order:

If the trader specified a particular price or the price limit within which the order should be executed, such an order is called a limit order. In such orders, the inherent risk is that the specified price or the bank may never be hit during the day and the position may not be closed out.

Market-if-touched (MIT) Order:

If an order is executed at the best available price after a trade occurs at a particular price or at a price more favourable than the specified price, it is called a Market-if-touched order.

Stop Loss Order:

When a trader holds a position, either long or short and wants to restrict his downside, he would place an order specifying a rate at which the deal could close out. This would insure him against a runaway loss in the event of a drastic adverse pric e movement. Stop loss orders are normally placed by specifying a range in which the order should be executed instead of giving a single price order.

Good TIII Cancelled (GTC) Order:

In terms of National Stock Exchange (NSE) regulations, Good till cancelled orders shall be cancelled at the end of 7 calendar days from the date of entering the order.

Various other forms of orders can be created as per the needs of the market and its players.

Explain the clearing Mechanism in Stock Exchange

6. THE CLEARING MECHANISM

The clearing house is an inseparable part of a future exchange. This exchange acts as a seller for the buyer and a buyer for the seller in the execution of a futures contract. The moment the buyer and the seller agree to enter into a contract, the clearing house steps in and bifurcate the transaction, such that

the buyer buys from the clearing house, and
the seller sells to the clearing house.

Thus, the buyer and the seller do not get into the contact directly. In other words, there is no counter-party risk. The idea is to secure the interests of both.

The clearing house has to be solvent enough. The solvency is achieved through imposing on its members, cash margins and/or bank guarantees or other collaterals, which are encashable easily. The clearinghouse monitors the solvency of its members by specifying solvency norms.

What do you understand by the term margins?

MARGINS –
Margins introduce a financial stake on the client, *ab initio*, to ensure performance of the contract and to cover day to day adverse fluctuations in the prices of the securities bought. The margins paid by the investor is placed at the disposal of the clearing house through the brokerage firms. The margins provide protection to the clearing house.
The margins for future contracts have two components –

1. Initial Margin

In a future contract, both the buyer and seller are required to perform the contract. Accordingly, both the buyers and sellers are required to put in the initial margins. It is also known as performance margin. The initial margin is the first line of defence for the clearinghouse.

2. Maintenance Margin

In order to start dealings with a brokerage firm for buying and selling futures, the first requirement for the investor is to open an account with the firm, called the equity account. Maintenance Margin is the margin required to be kept by the investor in the equity account equal to or more than a specified percentage of the amount kept as initial margin. Normally the deposit in the equity account is equal to or greater than 75% to 80% of the initial margin.

In case the requirement is not met, the investor is advised to deposit cash to make up the shortfall. If the investor does not respond, then the broker will close out the investor's position by entering a reversing trade in the investor's account.

Explain making to market

MARKING TO MARKET

It means debiting or crediting the client's equity accounts with the losses or gains of the day based on which, margins are sought or released. Through marking to market process, the clearing house substitutes each existing future contract with a new contract.

Example:

Suppose on Monday morning, you take a long position in a future contract that matures on Friday afternoon. The agreed upon price is Rs.100. At the close of trading on Monday, the future price rises to Rs.105. Marking to market feature means that three things occur –

4. You will receive a cash profit of Rs.5
5. The existing futures contract with a price of Rs.100 is cancelled.
6. You will receive a new futures contract at Rs. 105.

The marking-to-market feature implies that the value of the futures contract is set to zero at the end of each trading day.

What are SIFs?

STOCK INDEX FUTURES (SIFs)

A future contract on a stock market index gives its owner the right and obligation to buy or sell the portfolio of stocks represented by that index. SIFs have revolutionized the equity trading all over the world.

SIFs have been introduced in the Indian stock markets on S & P CNX Nifty (Nifty) of NSE and on BSE sensex of BSE. The SIF contracts involve the payment of cash on the delivery date of an amount as indicated below –

Cash Payment = (I – P) X M

Where,
I = The value of the index at the close of the last delivery date of the contract.
P = The purchase price of the Futures Contract
M = The Multiplier in use of Nifty of NSE.

The Stock Index Futures Contracts have a multiplier of 200, while in the case of BSE Sensex, the multiplier is 50.

7. OPTIONS

1. **Meaning –** An option is the right but not the obligation to enter into a transaction. An option is the right, but not the obligation, to buy or sell something at a stated date at a stated price. The holder of the option can exercise the option at his discretion or may allow the option to lapse. For example, you may enjoy the option to buy a certain apartment on or anytime before December 31 of the current year at a price of Rs.10 lakhs.

2. **Key terms and phrases used in discussion of options**

   a. **Option holder and option writer –** The option holder in the buyer of the option. The option writer is the seller of the option. Any one eligible to enter into a contract as per the Law of Contract can write an option irrespective of the fact whether he one owns the under-lying asset or not.

b. **Covered and uncovered (naked) option –** When the writer of an option owns the stock which he is obliged to deliver, the upon exercise of the option he has writter, he is called a covered writer and the option is called covered option. On the other hand, if he does not own the stock which he has written the option for, he is called an uncovered or naked Writer and the option is called an uncovered (naked) option.
c. **Exercise price or striking price –** The price at which the option holder can buy and / or sell the underlying asset is called the exercise price or striking price.
d. **Expiration date or maturity date –** The date when the option exercises or matures is referred to as expiration date or maturity date. After the expiration date, the option is worthless.
e. **Exercising the option –** The act of buying or selling the underlying asset as per the option contract.
f. **European and American Option –** A European option can be exercised only on the expiration date. An American option can be exercised on or before the expiration date.
g. **Parties to an option Transaction –**
   (i) Buyer or holder of an option (call or put)
   (ii) Seller or writer of an option (call or put)
   (iii) The Clearing House
h. **In-the-Money –** If the actual price of the underlying asset is more than the Strike/exercise price, then the call is said to be in the money.
i. **At-the-Money –** If the actual price of the underlying asset is same as the strike / exercise price.
j. **Out-of-the-Money –** If the actual price is less than the strike price, the call option is said to be out-of-the-money.
k. **Going long a stock –** It means buying the stock
l. **Selling long –** It means that the seller owns the stock which he is supposed to deliver to the buyer.
m. **Selling Short –** It means that the seller does not own the stock which he is supposed to deliver and will have to borrow the stock now for delivering to the buyer and buy the stock later to set off the borrowing.
n. **Call Option –** A call option provides to the holder a right to buy specified assets at specified price on or before a specified date.
o. **Put Option –** A put option provides to the holder a right to sell specified assets at specified price on or before a specified date.
p. **Option Premium –** The buyer of the option (option holder) has to buy the right from the seller (option writer) by paying an option premium.
q. **Covered Call Options or Covered Calls –** Call writers are considered to be covered if they have any of the following positions –
   (i) A long position in the underlying asset.
   (ii) An escrow – receipt from a bank.
   (iii) A security that is convertible into requisite number of shares of an underlying security.
   (iv) A warrant exercisable for requisite number of shares of the underlying security.

(v) A long position in a call on the same security that has the same or a lower strike price and that expires at the same time or later than the option being written.

r. **Covered Put –** There is only one way for put writers to be covered. They must own a put on the same underlying asset with the same or later expiration and the same or higher strike price than the option being written.

s. **Tenure of an option –** It is the period for which an option is valid.

Explain the terms

a. Straddle
b. Strip
c. Strap
d. Spreads

3. Strategies using Hybrid option combinations

a. **Straddle –** It is a strategy which involves buying or selling (writing) both a call and a put on the same stock with both the options having same exercise price.

b. **Strip –** It is the strategy of buying two put options and one call option of the same stock at the same exercise price and for the same period. This strategy is used when the possibility of a particular stock moving downwards is very high as compared to the possibility of it moving up.

c. **Strap –** A strap is buying two calls and one put where the buyer feels that the stock is more likely to rise steeply than the fall. It is opposite to strip.

d. **Spreads –** A spread involves the purchase of one option and sale of another (i.e. writing) on the stock. It is important to note that spreads comprise either all calls or all puts and not a combination of two, as in a straddle, strip or strap.

Vertical spreads – Option spreads having different exercise prices but the same expiration date. These are listed in a separate block in the quotation lists.

Horizontal Spreads – Here, the exercise prices are same and the expiration date are different. These are listed in horizontal rows in the quotation lists. Time spreads and calendar spreads are forms of horizontal spreads.

Diagonal Spreads – Mixtures of vertical and horizontal spreads with different expiration dates and exercise prices are called diagonal spreads.

4. How Options Work?

Taking an example of a share option, the purchase of an option is the right but not the obligation to buy or sell a specific number of shares within a fixed time period at a price that is stipulated when the option is bought. The sale offers the purchaser, the right but not the obligation to exercise but commits the seller to fulfill those functions.

5. Price of an option

Strike price of an option.

Options are generally traded on different types of strike prices. At-the-money, in-the-money and out-or-money. e.g., If the call option is traded at a strike price equal to that of underlying spot price of the equity, then it is called "AT-The-Money". If the strike price is lesser than the underlying spot price, it is called "In-The-Money" and similarly if the strike price is greater than the underlying spot price then it is called "Out-Of-Money"

Thus, if the buyer of an option is making a profit/loss then the option is "In-The-Money" / "Out-Of-Money" respectively.

An option writer charges an upfront premium from the buyer for selling a right. The premium charged consists of two parts (1) the intrinsic value and (2) time value. The intrinsic value of a put option is the difference between the strike price and the spot price, whereas the intrinsic value of a call option is the difference between the spot price and the strike price.

Time value of an option is the price the buyer of an option takes. This is over and above the intrinsic value of that an option holder pays. Generally, the premium charged by the writer of an option is equal to the sum of both the intrinsic value and the time value.

What are the factors affecting the price of an option?

6. Factors affecting the price of an option?

1. Current value of the underlying asset, as the options derive their value from the underlying assets.
2. Expected volatility in the value of the underlying asset – The higher the variations in the value of underlying assets, the greater is the value of the option.
3. Strike / Exercise Price – In case of all option, the value of option will decline as the strike price increases, and in case of put option, the value will increase as the strike price increases.
4. Expiration time of option – The longer the time to expiry, higher would be the value of the option.
5. Rate of interest – The financial features price are based on the cost of money, so the interest rate factor is one of the determinants of options price. Increase in interest rate will increase the value of call option and reduce the value of put option.
6. Income from underlying asset – During the life of an option, there may arise interest/dividend from the underlying assets. So, the value of the call option decreases and the value of put option increases as more and more interest and dividends are paid on the underlying assets.

Effect of different factors on the valuation of option

S. No	Factors	Call Option	Put Option
1.	Increase in value of underlying Asset	Increases	Decreases
2.	Extent of volatility in value of asset	Increases	Decreases
3.	Increase in strike price	Decreases	Increases
4.	Longer Expiration Time	Increases	Decreases
5.	Increase in rate of interest	Increases	Decreases
6.	Income from Asset	Decreases	Increases

7. How to use options for speculations?

An option gives the investors an immense speculative opportunity. A person can for a small premium paid take huge positions in a particular stock. The only risk is the premium which he has to forego if the thing go against him.

8. Differentiate between Futures and Options

1. The futures involve obligations while the options involve right. In futures, the obligations must be fulfilled by both the parties. In case of options, the option holder has the right both to exercise and not to exercise his option.
2. In the futures, there is no premium payable to buy the futures. However, some margin is required to be deposited with the exchange. But, in case of options, the option holder has to pay a premium to buy the option.
3. In futures, the profit or loss of both the parties depend upon the specified price and the actual price on the settlement day. Both parties are exposed to unlimited profit or loss. In options, the loss of the option holder is restricted to the premium paid but his gains are unlimited. Similarly, the profit of the option writer is limited to the premium received, but he is exposed to unlimited risk.
4. Generally, the maturity period of futures is longer than that of the options.

9. Differentiate between Forwards and Futures

1. A forward contract is a tailor-made contract (the terms are negotiated between the buyer and seller) whereas a futures contract is a standardized contract (quantity, date and delivery conditions are standardized)
2. There is no secondary market for forward contracts. Future contracts are traded on organized exchanges.
3. Forward contracts usually end with deliveries. Futures contracts are settled with differences.
4. Usually no collateral is required for a forward contract. In a futures contract, however, a margin is required.
5. Forward contracts are settled on the maturity date whereas future contracts are 'marked to market' on a daily basis. This means that profits and losses on futures contracts are settled daily.

What are the advantages of options?

10. Advantages of Options

1. There is limited risk for many option strategies. The trader can lose the entire premium but that amount is known when the position is initiated.
2. There are no margin calls for many strategies.

3. Options offer a wide range of strategies for a variety of conditions.
4. Options offer a way to add to futures position without spending any more money or premiums. Thus, the option trader has more leverage.
5. With a forward and futures contract, the investor is committed to future transactions. With an option, he enjoys the right to go ahead but he can walk away from the deal if he so desires.
6. The options have certain favourable characteristics. They limit the downside risk without limiting the upside. It is quite obvious that there is a price which has to be paid for this any way, which is known as the option premium.

What are the disadvantages of options?

11. Disadvantages of Options

1. In case of high volatility, the option premium can be very expensive.
2. Currently, there is more liquidity in futures contract than there is most options contract. Entry and exit from some markets can be difficult.
3. There are more complex factors affecting premium prices for options. Volatility and time to expiration are often more important than price movement.
4. Many options contract expire weeks before the underlying futures. This can be often occur close to the final trading day of futures.

6 INDIAN STOCK MARKET

An Overview

Preliminary

The Nature of Indian Stock Market

Money Market
Debt Market
Security Market

Reasons for failure of Issues in Primary Market in the early 90's
Measures taken by SEBI for promotion Investor Protection and Market Development
Depository System
Stock Lending Scheme
Book Building
Private Placements of Shares
Buy-back of Securities
New Financial Instruments in the Capital market
Alternate Financial Instruments: Pros & Cons
The Indian Capital Market and Financial Instruments
Broad basing Money Market

Recent Development In Indian Economy

Industrial Policy, 1991
Trade Reforms
Reforms in Banking Sector
Disinvestments of Public Sector Undertakings

New Financial Instruments

CCCPs
Stock Invest
Non- Convertible Debentures on Pvt Placement Basis
Index- Linked Gilts
Variable Rate Instruments
ZCBs
Warrants

TEAM OF PROFESSORS AT KALPESH CLASSES

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NOW LIVING ~~WORKING~~ TOGETHER.

I. PRELIMINARY

Stock Markets are said to reflect the health of a country's economy. On the other hand, major economic indicators determine stock market movements to a large extent. From a thorough analysis of the various economic indicators and implications on the stock markets, it is known that the stock market movements are largely influenced by money supply, inflation, credit / deposit ratio and fiscal deficit apart from political instability. Besides, fundamental factors like corporate governance, industrial growth etc., also exert a certain amount of influence on the stock markets.

Buying and selling of securities has become a specialized business since it involves a detailed understanding not only of financial management but also of various factors which affect the price behaviour of securities in the stock market. Even with an understanding of these factors, it is often impossible to predict the behaviour of stock market in the short-run, since, apart from factors listed above, speculative tendencies play a major role in the stock market.

Classify the Capital Market in India

II. CLASSIFICATION OF INDIAN STOCK MARKET

Indian capital market can broadly be classified into the following:-

1. **Money Market –** It is a market which deals in short-term securities such as treasury bills, certificate of deposits, etc.
2. **Debt Market –** It is a market dealing in debt securities, such as debentures, bonds, etc.
3. **Security Market** – It is a market dealing in equity linked securities. This market comprises of primary market and secondary market.

Primary market and secondary market have already been discussed elsewhere in the book.

Why were the public issues failed in early 90s?

III. REASONS FOR FAILURE OF ISSUES IN PRIMARY MARKET IN THE EARLY 90s

i. The companies raised huge amounts of capital from the new issues market at fantastic premia for projects which were not taken over by the companies. This is because companies were allowed free pricing after abolition of CCI.

ii. The shares of these companies are now quoted for a Price which is much below the offer price. This has resulted in investors losing confidence in equity market.

iii. Resource mobilization has suffered from poor investor response in the primary market for public and rights issues, which have been adversely affected not only by risk aversion of small investors to new issues, but also by lack of sustained buoyancy in the secondary market and underlying sluggishness of the industry.

iv. Mobilisation of substantial amount has taken place through private placement.

IV. MEASURES TAKEN BY SEBI FOR PROMOTION OF INVESTOR PROTECTION AND MARKET DEVELOPMENT

What measures did SEBI takes?

To protect investor's Interest & develop the market

1. **Computerisation of Stock Exchanges –** The computerization of stock exchanges has brought a qualitative improvement in the market and its transparency. It has reduced the transaction cost and time. About 98% of total turnover on the stock exchange is on-line screen based trading.

2. **Expansion of trading terminals of Stock Exchanges** -As a result of expansion of trading terminals, investors spread across a large number of cities have now been able to gain access to stock markets.

3. **Dematerialisation of shares** – SEBI has introduced paperless trading by setting up NSDL. The dematerialization has resulted in reduction of time and cost, elimination of various risks associated with paper based or physical settlement, increasing the trading volumes on stock exchanges. There has been substantial increase in quantity of scrips dematerialized and trading volumes.

4. **Securities Lending Scheme** – This has resulted in filling a long standing gap in the secondary market. It improves the efficiency of the settlement system.

5. **Clearing Corporation / Settlement Guarantee Fund** – SEBI has advised stock exchange to set up clearing corporation / settlement guarantee fund to ensure timely completion of settlement. Timely completion of settlement contributes to both efficiency and transparency.

6. **Buy-back of Shares** – The companies are empowered to purchase their own shares or other specified securities subject to SEBI regulation. This will enable the profitable and cash rich companies to utilize their earnings and reserves to reduce the outstanding equity shares. It will also lead to revival of the capital market.

7. **Amendment of Takeover Regulation** – SEBI take over regulations are amended for permitting easier consolidation by promoters.

8. **Publication of Results** – The listed companies are required to publish unaudited results on quarterly basis.

9. **Derivatives Trading** – SEBI has permitted derivatives trading on stock exchanges subject to certain guidelines and regulations. In order to facilitate development and regulation of markets for derivatives, the Securities Laws (Amendment) Bill, 1999, proposing expanded definition of securities including derivatives has been passed by parliament.

10. **Rolling Settlement** – 'Rolling settlement' was introduced by SEBI for the first time in 1998 by making it optional for demat scrips. Accordingly, trading in Demat Shares commenced on the basis of a T + 5 rolling settlement cycle with effect from January 15, 1998.

    With effect from July 2, 2001, there would be a compulsory rolling settlement on a daily basis. In other words, each trading day will be taken as if it is a settlement. When an investor buys shares, he will have to pay for them and when he sells them, he will have to give delivery. The risk containment measures like margin requirements, exposure limits, etc., for rolling settlement would be the same as those for other settlements.

11. **Initial Public offers (IPOs) through Secondary Market** – SEBI considered and accepted a system envisaging the use of existing infrastructure of stock exchanges for marketing IPOs. The essential features are as follows:-
    a. The broker would place orders on behalf of his clients. After finalization of share allocation, the broker will advise successful allottees to submit the application form and the amount payable for shares.
    b. The broker will open a separate escrow account for the primary market issue.
    c. The clearing house of the exchange will debit the primary issue account of the broker and credit the issuer's account.
    d. The Certificates will be delivered to the investors or their depository accounts will be credited,

12. Internet Trade: SEBI has proposed internet trading in lmited way under Order Routing System (ORS) through registered stock brokers on behalf of clients. Investors can place, buy / sell orders through the internet and would be able to execute trade on their computers by the brokers filter. While executing the traders, all the necessary safety and integrity measures need to be adhered to in the transactions. The stock exchanges must ensure that the systems used by brokers have provision for security, reliability and confidentiality of data through the use of encryption technology. Brokers must enter into an agreement with clients spelling out obligations and rights. The exchanges also are required to ensure that the brokers have a system based control on the trading limits of clients and exposures taken by them. The brokers on the other hand must set pre-defined limits on the exposure and turnover of each client.

13. Negotiated Deals – A negotiated deal was defined as any transaction which either had a value of Rs. 25 lakhs or a trade volume of not less than 10,000 shares at one price, not formed through the stock exchange and order matching system. In order to introduce transparency and price discovery in negotiated deals, SEBI issued guidelines that such transactions will be permitted only if they are executed on the screen of the stock exchange, following the price and order matching system of the exchange just like anyother deal on stock exchanges.

14. Corporate Governance – SEBI has issued Corporate Governance Code which will raise awareness and help in raising the standard of corporate governance in India. Corporate governance is an informational tool for investor's protection.

V. DEPOSITORY SYSTEM

Refer Chapter Discussed elsewhere in the book

Write short notes on stock lending scheme.

VI. STOCK LENDING SCHEME

In a stock lending scheme, the legal title of a security is temporarily transferred from a lender to a borrower. The lender retains all the benefits of ownership, other than the voting rights. The borrower is entitled to utilize the securities as required but is liable to the lender for all the benefits (e.g., dividends, interest or rights). The stock lending scheme began as a measure to cover short sales, i.e., selling shares without processing them.

Advantage of Stock Lending

1. It provides income opportunities for security – holders.
2. It is particularly attractive for large institutional holders of securities, as it is an easy way to generate income to offset custody fees and requires little, if any, of their involvement of time.
3. It gives borrowers access to lender's portfolios, which provide the flexibility necessary when borrowing for strategic positioning and financing inventories.
4. It facilitates timely settlement, increase the settlements, reduces market volatility and improves liquidity.

Guarantee to Lender
The borrower has to deposit the collateral securities, which would be cash, bank guarantees, government securities or certificates of depositor or other securities, with the approval intermediary. In case the borrower fails to return the securities he will be declared a defaulter and the approved intermediary will liquidate the collateral deposited with it. The borrower can't discharge his liabilities of returning the equivalent securities through payment in cash or kind.

Approved intermediaries – There are 4 entities register with SEBI.
1. National Securities Clearing Corporation Ltd. (NSCCL)
2. Stock Holding Corporation of India Ltd. (SHCIL)
3. Deutsche Bank
4. Reliance Capital

VII. BOOK BUILDING
Discussed elsewhere in the book

VIII. PRIVATE PLACEMENT OF SHARES
Discussed elsewhere in the book

State the advantages of securities.

IX. BUY-BACK OF SECURITIES
The corporates are empowered to purchase its securities by virtue of sections 77 A and 77 B of the Companies (Amendment) Act.

Advantages:-
1. **Utilisation of reserves –** The profitable and cash rich companies can utilize their earnings and reserves to reduce the outstanding equity shares.
2. **Revival of the Capital Market –** Buyback can lead to revival of the capital market by flaring up the market value of shares in a bearish market. It will help the company to maintain the market price of its shares and to keep it stable.
3. **Rise in market price of shares –** Buyback leads to rise in earning per share, which results in rise in market price of shares as the demand of the share increases.
4. **Liquidity to Dormant share –** Buyback would lead to liquidity to those shares which are dormant as they are generally held by the employees and executives. By bringing the buyback option, the company would be able to purchase those shares from the employees, by etc.
5. **Odd Lots –** Odd lots are not tradeate in the market and hence they are more or less dormant in nature. As the Companies Act permits buyback from odd lots, it could act as a relief to the shareholders by way of selling those shares to the company.
6. **Restructure of capital base by companies with special reference to PSUs –** Buyback of PSU's share correct any undervaluation and send powerful signals to the market about the PSUs faith in the intrinsic value of their shares. This also gives a boost to governments disinvestment programme.

7. **Proper Utilisation of Excess Funds –**Many companies have excess cash without any profitable investment option. It would be better for them to return surplus cash to shareholders than go on spending simply for want of alternatives.

X. NEW FINANCIAL INSTRUMENTS IN THE CAPITAL MARKET
Discussed elsewhere in the book

XI. ALTERNATE FINANCIAL INSTRUMENTS: PROS AND CONS
Discussed elsewhere in the book

Write a note on development of Indian Capital Market

XII. THE INDIAN CAPITAL MARKET AND FINANCIAL INSTURMENTS
The Indian capital markets have witnessed a boom in the last decade and undergone a metamorphosis in terms of the number of investors, amount of funds utilized, number of instruments, geographical spread, investor awareness and regulatory changes. The corporate sector has seen a lot of growth and a set of innovations in the last decade. With the growing capital market, the role of finance managers has become more important. Future poses bigger challenges for them specially in the areas of raising financial resources and how various innovations are taking place in them.

The recent years have been witnessing emergence of innovative financial techniques and new financial instruments in the financial market. These have been discussed in the chapter “Types of Financing”. However, a lot of innovation needs to be done in the capital markets.

Why Indian Money Market – needs to be Broad based?

XIII. BROAD BASING MONEY MARKET -
The Indian money market is characterized by shortage of financial instruments. Continuous development and refinement of existing instruments is necessary. Widening and deepening of the market by increasing the number of instruments is necessary for following reasons –

1. It would broaden the base for operations by adequate supply of funds.
2. It will provide the investors, lucrative outlet for deployment of funds.
3. It will provide financial stability to the financial market and discourage unhealthy practices in the market through the availability of a variable and attractive instrument.
4. A large number of instruments lead to flexibility of the main attractions for borrowers and investors, since issues can be adapted to the needs of both.
5. Absence of proper instruments may lead to emergence of unorganized or unauthorized market leading to unethical practices of distorted interest rate structure.

Write a note on recent development in Indian economy

XIV. RECENT DEVELOPMENT IN INDIAN ECONOMY

1. **Industrial Policy, 1991 –** The New Industrial Policy aims at liberalisation & relaxation of controls and removal of procedural difficulties which have been acting as hindrances to the establishment and growth of industrial ventures.
   The Industrial Policy Statement demonstrates the shift towards competition and integration of India’s economy with the global economy.

The major initiatives in the Industrial policy are-

a. Comprehensive measures to unshackle the Indian industry from myriad administrative and legal controls.
b. Extensive liberalisation to facilitate free flow of foreign investments.
c. Elimination of restrictions and expansion of industrial undertaking.

2. **Trade Reforms –** Indian rupee has been made fully convertible on current account and partially convertible on capital account. Import trade has been liberalised.

3. **Reforms In Banking Sector –** There has been a significant reduction in Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR). A number of private banks have come up. Bank management has given more autonomy and has been made professional in nature.

4. **Disinvestment of Public Sector Undertakings (PSUs) –** Government has been vigorously pursuing disinvestment of PSUs to reduce government control in these undertakings and to raise funds to reduce fiscal deficit.

XV. NEW FINANCIAL INSTRUMENTS-

What are CCPS? Give the salient features:

CUMULATIVE CONVERTIBLE PREFERENCE SHARES (CCPS) –

The Government has issued guidelines to companies proposing to issue CCPs. The salient features are:

1. The entire issue of CCP would be convertible into equity shares between the end of 3 years and 5 years, as may be decided by the company.
2. The conversion of CCP into equity would be deemed as being one resulting from the process of redemption of the preference shares out of the proceeds of the fresh shares made for the purposes of redemption.
3. The rate of preference dividend payable on CCP would be 10%.
3. The preference shares would have voting rights as applicable to preference shares under the Companies Act, 1956.
   - The face value of the aforesaid shares will ordinarily be Rs. 100 each.

It appears that this scheme was not found favourable by the investors.

Critically assets & elaborate on the advantages & disadvantages of CCPS.

ISSUERS ADVANTAGES	INVESTORS ADVANTAGES	INVESTORS DISADVANTAGES

The 10% dividend on CCP shares is lower than the rate of interest in case of debentures (pre-tax only). The effective cost of debentures to the company depends on the tax rate. Therefore, for new companies with no tax liability. CCPs may offer a cost advantage.	CCP shares give an assured return of 10% p.a. even during the gestation period, which may not be available in the case of equity shares. Even if the profits are inadequate in the initial stage, accumulates and the entire amount is paid before any dividend is paid to the equity shareholders.	CCP shareholders, u/s 87(2) of the Companies Act, will have right to vote only on resolutions which directly affect their rights and u/s 87(2)(b)(i), on every resolution, if the dividend has remained unpaid for an aggregate period of not less than two years preceding the date of the meeting. This limits the extent to which CCP shareholders can influence the working of the company.
The CCP shares are deemed as equity and so assure a large equity base for substantial borrowing for financing the same project or further investments	There is a possibility of significant capital gain due to appreciation in the share price on conversion, if the project is economically viable and the company starts paying dividend.	The CCP shareholder do not have an option regarding conversion.
In the initial years, CCP shareholders are not entitled to voting rights and so the management can retain full control over the company with a small capital contribution of its own.		The investment is not secured against the assets of the company as against Convertible Debentures which are secured.
The instrument is deal for capital – intensive project having long gestation period like steel fertilizers and power.		
The planning of capital structure is facilitated since there is not uncertainty regarding conversion unlike Optionally Convertible Debentures.		

STOCKINVEST-

Discussed elsewhere in the book

Explain about non-convertible debentures issued on private placement basis.

NON – CONVERTIBLE DEBENTURES ISUED ON PRIVATE PLACEMENT BASIS –
The investment institutions like UTI, LIC, GIC and Mutual Funds and some banks agree to subscribe to the Non-Convertible Debentures issued by the Companies to meet their long-term Working Capital requirements.

The Procedure is very simple and the investing institutions after satisfying the eligible criteria as per the Government guidelines will subscribe to the debentures issued by the company. However, in view of the recent relaxation on ceiling of interest rates, the investing institutions have the freedom to charge interest at a higher rate over and above 14% depending upon the company's standing. (For any inquiry or admission to kalpesh classes dial 2382 0676)

What are Index – Linked Gilts? Explain

INDEX – LINKED GILTS –

Currently, the dated securities issued by the Central Government offer a coupon rate varying between 10 and 11.5 %p.a. (recently hiked to 12% p.a. on new issues), depending upon the term of maturity. Given an average annual inflation rate of 10% p.a., the inflation adjusted rate of return of real rate of return earned on these securities is just marginally positive and can be negative in those periods, where the inflation rate exceeds the coupon (nominal) rate. To protect the institutional investment (a significant part of which gets chanalized into Government securities) from the purchasing power risk or inflation risk, we can consider the introduction of "Index-Linked Gilts." These index-linked gilts are inflation-proof over their terms of maturity.

- The base for index-linking can be the Consumer Price Index (CPI) and the base date for index linking can be the CPI.
- Each intervening coupon payment and the maturity proceeds are to be increased in the ratio of the CPI value.

Index-Linked Gilts were introduced in U.K. in 1981 and have been growing in importance over the last ten years. Given the fact that an index-linked gilt-edged stock is a low income-high capital gains stock, the stock has also attracted considerable amount of investment from individual investors in the higher tax brackets.

What are variable Rate Instruments?

VARIABLE RATE INSTRUMENTS –
In this, the coupon rate of interest is not fixed but varies in accordance with some predetermined formula. For example, the instrument may provide for the coupon being determined at six monthly intervals at a margin above the six-month inter-bank rate. This instrument helps the

borrower as he does not have to commit to a fixed interest loans at rates which are temporarily very high.

ZERO COUPON BONDS (ZCB)

Discussed elsewhere in the book

WARRANTS –

Discussed elsewhere in the book

7 FINANCIAL SERVICES

An Overview

Preliminary

Non-Banking Financial Corporations (NBFCS)

Some Problems in NBFCs
Categories of NBFCs
Strengthening of NBFCs
Regulation – NOF, Registration etc.,

Asset/Fund Based Services

Leasing

- *Meaning*
- *Types*
- *Advantages*
- *Disadvantages*
- *Financial Evaluation*
- *Structure of Lease Rentals*
- *Evaluation of Lease Methods*

Hire Purchase and Instalment Scheme Financing
Consumer Credit
Factoring
Forfaiting
Housing Finance System in India

- *NHB and its role*
- *Structure of Housing Sector*
- *Terms and Conditions of Housing Finance*

Fee Based Services -Merchant Banking:

- *Merchant Banker*
- *Categories*
- *Activities*
- *Underwriting Obligation*
- *Documents to be furnished*
- *Checklist for MBs*

Mergers and Acquisitions:

- *Meaning*
- *Types*

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- *Methods*
- *Joint Ventures*
- *Sell – offs*
- *Corporate Control*
- *Changes in Ownership Structure*

Valuations

- *Regulatory Aspects*
- *Exempted Categories in SEBI Regulations*
- *Definitions*
- *Other Regulatory Provisions*

I. PRELIMINARY

The economic reforms and deregulation have resulted in impressive growth recorded in financial services industry. Since eighties, several innovative financial products have also been introduced. All these developments have resulted in specialised financial service institutions assuming increasing importance.

Financial services in Indian include Merchant Banking, Portfolio Manager, Credit Rating Agencies etc. These services aim at providing funds or substitutes of funds for the desired venture at an optimum cost to the promoters and with best possible returns to the investors within the regulatory framework.

Write a note on NBFCs

II. NON-BANKING FINANCIAL COMPANIES (NBFCS)

NBFCs are financial intermediaries outside the traditional banking system. In India, more than 70% of the financial requirements in trade and commerce is met by NBFCs. Of course, the lending rate of interest is high.

NBFCs have always had a special place in the Indian economy. They have stepped into any vaccum that banks happened to leave. When banks found lending to some entrepreneurs risky, the NBFCs stepped in. (To know more about us visit KalpeshClasses.com)

Because of liberalisation policy adopted by India, there has been proliferation of NBFCs during the 1980s and particularly during the 1990s. However, as a result of strict RBI regulation, the number of registered NBFCs have significantly come down.

Some Problems in the functioning of NBFCs

1. Many NBFCs have become bankrupt and then closed because of mismanagement.
2. NBFCs can not meet the strict RBI Regulations.
3. A number of NBFCs resort to take huge deposits from the public at high rates of interest which they could not sustain.
4. With the falling interest rate regime, and improvement in credit availability, the companies have preferred to go traditional source of finance on account of lower costs and longer repayments.
5. NBFCs have been scandal-prome because of greedy promoters and investors.
6. NBFCs have not been able to grow because of compulsory credit rating, barriers to entry, restrictions on the quantum of the funds that be raised etc.

Categories OF NBFCs

- Loan Companies
- Investment companies
- Hire Purchase Finance Companies
- Equipment leasing companies
- Mutual benefit finance companies

- Misc. Finance companies
- Misc. Non-banking Companies
- Housing Finance Companies
- Merchant Bankers
- Credit and business
- Insurance, Chitfund, etc.

STRENGTHENING OF NBFCS:
RBI has taken many measures to ensure healthy growth of NBFCs. In January 1998, RBI had laid down norms relating to capital adequacy, income recognition, asset classification, credit rating, exposure norms etc. RBI has developed a comprehensive system to supervise those NBFCs which are accepting and holding public deposits. Minimum net owned funds has been made mandatory. In order to further strengthen the NBFCs, entry of MNCs and FDIs in the NBFCs sector should be encouraged. The focus should not be on failure of some institutions but on tightening of regulation and supervision. The regulatory framework should be growth oriented and not merely control oriented.

REGULATION OF NBFCS: RBI ACT FRAMEWORK:

What are the two essential pre requisites for an NBFC to commence business?
Salient features of Chapter III – B:

Under sub-section (1) of Section 45-IA of the Act, a non-banking financial company (NBFC) cannot commence or carry on the business of a non-banking financial company without complying with the following two essential pre-requisites:

1. The NBFC should obtain a certificate of registration.
2. It must have a Net Operating Fund (NOF) of Rs. 200 lakhs.

   These two requirements are cumulative, and not alternative.

Computation of NOF:

The expression 'NOF' is defined in section 45-IA of the Act. The basis for the computation can be made through the following step-by-step process:

Step 1: Add Paid-up equity capital and Free reserves (say) – (A) A = Paidup Capital + Free Reserves

Step 2: Accumulated balance of loss, Deferred revenue expenditure, + = B other intangible assets

Step 3: C = A – B

Step 4: Add figures, if any, under the following items:

(i) Investments in shares of
- Subsidiaries
- Companies in the same group
- other NBFCs

(ii) Book value of debentures, bonds, outstanding loans and advances (including hire-purchase and lease finance) made to
- Subsidiaries
- Companies in the same group

(iii) Deposits with
- Subsidiaries
- Companies in the same group.

If the resultant figures exceeds 10% of (C). (say) – (D)
Find out the excess

Step 5: The NOF of the NBFC will be (C) minus (D).

NBFCs exempted from the registration / NOF requirements:

List the institutions exempted from registration of Sec. 45-1A

With this in mind, the grading of construction agencies is designed to benefit the various entities involved in the following manner.

- Insurance Companies
- Stock Exchanges.
- Stock-broking companies.
- Mutual Benefit Financial Companies Nidhis notified under section 620A of the Companies Act or mutual benefit company.
- Chit Fund Companies.
- Housing Finance Companies.
- NBFC satisfying all the following conditions :
  - is registered with the SEBI as a Merchant Banker.
  - is carrying on the business of merchant banker in accordance with SEBI Rules and Regulations.
  - acquires securities only as a part of its merchant banking business.
  - does not carry on any of the activities referred to in the definition of 'financial institution'.
  - does not accept 'public deposits' as defined in the RBI Directions relating to Acceptance of Public Deposits.

Explain the procedure involved in obtaining certificate of registration by NBFC.

Procedure for obtaining registration:

Application	Application must be in the Form prescribed by RBI to be filled in accordance with the instructions contained in the Form itself. Documents required to be enclosed (9 in number) should also be prepared in accordance with the instructions, and be attached to the application.
Where to submit	The Regional Office of the RBI under whose supervision, the company's registered office is situated.
Processing by the RBI	RBI may have to ensure itself that the conditions spelt out in sub section (4) of section 45-IA are fulfilled. These conditions broadly cover the following areas:
	♦ Capacity of the NBFC to meet the creditors' claims in full, when the claims accrue.
	♦ NBFC does not conduct its affairs in a manner detrimental to the interests of depositors.
	♦ General character of the management of NBFC is not prejudicial to the public interest or the interest of its depositors.
	♦ NBFC has adequate capital structure and earning prospects.
	♦ The grant of certificate will serve public interest.

	♦ The grant of certificate will not be prejudicial to the operation and consolidation of the financial sector consistent with monetary stability, economic growth or such other relevant factor.
	♦ Any other condition which, in the option of RBI, shall be necessary to ensure that the business of NBFC shall not be prejudicial to the public interest or in the interest of the depositors.
Issue of certificate	RBI will thereafter grant a certificate of registration, with or without specified conditions (Section 45-IA(5).
Cancellation of registration	RBI can cancel the registration in the following situations (Section 45-10A(6)):
	a. When NBFC ceases to carry on business.
	b. When NBFC fails to comply with any condition specified by RBI while granting certificate of registration – (a)
	c. When NBFC is, at any time, found to have failed to fulfill any of the conditions mentioned in 'Processing by the RBI' above – (b)
	d. When NBFC fails to comply with any Directions issued by RBI
	e. When NBFC fails to maintain accounts in accordance with any law, or with any direction or order issued by RBI.
	f. When NBFC fails to submit or offer for inspection its books of account and other relevant documents when demanded by RBI.
	g. When NBFC has been prohibited from accepting deposits by an order of RBI, and that order has been in force for not less than three months.
Procedure for cancellation of registration	NBFC should be given a reasonable opportunity of being heard.
	Where action for cancellation is proposed on the grounds stated as (a) or (b) above, NBFC must generally be given an opportunity by the RBI for taking necessary steps to comply with the conditions, except in cases where RBI is of the opinion that the delay in cancelling the certificate of registration shall be prejudicial to public interest or the interest of the depositors or the NBFC.
Appellate remedy	If the application for registration is rejected by RBI, or if the certificate of registration is cancelled by RBI, the company can prefer an appeal to the Central Government within 30 days from the date on which the order was communicated to it.
	The decision of the Central Government on the appeal, if any, filed by NBFC shall be final [Section 45 – IA]
	Where no appeal has been preferred by the NBFC within the stipulated time, the decision of the RBI shall be final [Section – IA(7)]
Utilisation of funds during interregnum	Till such time as the certificate of registration is granted by RBI, the NBFC can keep its capital funds invested in any type of deposits with a bank. Investment in any other types of securities will invite penal action.

Subject to the provisions of Chapter III-B, non-corporates are not permitted to accept deposits after April 1, 1997. However, individuals can accept deposits from (1) relatives, (2) any other individual for his personal use but not for lending or business purposes. The non-corporate entities, which hold deposits, should repay them immediately after such deposits become due for repayment or within two years from the date of such commencement whichever is earlier. The non-corporate entities are prohibited from issuing/causing to be issued any advertisement in any form for soliciting. (For any inquiry or admission to kalpesh classes dial 2382 0676)

Salient Features of Chapter III – C:

RBI Acceptance of Public Deposits Directions: In perseverance of its powers under the provisions of Chapter III-B and C, RBI has issued the following directions:-

1. NBFC Directions 1977
2. MNBC Directions 1977
3. RNBC Directions 1987

Later RBI issued NBFCs Acceptance of Public Deposits (RBI) Directions, 1998 in place of NBFC directions, 1977.

Items to be included or excluded under 'Public Deposit': Para 2(1)(xii) of the Directions defines a 'public deposit'. The term 'deposit' is defined in section 45-I(bb) of the Act in general terms, namely, 'deposit' includes and shall be deemed always to have included any receipt of money by way of deposit or loan or in any other form', and then enumerates certain items which are not to be included.

Deposits

- Received from or guaranteed by Central / State government, local authority, foreign government/citizen, authority, person;
- Received from IDBI / LIC / GIC / SIDBI / UTI / NABARD / Electricity Boards / TIIC / NIDC / ICICI / IFCI / IIBI / STC / REC / MMTC / SIDCS / ADB / IFC /any institution specified by the RBI;
- Received from any other company;
- Received by way of subscription to shares/stocks/bonds/debentures, or by way of calls in advance on shares;
- Received from directors/shareholders, provided the amount is not given out of borrowed/acquired funds from others;
- Raised by issue of convertible bonds/secured debentures not exceeding the market value of the security; and
- Brought by way of unsecured loan in pursuance of stipulations of lending public financial institutions such as SFCs, banks, GIC, those specified by the Companies Act (Section 4-A) by promoters or their relatives but not from friends/business associates till the repayment of the institutional loan.

Computation of Net Owned Fund (NOF):

For the purpose of these Directions, the definition of 'net owned fund' specified in para 2(1)(x) of the Directions is relevant. The computation has to be made in the same manner explained for registration purposes, with the modification that 'paid-up preference shares which are compulsorily convertible into equity' must also be included.

Restriction / Procedures on Mutual Benefit Financial Companies (MBFC) :

- Should not accept or renew any public deposit except from its shareholders.
- Deposits from shareholders should not be in the nature of current account. (Savings Bank accounts are not prohibited).
- Interest rate on deposits should not exceed 16% p.a., and interest can be paid or compounded at rests, which shall not be shorter than monthly rests.
- Receipts in the prescribed manner must be furnished to depositors as required in para 4(15) of the Directions.
- Must maintain the Register of Deposits in the manner laid down in para 16 of the Directions.
- Should not pay any brokerage/commission/incentive/any other benefit, to any person for public deposits from its shareholders.
- Security deposit received from employees should be deposited in a scheduled bank or post office in the joint names of the employee and company. The amount should not be withdrawn without the consent of the employee. The amount shall be repayable to the employee along with interest, unless such amount or any part thereof is liable to be appropriated by the company for any failure on the part of the employee for due performance of duties.
- Submission of returns/documents to RBI as required under para 8 of the Directions.

Restriction on NBFC:

Minimum Credit Rating: Under para 4(1) of the Directions, no NBFC having specified NOF can accept public deposit unless it has obtained minimum investment grade or other specified credit rating for fixed deposits from any one of the approved credit rating for fixed deposits from any one of the approved credit rating agencies at least once a year.
The approved credit rating agencies and the minimum credit rating are specified as follows:

	Name of the agency	Minimum investment grade rating
(a)	The Credit Rating Investment Services of India Ltd. (CRISIL)	FA – (FA Minus)
(b)	ICRA Ltd.	MA – (MA Minus)
(c)	Credit Analysis & Research LTD. (CARE)	CARE BBB (FD)
(d)	Duff & Phelps Credit Rating India (P) Ltd. (DCR India)	Ind BBB – (BBB Minus)

Period of Deposits: The NBFCs cannot accept deposits payable on demand. They can accept/renew deposits for a minimum period of 12 months to a maximum period of 60 months.

Ceiling on Quantum of Deposits: Equipment Leasing Company / Hire Purchase Finance Company with a minimum NOF of Rs 25 lakhs, having a rating of ‘A’ and above but less than ‘AA’ and complying with the prescribed prudential norms can accept/renew deposits up to a maximum of 1.5 times of their NOF.

The restrictions on the maximum amount deposits for those complying with prudential norms of investment companies and loan companies are:
- Having a rating of A and above but less than AA, one-half of NOFs;
- Having a rating of AA and above but less than AAA, equal to NOFs; and
- Having a rating of not less than AAA, twice the NOFs.

In case of downgrading of the credit rating to any lower level, all NBFCs must immediately stop accepting deposit/renewing existing deposits, report the position within 15 days to RBI and must reduce the amount of excess public deposits within a period of one year or such further period as may be extended by the RBI.

III. ASSET / FUND BASED SERVICES:

What do you understand by the term 'Leasing'? Who are the parties involved? What are the types of seating? Also discuss the advantages & disadvantages?

1. LEASING:

Meaning – A lease is contractual arrangement under which the owner of an asset (called the lessor) agrees to allow the use of his asset by another party (called the lessee) in exchange of periodic payments (called lease-rental) for a specified period. At the end of the lease contract, the asset reverts back to the real owner, i.e. the lessor. However, in long term lease contracts, the lessee is generally given the option to buy or renew the lease.

Parties to a Lease Agreement –

A. **Lessor –** Who is the owner of the asset permitting use to the other party on payment of periodical amount.
B. **Lessee –** Who acquired the right to use the asset on payment of periodical amount.

TYPES OF LEASING:

A. **Operating Lease –** In this, the lessee acquires the use of an asset on a period to period basis. The main characteristics of operating lease is as follows:
   i. The lease can be cancelled by the lessee prior to its expiration at a short notice.
   ii. The lessee is not given any uplift to purchase the asset at the end of the lease period.
   iii. The lease is for a smaller period.
   iv. The sum of all the lease payments by the lessee does not necessarily fully provide for the recovery of the cost of the asset.
   v. The lessor has the option to lease out the asset again to another party.
   vi. This type of lease is preferred by the lessee when the long term suitability of the asset is uncertain, when the asset is subject to rapid obsolescence or when the asset is required for immediate use to tide over a temporary problem. Computers and Office Equipment are the very common assets which form the subject matter of many operating Lease agreement.

B. **Financial Lease – The characteristics of a Financial Lease are :-**

   i. The lease is for a longer period.
   ii. They are non-cancellable, in the sense that the lessee is contractually obliged to make lease payments during the entire period specified in the contract.
   iii. This form of lease entails lower risk to the lessor as compared to operating lease.
   iv. The insurance, maintenance and service costs are borne by lessee.
   v. The lessee acquires most of the economic values associated with the outright ownership of the asset.
   vi. At the end of lease period, generally, the lessor agrees to transfer the title of the asset to the lessee at a nominal cost.
   vii. The lessee is given an option to purchase the asset at the expiry of the lease.

viii. Usually 90 percent of the fair value of the asset is recovered by the lessor as lease rental.

Financial leases are commonly used for leasing land, buildings and large pieces of fixed equipment.

C. Leveraged Lease: A leveraged lease is one that involves a third party who is a lender, in addition to the Lessor and Lessee. Under this arrangement, the lessor borrows fund from the lender and himself act as equity participant. Normally, the amount borrowed is substantial vis-à-vis the funds provided by the Lessor himself. The third party usually involved in financing the transaction is a Financial Institution like UTI, Insurance Company, Commercial Banks, etc.

Such types of Leases are popular in structuring leases of very expensive assets such as the Lease of a plane or a ship.

D. Sales and Lease Back Leasing: Under this arrangement, the firm sells an asset, already owned by it or another firm/party and hires it back from the buyer. The lessor is ordinarily a financial institution. A sale lease back arrangement is preferred by a firm that is suffering from the shortage of funds for its operations. By such an arrangement, the firm can salvage its liquidity position and also retain the services of the asset for the life of the lease. This lease is similar to financial lease.

E. Sales – Aid-Lease – When the leasing company (lessor) enters into, an arrangement with the seller, usually manufacturer of equipment, to market the latter's product through its own leasing operations, it is called a 'saled-aid-lease' The leasing company usually gets a commission on such sales from the manufacturer and doubles its profits.

Advantages of Leasing:

a. It is an easy method of financing capital asset having a heavy cost because it spreads the capital cost over a reasonable period and sufficiently flexible as the lease rentals can be structured according to the needs of the lessee.
b. It helps to conserve funds which can be used for other urgent needs.
c. The procedure is simple for both the lender and the borrower.
d. Lease rentals are deductible expenses for the purpose of tax.
e. It is an 'off Balance-sheet' method of financing and thus helps in window dressing.
f. The lessee is protected from technological obsolescence particularly under operating lease arrangement.
g. Piecemeal financing of small equipment is conveniently possible through lease arrangement only, as a debt financing for such items is impracticable.
h. The use of leased asset does not affect the borrowing capacity of the lessee as lease payment may not require normal lines of credit and are payable from income during the operating period. This neither affects the debt-equity ratio or the current ratio of the lessee.
i. This method has several advantages to lessor also, e.g.,
   (i) It is a safe asset based financing for a productive purpose.
   (ii) The lessor enjoys tax benefit by depreciation on the asset.
   (iii) Lease rentals provide regular cash income maintaining liquidity of the concern.

Disadvantages:

a. The lease rentals become payable soon after the acquisition of assets and no moratorium period is permissible as in case of term loans from financial institutions. The lease arrangement may, therefore, not be suitable for setting up of the new projects as it would entail cash outflows even before the project comes into operation.
b. The leased assets are purchased by the lessor who is the owner of equipment. The seller's warranties for satisfactory operation of the leased assets may sometimes not be available to lessee.
c. Lessor generally obtain credit facilities from banks etc. to purchase the leased equipment which are subject to hypothecation charge in favour of the bank. Default in payment by the lessor may sometimes result in seizure of assets by banks causing loss to the lessee.
d. Lease financing has a very high cost of interest as compared to interest charged on term loans by financial institutions / banks.

How does a Lessee & a Lessor evaluate a lease proposal? Explain.

FINANCIAL EVALUATION:

a. Lessee's Point of view:
The leasing in essence, is an alternating source of financing to borrowing. The lease evaluation is thus debt financing versus lease financing. The evaluation of lease financing from point of view of Lessee involves the following steps.

Step 1: Determine the after tax cash outflow for each year under the lease alternative. This is arrived at by multiplying the lease rental (L) by (1 – t).

Step 2: Determine the after – tax cash outflows for each year under the buying alternative based on borrowing.

This is equal to Loan Instalment (Gross cash outflow, GCO)
(-) r * t
(-) D * t

Where,
R = interest
T = tax
D = depreciation

Step 3: Compare the present value (pv) of the cash outflows associated with leasing (step 1) and buying (step 2) alternative by employing after tax cost of debt (Kd) as the discount rate for the purpose.

Step 4: Select the alternative with the lower present value of cash outflows. The decision criterion is:

i. pv of cash outflows under leasing alternative is greater than pv of cash outflow as per buying alternative – Buy the asset.
ii. Pv of cash outflows under leasing alternative is less than PV of cash outflows as per buying alternative – Lease the asset.

b. Lessor's Point of View:
The lessor will undertake cost-benefit analysis of leasing out the assets. He will be willing to go for leasing arrangement only in the event when the asset earns returns which exceeds his weighted average cost of capital (Ko). In other words, after – tax cash inflows accruing to him must generate a rate of return which is greater than Ko. In operational terms, NPV should be positive.

List of steps required for financial evaluation from Lessor's point of view :

Step 1: Determination of cash outflows – It would constitute cost of the asset minus tax advantage due to investment allowance, if any.

Step 2: Determination of cash inflows:

Lease Revenue (Gross Cash Inflow)	XXX		
Less: Tax on lease revenue		XXX	
Add: Tax shield on depreciation		XXX	
Cash flows			XXX

Step 3: Determination of pv of cash inflows – cash inflows after taxes can be discounted by the appropriate weighted arrange cost of capital of the lessor to arrive at present value of cash inflows.

Step 4: Go for leasing if PV of cash inflows exceeds the PV of cash outflows.

What are the three types of Lease Rentals?

STRUCURE OF LEASE RENTALS (LR):

Lease Rentals are tailor made to enable the lessee to pay from the funds generated from its operation. For example, if profits from the leased plant start from the third year and go on increasing, then the lessee will structure the instalments of the plant in such a way that he will pay more amount in 4th year and onwards, i.e. ballooned lease rentals.

Types of Lease Rentals (LR):

a. Deferred LR b. Stepped up LR c. Ballooned LR

What are the Methods of evaluating a lease proposal?

METHODS OF EVALUATION OF LEASE:

a. **Present Value (PV) Analysis:** In this method, the present value of annual lease payments (tax adjusted) is compared with that of the annual loan repayments adjusted for the tax shield on depreciation and interest. The alternative which has lesser cash outflow will be chosen.
b. **Internal Rate of Return (IRR) analysis –** Under this method, there is no need to assume any cost of capital for discounting purpose unlike the PV method. The result of this analysis is the after tax cost of capital explicit in the lease which can be compared with that of the other available sources of finance such as a fresh issue of equity capital, retained earnings or debt. If the cost of lease is lower than other, then leasing option should be preferred.

c. **Bower-Herringer-Williamson Method :**

This method segregates the financial and tax aspects of lease financing. If the operating advantage of a lease is more than its financial disadvantage lease will be preferred.

The procedure of evaluation is briefly as follows:

1. Compare the PV of debt with the discounted value of lease payments (gross), the rate of discount being the gross cost of debt capital. The net present value is the financial advantage (or disadvantage).
2. Work out the comparative tax benefit during the period and discount it at an appropriate cost of capital. The present value is the operating advantage (or disadvantage) of leasing.
3. If the net result is an advantage, select leasing.

Write brief notes on Consumer Credit

2. CONSUMER CREDIT:

In India, in the last decade, there has been a boom in the consumer credit. Consumer credit offered to individuals to acquire consumer durable goods. In such a transaction, the individual – customer buyer pays only a part of the total price as down payment and the balance is paid with interest over a period of time.

Categories of consumer credit:

b. Hire Purchase – Goods are hired to the customer and the title passes only at the end of the hire period.
c. Credit sale agreement – The purchase price of goods is paid by instalment. The agreement can not be cancelled by the buyer.
d. Conditional Sale – The ownership is not transferred to the customer until the total purchase price including the credit charge is paid. The customer can't terminate the contract.

3. HIRE PURCHASE AND INSTALMENT SCHEME FINANCING

In case of Hire purchase, the seller hands over the asset to the buyer, but the title to the goods is transferred only after payment of last instalment. In case of default in payment, the seller has a right of repossession. The instalments paid by the buyer to the seller on repossession are treated as 'hire' towards use of an asset. The hire purchaser shows the asset in his Balance – Sheet and can claim depreciation, which is tax deductible, although he may not be the owner at that time. The interest part of the instalment being an expenditure is also tax deductible.

In case of Instalment sale, the title to the goods is immediately transferred to the buyer, though the payment of price along with interests is settled over agreement period. This is like a credit sale over a longer period. In case of default, the seller has no right of repossession, but a remedy is to sue and recover the dues through the Court of Law.

Both Hire – Purchase and Instalment Scheme finances can be availed much faster as compared to term loans from financial institutions or banks.

Mode of payment:

a. Down Payment Schemes
b. Deposit Linked Scheme

Repayable Period and Rate of Interest (ROI):

Repayment period ranges from between 12 to 60 monthly instalments. The rate of interest is greatly a flat one while some schemes mention EMI associated with different schemes instead of rates of interest.

4. FACTORING:

Discussed elsewhere in the book

What are the various types of factoring?

Types / Forms of Factoring:

a. **Recourse Factoring –** Under recourse factoring, the factor purchases the receivables on the condition that any loss arising out of irrevocable receivables will be borne by the client. In other words, the factor has recourse to the client if the receivable purchased turnout to be irrecoverable.

b. **Non-recourse or Full factoring –** As the name implies, the factor has no recourse to the client if the receivables are not recovered, i.e. the client gets total credit protection. In this type of factoring, all the components of service, viz. Short-term finance, administration of sales ledger and credit protection are available to the client.

c. **Maturity Factoring –** Under this type of factoring arrangement, the factor does not make any advance or pre-payment. The factor pays the client either on a guaranteed payment date or on the date of collection from the customer.

d. **Advance Factoring –** In this, the factor makes prepayment of around 80% of the invoice value to the client. The balance is paid on collection / guaranteed payment date.

e. **Notified Factoring –** In case of notified factoring, the customer is intimated about the assignment of debt to the factor and also directed to make payments to the factor instead of the firm. It is also called 'Disclosed Factoring'.

f. **Non-notified (Undisclosed) Factoring –** This facility is one under which the supplier / factor arrangement is not disclosed to the customer unless there is a break of the agreement on the part of the supplier or, exceptionally, where the factor considers himself to be at risk.

g. **Bank Participation Factoring –** In bank participation factoring, the supplier creates a floating charge on the factoring reserves in favour of banks and borrows against these reserves. For instance, if factor reserve is 20%, the supplier firm can borrow to the extent of 80%, of this reserve from Bank, thereby reducing its investments on receivable.

h. **International Factoring –** This deals with exports. The factoring service may include completing legal and procedural formalities pertaining to export. It is also called export cross – border factoring. The parties in this factoring are exporter (client), importer (customer), export factor and import factor.

Enumerate the steps involves in Factoring

Mechanics of Factoring

The following is the procedure in factoring service –

- Seller (Client) negotiates with the factor for establishing factor relationship.
- Request by seller for credit check on the buyer (customer) whose name and address is furnished to the factor.
- Factor checks the credit credentials and approves the buyer, the credit limit and the period upto which credit can be given are fixed.
- Seller sells goods to the buyer.
- Seller sends invoice to the factor. The invoice is accounted for in the buyers' accounts in the factor's sales ledger.
- Factor sends notice of assignment / copy of invoice to the buyer.
- Factor advises the amount to which seller is entitled after retaining margin, say, of 20%, the residual amount being paid later.
- On the expiry of the agreed credit period, buyer makes the payment of invoice to the factor. At this point the factor pays to seller margin money retained as per point above. If however, the buyer defaults to pay the factor, it would still make the final payment to the seller in the case of without recourse factoring.

5. FORFAITING:

Discussed elsewhere in the book

Differentiate:

1. Forfaiting & Export Factoring
2. Factoring & Bills Discounting

Difference between Forfaiting & Export Factoring

Sr. No.	Forfaiting	Export Factoring
1.	A forfaiter discounts the entire value of the note /bill	In a factoring arrangement the extent of financing available is 75 – 80%
2.	The faifaiter decision to provide financing depends upon the financial standing of the availing bank.	The export factor bases his credit decision on the credit statement of the exporter.
3.	It is a pure financial agreement.	It includes ledger administration, collection, etc.
4.	It is a short term financial deal.	It spreads over 3-5 years.

Difference between Factoring & Bills Discounting

Sr. No.	Factoring	Bills Discounting
1.	Also called 'Invoice Factoring'	Also called 'Invoice Discounting'

2.	The parties are client, factor and debtor.	The parties are drawee, drawer and payee.
3.	It is management of book debts.	It is a sort of borrowing from commercial banks.
4.	Grace time is not given.	Grace time is 3 days
5.	There is no specific Act.	Negotiable Instruments Act is applicable.
6.	Provision of advance payment on book debts is available	No such provision to available.

Write a note on Housing finance system in Inaida

6. HOUSING FINANCE SYSTEM IN INDIA:

Housing finance is provided in the form of mortgage loans, i.e. it is provided against the security of immovable property of land and buildings. Basically, housing finance loans are given by the housing and Urban Development Corporation (HUDCO), the apex cooperative Housing Finance Societies and Housing Boards in different states, Central and State Governments, LIC, Commercial banks, GIC and a few private finance companies (e.g., HDFC, ICICI) and nidhis. The government provides direct loans mainly to their employees. The participation of commercial and urban co-operative banks has been increasing in recent years.

Apart from these, there is informal sector (e.g., household relatives and friends, community based organisations, public and private employers who provide housing loans to their employees and private moneylenders). It is estimated that the informal sector contributes about 80% of the total investment in housing.

Write a note on the role played by NHB in Housing Finance.

National Housing Bank (NHB) and Its Role –

NHB was set up in July 1988 as an apex housing finance institution it is a wholly owned subsidiary of the RBI. The explicit and primary aim of NHB is to promote housing finance institutions at local and regional levels in the private and joint sectors by providing financial and other support to such institutions. It refinances housing loans under its refinance schemes for scheduled commercial and co-operative banks, housing finance companies, apex co-operative housing finance societies, and so on.

List the constituent of formal sector in Housing Finance.

Structure of Housing Sector – The formal sector

a. **Central and State Government –** The government provide budgetary support to the housing sector. Also, it provides equity support to public sector specialized housing finance institutions.
b. **Commercial banks –** RBI regulations require commercial banks to allocate 3% of their annual increase in deposits for lending to housing sector. Direct lending by commercial

banks includes lending to individuals. Indirect lending in the firm of investment in securities of specialised housing finance institutions.

c. **Insurance Companies –** Insurance Companies have assisted in establishing housing companies as subsidiaries to play more active roles in the housing market, e.g., LIC Housing Finance.

d. **Housing Finance Companies –** HFCs play a very important role in providing finance for housing. They are accredited to NHB for refinancing. HFCs accept deposits from the public and outside the regulatory framework of NHB.

e. **Co-operatives –** Co-operatives have made a substantial contribution to the housing sector with a country wide network of more than 90,000 primary societies, responsible for the construction nearly 2 million housing units, mostly for commercially weaker sections of society.

Evaluate the role played by Housing Finance

Evaluation of the Role of Formal Sector:

The formal sector's contribution to housing supply has been only about 20% of the total financing. On the other hand, informal sector accounts for about 80% of all housing investment activity.

The housing finance segment is growing at a compound annual rate of 30%. The disbursals by home finance institutions (HFIS) shows that in 2000-01, the 29 approved HFIs are expected to disburse Rs. 1,25,000 million against Rs. 95,00 million in 1999-2000.

Terms and Conditions of Housing Finance:
While the terms and conditions of Housing Finance may vary slightly from company to company, we give below the typical terms of a large Housing Finance company.

i. **Loan Purpose**: Purchase of ready built-up dwelling unit.
ii. For Construction, Extension, Renovation of Dwelling unit.
iii. **Loan Amount**: The amount of loan shall be dependent on the following factors:
- Total income of applicant and Co-applicant(s).
- Age of the applicant and co-applicant.
- Qualification
- Number of Dependents
- Stability & continuity of occupation

- Savings History
- Total Cost of Property

Loan amount to be restricted to 85% of the cost of the property or Rs. 25 lakhs whichever is lower.

Loan Costs: Processing fee -1% of the loan amount applied for
Administrative fee – 1% of the loan amount sanctioned.

iv. The loan shall carry a rate of interest as follows:

Category – I – Very Low risk Category
Variable Rate Mortgage Scheme stands revised w.e.f. 5th August, 2000 to 13.50% p.a. for all slabs and durations.

Category – II- Low Risk Category
In case of fixed rate scheme the revised rates w.e.f. 5th August, 2000 are listed below :-

Loan Amount (Rupees)	Rate of Interest (p.a.) Upto 7 yrs Above 7 yrs.	Above 7 yrs. & upto 15 yrs
Upto Rs. 25,000	12.50%	12.50%
Rs.25,001 to Rs. 2,00,000	13.50%	14.00%
Rs.2,00,001 to Rs. 25,00,000	13.75%	14.00%

Category – III – Moderate Risk Category
14.50% p.a. fixed rate of interest for all slabs and durations.

Rate of interest is subject to change depending on the money market conditions.

v. Loan Disbursement: The loan will be disbursed after completion of legal and technical formalities by the borrower and will be subject to the legal and technical appraisal being satisfactory. The borrower is required to invest his own share/ contribution before release of disbursement by MHDFC. In exceptional cases and at the discretion of MHDFC a pro-rata arrangement can be worked out depending on the facts of each case. At any stage the disbursement shall not exceed 80% of the total amount invested in the property at that point of time. (To know more about us visit KalpeshClasses.com)
Loan shall be disbursed in one or more suitable instalments depending on the stage of construction.

vi. Loan Repayment: Loan can be repaid over a period of 5 to 15 years. However, the repayment period shall generally not exceed the date of retirement or 65 years of age of the borrower and /or co-borrower. Loans can be repaid by means of Equated Monthly Instalments (EMIs), comprising principal and interest. Repayment by way of EMI will commence from the month following the month in which final disbursement is made.

Prior to commencement of EMI, simple interest on the loan disbursed shall be payable at the end of each month commencing the month in which first disbursement is made and shall continue till the month in which final disbursement is made.

Loans are generally repaid by means of EMI. However, on a case to case basis and at the sole discretion of MHDFCL, repayments can also be accepted in one or a combination of the following plans.

- Step-up Repayment Plan
- Step-down Repayment Plan
- Repayment Holiday Plan
- Balloon Payment Plan.

vii. Security The loan will be secured by first mortgage charge on the Housing Property by way of equitable mortgage.

What do you mean by Merchant Banking?

IV. FEE BASED SERVICES:

Merchant Banking:
In the present day capital market scenario, the merchant banks play as an encouraging and supporting force to the entrepreneurs, corporate sector and the investors. The recent developments of the Indian Capital market environment have made the various financial institutions as various sources of finance for the organisations. Several new institutions have appeared in the financial spectacle and merchant bankers have joined to expand the range of financial services. Merchant banks are also called 'Investment Banks'. They help in promoting and sustaining capital markets and money markets, and they provide a variety of financial services to the corporate sector.

Define "Merchant Banker". What are the activities undertaken by a Merchant Banker?

Definition of merchant Banker –

SEBI Act 1992 defines a Merchant Banker as follows:
"Merchant Banker means a person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities as manager, consultant, advisor or rendering corporate advisory service in relation to such issue management.

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Factors to be considered whole selecting a Merchant Banker:

i) Proposed size of the issue
ii) The condition of primary and secondary markets.
iii) The support of financial institutions by participating in the issue.
iv) The background, expertise and infrastructure facilities of the merchant banker.

Categories of Merchant Bankers as per SEBI:

Category Activities

i. To carry on any activity of issue management, which will, inter alia, consist of preparation of prospectus and other information relating to the issue, determining financial allotment and refund of the subscriptions, and
ii. To act as an advisor, consultant, manager, underwriter, portfolio manager

Activities of Merchant Banker:

a. Management of issue of corporate securities of existing companies and newly floated companies.
b. Offering financial expertise in mergers, takeover, capital reorganisation to corporate sectors.
c. Management of investment trusts.
d. Handling insurance business
e. Loan syndication and corporate advisory services.
f. Portfolio management.
g. Custodial and depository services.
h. Broking of corporate services
i. Attracting foreign investment
j. Liquidity Management

k. Underwriting of securities
l. Bill Discounting
m. Lease Financing
n. Arrangement of Venture Capital
o. Acting as trustees for Debentures.
p. Mobilisation of public deposits and managing fixed deposits, etc.

Underwriting obligation – When the issue is underwritten, a category I lead merchant banker shall accept a minimum underwriting obligation of 5% of the total underwriting commitment or Rs. 25 lakhs, whichever is less.

If he is unable to accept the obligation, he shall make arrangement to have such obligation undertaken by merchant bankers associated with the issue and advise SEBI about such arrangement.

Due Diligence Certificate – The standard of due diligence by a lead banker shall be such that he shall satisfy himself about all the aspects of offering, veracity and adequacy of disclosure in the offer documents.

The lead merchant banker who is responsible for verification of the contents of a prospectus or the letter of offer in respect of an issue and the reasonableness of the views expressed therein, shall submit to SEBI at least two weeks prior to the opening of the issue for subscription, a due diligence certificate as specified in Schedule III.

What are the documents which a lead MB must file with SEBI relating to a public issue?

Documents to be furnished to SEBI:
The lead merchant banker responsible for the issue should furnish to SEBI the following documents in connection with the issue managed by him:

i. particulars of the issue,
ii. draft prospectus for public issue or draft letter of offer for rights issue,
iii. memorandum of understanding entered into by the Lead Merchant Banker with he issuer company,
iv. due diligence certificate as specified in Schedule III to SEBI Guidelines, 2000 along with the draft prospectus,
v. The following certificates:
    - that all amendments, suggestions or observations made by SEBI have been incorporated in the offer document.
    - fresh 'due diligence' certificate at the time of filing of prospectus with the Registrar of Companies as per the format specified at Schedule IV of SEBI Guidelines, 2000.
    - a fresh certificate immediately before the opening of the issue that no corrective action on its part is needed as per the format specified at Schedule V of SEBI Guidelines, 2000
    - furnish a fresh certificate after the issue has opened but before it closes for subscription as per the format specified at Schedule VI.

SEBI (Disclosure and Investor Protection) Guidelines, 2000.
Certificate duly signed by the Company Secretary or Chartered Accountants in case of listed companies making further issue of capital, certifying the following -

(1) all refund orders of the previous issues were dispatched within the prescribed time in the prescribed manner.
(2) all security certificates were dispatched to the allottee within the prescribed time and in the prescribed manner.
(3) the securities were listed on the Stock Exchanges as specified in the offer documents.

CHECKLIST FOR MERCHANT BANKERS –

The Merchant bankers as Lead Managers to any Issue are responsible for their due diligence performance. The checklist for Merchant Banker in case of Public Issue is as follows:

Memorandum and Articles of Association:

Public Issue:

1. Check whether the proposed objects of the issue are lawful and are covered by the objects clause of MOA.
2. Check whether the Authorised Capital is sufficient to take care of the proposed issue including retention of over subscription to the extent of 10% of the issue.
3. If the above requirements are not met, advise the company to take necessary action in this respect.

Stock Exchange requirements:

1. Check whether the Articles of Association comply with the requirements laid down by the Regional Stock Exchange. If not, advise the company to take necessary action to comply with the requirements laid down by the Regional Stock Exchange.
2. To ensure submission of Letter of Application to the stock Exchanges where listing of the securities is proposed, along with the supporting documents before filing the prospectus with the Registrar of Companies.
3. To check of only members of recognized Stock Exchanges are appointed as Managing / Principal / Official Brokers to the Issue.
4. Only Public Financial Institutions, Banks, Merchant Bankers authorized by SEBI, approved Investment Companies / Trusts with adequate capital and sufficient standing and experience and members of recognized Stock Exchanges are to be appointed as underwriters.
5. Deposit with the Regional Stock Exchange an amount equal to 1% of the quantum of issue as prescribed.

Define Mergers & Acquisition. What are the types of Mergers?

V. MERGERS AND ACQUISITIONS:

The concept of Mergers and Acquisition (M&A) has assumed added significance in the context of the ongoing programme of liberalisation and globalisation of the Indian economy.

Merger – When the shareholders of more than one company, usually two, decides to pool the resources of the companies under a common entity, "Merger" is the result.

Acquisition or take -overs – If one company acquires the controlling interest in another company, it is a case of acquisition or takeover.

Forms of Mergers and Acquisitions:
1. Expansion/Tender offer/ Joint Venture
2. Sell-offs/Spin-offs/Split-offs/Split-ups/Divestiture
3. Corporate Control/PremiumBuy-banks/Standstillagreements/Anti-takeover Amendments Proxy contests
4. Changes in ownership/Exchangeoffers/Share repurchases/Going Private/Leveraged Buy-outs

Types of Mergers and Combinations:

a. **Horizontal Merger –** It takes place between two companies which are in the same kind of business activity. For example, a merger between two steel firms.
b. **Vertical merger –** It is one in which the company expands backwards by merger with a company supplying raw materials or expands forward in the direction of the ultimate consumer. Thus, it involves merging of companies involved in different stages of the production cycle with in the same industry. For example, the merger of Reliance Industries Ltd. (RIL) with Reliance Petrochemicals Ltd (RPL) is an example of vertical merger as far as RIL in concerned.
c. **Conglomerate Mergers –** It involves firms engaged in unrelated types of business activity. For example, a steel producing firm merging with a petro-chemical processing firm.
d. **Product-extension Mergers –** It broadens the product lines of firms
e. **Geographic Market – extension Merger –** It involves two firms whose operations had been conducted in non-overlapping geographical lines.

What do you understand by Acquisitions? Also give the methods involved in acquisitions?

Acquisitions –
Acquisition or takeover aims at acquiring controlling interest in the other company. A controlling interest is that proportion of the total shareholding which results in control of the administration of the company through a majority in the Board of Directors. This could be as low as 5% or as high as 51% of the total number of shares.

Methods of Acquisition / Takeover

a. **Friendly Takeover –** The company intending to take over another corporation can approach the existing controlling interest of that corporation, for across the Board negotiations and purchase. It is called consent takeover or friendly takeover.

b. **Hostile Takeover –** The company seeking control over another company, purchases the required number of shares from non-controlling shareholders in the open market. This method normally involves purchasing of small holdings of small shareholders over a period of time at various places. As a strategy, the purchaser keeps his identity secret. It is called hostile or violent takeovers.

Define Joint Ventures

Joint Ventures –

It involves the intersection of only a small fraction of the activities of the companies involved and usually for a limited duration of ten to fifteen years or less. They may represent separate entity in which each of the parties makes cash and other forms of investments.

What are the types of sell offs?
Sell-offs – There are two major types of sells-offs-

a. **Spin-offs-** It creates a separate new legal entity. Its shares are distributed on a pro-rata basis to the existing shareholders of the parent company. The new entity acts as a separate decision making unit and develops policies and strategies different from that of the original parent. It is important to note that no cash is received by the original parent. In a sense, it represents a form of dividend, to the existing shareholders.

   A variation of spin-off in split-off in which a portion of existing shareholders receive stock in a subsidiary in exchange for parent company stock.

   Another variation in split-off in which the entire firm is broken up in a series of spin-offs, so that the parent no longer exists and only the new offspring survive.

b. **Divestiture** – It involves the sale of a portion of the firm to an outside third party. Cash or equivalent consideration is received by the divesting firm.

What do you understand by Premium Buy back & standstill agreement?

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Corporate Control:

a. Premium buyback: It represents the repurchase of a substantial stockholder's ownership interest at a premium above the market price (called greenmail)

b. Standstill agreement – Here, the substantial stockholder agrees not to increase his ownership which presumably would put him in an effective control position.

What are the forms in which changes can be brought in ownership structure?

Changes in Ownership Structure –

a. **Exchange offers –** It involves exchange of debt or preferred stock for common stock or vice versa. Exchanging debt for common stock increases leverage, exchanging common stock for debt decreases leverage.

b. **Share Repurchases –** It means the company buy backs some fraction of its outstanding shares of common stock.

2. Going Private – The entire equity in a previously public company is purchased by a small group of investors. Going private transactions typically includes members of the incumbent management group who obtain a substantial portion of the equity ownership of the newly private company.

VI. VALUATIONS:

Refer Chapter on 'Business Valuation' for detailed discussion.

Briefly discuss the regulations to which M & A are subject to SEBI

VII. REGULATORY ASPECTS OF MERGERS AND ACQUISITION (M&A) IN INDIA

New SEBI Regulations:

SEBI has, based on the recommendations of the Bhagwati Committee, formulated the SEBI Regulation. These Regulations have expanded the applicability of the takeover code to a wider area and also to takeover of management of companies.
Exempted Categories: Nothing contained in SEBI regulations 10,11 & 12 in respect of a listed company, viz.,

1. acquisition of 15% or more of the shares or voting rights of any company,
2. consolidation of holdings,
3. acquisition of control over company,

Shall apply in the following categories:

allotment in pursuance of an application made under a public issue: Provided that if such an allotment in a public issue is pursuant to firm allotment, and if full disclosure about the identity of the acquirer the purpose of acquisition, consequential changes in the Board of Directors of the company or change in control over the company or in voting rights and shareholding pattern of the company, if any, are given in the prospectus;

allotment pursuant to an application made by the shareholder for rights issue:

(i) to the extent of his entitlement; and

(ii) upto the percentage specified in regulation 11
The limit mentioned in sub-clause ii) will not apply to the acquisition by any person presently in control of the company and who has in the rights letter of offer made disclosure that he intends to acquire additional shares beyond his entitlement, if the issue is under subscribed;
this exemption shall not be available in case the acquisition of securities results in the change of control of management;

c. a preferential allotment made in pursuance of a resolution passed under section 81(1A) of the Companies Act, 1956: Full disclosure of the identity of the class of the proposed allottee(s) is made and if any of the proposed allottee(s) is to be allotted such number of shares as would increase his holding to 5% or more of the post-issued capital, then in such cases, the price at which the allotment is proposed, the identity of such person(s), need to be disclosed.

The purpose of and reason for such allotment is proposed, the identity of such person(s), the purpose of and reason for such allotment, consequential changes in the Board of Directors of the Company, if any, or change in control over the company or voting rights and the shareholding pattern of the company are given in the notice of the General Meeting called for the purpose of consideration of the preferential allotment:

"Board Resolution: A copy of the Board Resolution in respect of the proposed preferential allotment shall be sent to all the stock exchanges on which the shares of the company are listed for notifying on the notice boad."

d. allotment in pursuance of any underwriting agreement;

e. inter se transfer of shares amongst:

(i) group companies, coming within the definition of 'group' as defined in the Monopolies and Restrictive Trade Practices Act, 1969 (25 of 1969);

(ii) 'relatives' within the meaning of section 6 of the Companies Act, 1956 (1 of 1956);

(iii) a) Indian promoters and foreign collaborators who are shareholders;
b) Promoters

The transferor(s) as well as the transferee(s) in sub-clauses (a) and (b) have been holding individually or collectively not less than 5% shares in the company for a period of at least three years prior to the proposed acquisitions;

f. acquisition of shares in the ordinary course of business by-

(i) a registered stock-broker of a stock exchange on behalf of client;

(ii) a registered market maker of a stock exchange in respect of shares for which he is the market maker, during the course of market making;

(iii) by public financial institutions on their own account;

(iv) by banks and public financial institutions as pledges;

g. acquisition of shares by way of transmission on succession on inheritance;

h. acquisition of shares by Government companies within the meaning of section 617 of the Companies Act, 1956 (1 of 1956) and statutory corporations;

i. transfer of shares from State level financial institutions including their subsidiaries to co-promoter(s) of the company pursuant to an agreement between such financial institution and such co-promoter(s);

j. pursuant to a scheme -

(i) framed under section 18 of the Sick Industrial Companies (Special Provisions) Act, 1985;

(ii) of arrangement or reconstruction including amalgamation or merger or demerger under any law or regulation, Indian or foreign;

k. acquisition of shares in companies whose shares are not listed on any stock exchange.

The exemption under clause (k) above shall not be applicable if by virtue of acquisition or change of control of any unlisted company, whether in India or abroad, the acquirer acquires shares or voting rights or control over a listed company;

d) such other cases as may be exempted from the applicability of Chapter III (substantial acquisition of shares or voting rights in and acquisition of control over a listed company) by SEBI.

The benefit of availing of exemption from applicability of SEBI Regulations for increasing shareholding or inter se transfer of shareholding among group companies, relatives and promoters shall be subject to such group companies or relatives or promoters filing statements concerning group and individual shareholding as required under SEBI regulations.

Nothing contained in Chapter III of the SEBI Regulation shall apply to acquisition of GDRs / ADRs so long as they are not converted into shares carrying voting rights.

Definitions:

An "**acquirer**" means any person who, directly or indirectly, acquires or agrees to acquire shares or voting rights in the target company, or acquires or agrees to acquire control over the target company, either by the acquirer or with any person acting in concert with the acquirer.

"**Control**" shall include the right to appoint majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert indirectly, virtue of their shareholding or management rights or shareholders's" agreements or voting agreements or in any other manner.

"**Offer period**" means the period between the date of public announcement of the first offer and the date of closure of the offer;

"**Panel**" means a panel constituted by SEBI for the purpose of granting exemption from SEBI Regulations for –
(i) acquisition of10% or more of the shares or voting rights,
(ii) Consolidation of holdings,
(iii) Acquisition of control over a company.

"**Promoter**" means –
1. The promoter, i.e.,
   (i) the person or person who are in control of the company,
   (ii) Person or persons named in any offer document as promoters.
2. a relative of the promoter within the meaning of section 6 of the Companies Act, 1956 (1 of 1956);

3. where the '**Promoter**' is a corporate body, i) a subsidiary or holding company of that body, or ii) any company in which the 'Promoter' holds 10% or more of the equity capital or which holds 10% or more of the equity capital of the promoter, or iii) any corporate body in which a group of individuals or corporate bodies or combinations thereof who hold 20% or more of the equity capital in that company and that company also holds 20% or more of the equity capital of the 'Promoter'; and

4. where the '**Promoter**' is an individual, i) any company in which 10% or more of the share capital is held by the 'Promoter or a relative of the 'Promoter' or a firm or HUF in which the 'Promoter' or his relative is a partner or a coparcener or a combination thereof, ii) any company in which those specified in (i) above, hold 10% or more of the share capital, or iii) any HUF or firm in which the aggregate share of the Promoter and his relatives is equal to or more than 10% of the total.

"**Public Financial Institution**" means a public financial institution as defined in section 4A of the Companies Act, 1956.

"**Public Shareholding**" means shareholding in the hands of person(s) other than the acquirer and persons acting in concert with him

"**Sick Industrial Company**" shall have the same meaning assigned to it in clause (o) of sub-section (1) of section 3 of the Sick Industrial Companies (Special Provisions) Act, 1985 or any statutory amendment thereof.

"**State Level Financial Institution**" means a State financial corporation established under section 3 of the State Financial Institutions Act, 1951 and includes development corporation established as a company by a State Government with the object of development of industries or agricultural activities in the State.

"**Stock Exchange**" means a stock exchange which has been granted recognition under section 4 of the Securities Contracts (Regulations) Act, 1956 (42 of 1956).

"**Shares**" means shares in the share capital of a company carrying voting rights and includes any security which would entitle the holder to receive shares with voting rights.

"**Target Company**" means a listed company whose shares or voting rights or control is directly or indirectly acquired or is being acquired.

"**Takeover**" Takeover of companies is a well-accepted and established strategy for corporate growth. A takeover bid generally implies the attempt by an interested party to acquire shares carrying voting rights in a company in a direct or indirect manner with a view to gain control over the management of the company.

In the case of a company whose shares are listed on a Stock Exchange, sometimes, the price of its shares starts rising. Enquiries with the company management do not reveal any news of rights issue, bonus issue or any other news which might influence the market sentiments. Slowly rumours spread that some interested party is buying the shares. News of likely takeover of the company starts appearing in the press and in market gossip. The concerned company management panics and feverish attempts to build up its controlling power starts. The minority shareholders are uncertain whether to hold their shares or dispose them of.

Fees payable to SEBI
The acquirer shall, along with his application for exemption referred to above, pay a fee of Rs. 10,000 to SEBI either by a banker's cheque or demand draft in favour of the Securities and Exchange Board of India, payable at Mumbai.

Forwarding of application to panel
SEBI shall, on receipt of application for exemption, forward the same to the Takeover Panel within 5 days of receipt of the application.

Panel's Recommendation to SEBI
Within 15 days from the date of receipt of the above application, the Panel shall make its recommendation on the said application to SEBI.

SEBI's order on the application
SEBI shall –
- afford reasonable opportunity to the concerned parties;
- consider all the relevant facts including the recommendations if any;
- pass an order on the application within 30 days thereof.

Publication of SEBI's order
SEBI shall publish its order on the above application.
SEBI's power

To remove any difficulties in the interpretation or application of the provisions of SEBI Regulations, SEBI shall have the power to issue directions through guidance notes or circulars.

Register to be maintained by the company

Every company whose shares are listed on a stock exchange shall maintain a register in the specified format to record information received under –
1. Sub-Reg. 6(3)
2. Sub-Reg. 7(1); and
3. Sub-Reg. 8(2) viz;

(i) disclosure by a promoter or any person having control over the company of the number and percentage of shares or voting rights held by him or by person(s) acting in concert with him in that company,
(ii) any acquirer, who acquires shares or voting rights which (taken together with shares or voting rights, if any, already held by him) would entitle him to more than five per cent shares or voting rights in a company, in any manner whatsoever.
(iii) a promoter or every person having control over a company.

SEBI's power to call for information

The Stock Exchanges and the company shall furnish to SEBI information with regard to disclosures-
1. relating to transitional provision,
2. acquisition of 5% or more shares or voting rights of a company,
3. continued disclosures as an when required by SEBI.

Format of reports to SEBI / Stock Exchange / Target Company
Under the provisions of SEBI (Substantial Acquisition of Shares & Takeovers) Regulations, 1997, Acquirer(s), Merchant Banker(s) and Target Companies are required to maintain certain records/to furnish certain information/reports to SEBI/Stock Exchanges in accordance with specific provisions stipulated in the regulations.

In order to ensure uniformity in compliance of these requirements by all concerned and to enable the concerned persons to furnish all the relevant information in the first instance itself, SEBI has standardized the formats of the following reports/records:
1. Format for filing the information with SEs by acquirer as required u/r 3(3).

2. Format of report to be filed with SEBI as required u/r 3(4).
3. Format for filing the information by acquirer with Target Company as required u/rs 7(1), 8(1), and 8(2)
4. Format of the Register to be maintained by the Target Company in terms of Regulation 8(4).
5. Format of due diligence certificate to be furnished by Merchant Banker in terms of Regulation 24(2)
6. Format of 45 days report required to be filed by Merchant Banker with SEBI in accordance with Regulation 24(7).

With the standardization of these formats, all the concerned persons are advised to maintain records/ to furnish the information / report, as applicable, strictly in accordance with these formats, w.e.f. 1.4.1999.

MINIMUM NUMBER OF SHARES TO BE ACQUIRED
The minimum number of shares to be acquired by an acquirer is regulated as under:

Minimum 20% of the voting capital: The public offer shall be made to the shareholders of the target company to acquire from them an aggregate minimum of 20% of the voting capital of the company-
Subject to the condition that –
(i) the acquisition of shares from each of the shareholders shall not be less than the minimum marketable lot; and
(ii) the entire holding if it is less than the marketable lot.

Modification of above requirement : Where an open offer is made by an acquirer (having entitlement to exercise more than 75% of the voting rights in that company), the quantum of public offer shall be for such percentage of the voting capital of the company as may be decided by the acquirer.

Where the offer is conditional upon minimum level of acceptance from shareholders, minimum acceptance of 20% will not be applicable, if the acquirer has deposited in the escrow account in cash a sum of 50% of the consideration payable under the public offer.

Reduction in the public shareholding : If the public offer results in public shareholding being reduced to 10% or less of the voting capital of the company, or if the public offer is in respect of a company which has public shareholding of less than 10% of the voting capital of the company the acquirer shall-
(a) either within 3 months from the date of closure of the public offer, make an offer to buy out the outstanding shares remaining with the shareholders at the same offer price. This may result in delisting of the target company.
(b) Undertake to disinvest through an offer for sale or by a fresh issue of capital to the public. This shall be within a period of 6 months from the date of closure of the public offer.
The quantum of such offer for sale or such issue shall be such number of shares as would satisfy listing requirements.
The letter of offer, in the above case, shall state clearly the option available to the acquirer, i.e., disinvestments of shares held by the acquirer or fresh public issue.

General obligations of the merchant banker

The merchant banker appointed by an acquirer in connection with acquisition of shares or voting rights in terms of the SEBI Regulations shall ensure that,

- The acquirer is able to implement the offer made by the acquirer in terms of his public announcement of offer.
- The provision relating to escrow account in respect of such acquisition has been made.
- Firm arrangements for funds and money for payment through verifiable means to fulfil the obligation under the said public offer are in place.
- The contents of the public announcement of offer and the letter of offer are true, fair and adequate and are based on reliable sources, quoting the source wherever necessary.
- The draft public announcement of offer and letter of offer are sent to all the Stock Exchanges on which shares of the target company are listed in accordance with the SEBI Regulations.
- The public announcement of offer is made in terms of the SEBI Regulations.

Due diligence certificate

Along with the draft letter of offer, the merchant banker shall furnish to SEBI a due diligence certificate.

Creation of escrow account

The acquirer shall, on or before the date of issue of public announcement of offer, create an escrow account by way of security for performance of his obligations under the SEBI Regulations in the following manner:

(a) the escrow amount shall be calculated in the following manner-
  (i) for consideration payable under the public offer.
  Upto and including Rs. 100 crores – 25%;
  Exceeding Rs. 100 crores – 25% upto Rs. 100 crores and 10% thereafter;
  (ii) in respect of offers subject to a minimum level of acceptance and where the acquirer does not want to acquire a minimum of 20% - 50% of the consideration payable under the public offer in cash;

(b) the total consideration payable under the public offer shall be calculated on the basis of full acceptance and at the highest price if the offer is subject to differential pricing, irrespective of whether the consideration for the offer is payable in cash or otherwise;

(c) the above escrow account shall consist of –
  (1) cash deposit with a scheduled commercial bank, or
  (2) bank guarantee in favour of the merchant banker, or
  (3) deposit of acceptable securities with appropriate margin, with the merchant banker.
  (4) cash deposited with a scheduled commercial bank in respect of cash in (a) (ii) mentioned above.

GENERAL OBLIGATIONS OF THE BOARD OF DIRECTORS OF THE TARGET COMPANY

The Board of Directors of the target company has the following obligations in connection with the acquisition of shares or voting rights by an acquirer in respect of the target company :

Restriction on sale/transfer of assets, etc.,: Unless the approval of the shareholders of the target company is obtained after the date of announcement of public offer, the Board of Directors of the target company shall not during the offer period,

(a) sell, transfer, encumber or otherwise dispose of or enter into an agreement for sale, transfer, encumbrance or for disposal of assets otherwise, not being sale or disposal of assets in the ordinary course of business of the or company or its subsidiaries, or
(b) issue any authorized but unissued securities carrying voting rights during the offer period, or
(c) enter into material contracts.

Restriction on appointment of directors – Once the public announcement of offer has been made, the Board of Directors of the target company shall not-

(a) appoint an additional director, or
(b) fill in any casual vacancy on the Board of Directors by any person(s) representing or having interest in the acquirer till the date of certification by the Merchant Banker that the acquirer has fulfilled all his obligations under the SEBI Regulations. However, upon the closure of the offer and deposit of full amount of consideration payable to the shareholders in the special deposit account, the target company can effect changes as would give the acquirer representation on the Board or control over the company.

Restriction on interested director: The Board of Directors on the target company shall not allow any person or persons representing or having interest in the acquirer, if he is already a director on the said Board, before the date of public announcement, to participate in any matter related to the offer, including any preparatory steps leading thereto once the public announcement has been made.

List of shareholders required by the acquirer : The target company shall furnish to the acquirer, within 7 days of the request of the acquirer or within 7 days from the specified date, whichever is later, a list of shareholders or warrant holders or convertible debenture holders as are eligible for participation where the period of exercise of option by such warrant holders or conversion of convertible debentures falls within the offer period, containing names, addresses, shareholding and folio number and of those persons whose applications for registration of transfer of shares are pending with the company.

Obligations where acquirer increases his shareholding: The company shall comply with the obligation on the part of the acquirer where he, in pursuance of an agreement acquires shares which along with his existing holdings exceed 15% of the voting rights and, such agreement contains a clause to the effect that in case of non-compliance of the obligation by the acquirer, the agreement shall not be acted upon by the seller and the acquirer.

Verification of securities: The Board of Directors of the target company shall facilitate the acquirer in verification of securities tendered for acceptances

Unblased comments – If the Board of Directors of the target company so desire, it may send its unblased comments and recommendations on the offer(s) to the shareholders of the target company, keeping in mind the fiduciary responsibility of the Directors to such shareholders.

For this purpose, it may seek the opinion of an independent merchant banker or a committee of independent directors.

Liability for mis-statement : The Directors of the target company shall be liable for any mis-statement or for concealment of material information in their comments in terms of the Regulations and SEBI Act.

VIII. Securities and Exchange Board of India – Rules and Regulations for Merchant Bankers-

The students are advised to refer the Institutes study material for detailed understanding.

8 PORTFOLIO MANAGEMENT

An Overview

Meaning of Portfolio
Meaning of Portfolio Management

Portfolio Manager

Discretionary and Non – Discretionary
Definition of Securities
Needs for and role of Portfolio Manager
Additional Services to NRIs
Remittance of Funds
Registration
Portfolio Manger's Obligations
Co - ordination

Functions of Portfolio Managers

Objectives of Portfolio Management

Security
Stability
Capital Growth
Marketaboility
Liquidity
Diversification
Tax Advantage

Activities In portfolio Management

Basic Principles of Portfolio Management

Effective Investment planning for the Investment
Constant review of Investment

Factors Affecting Investment Decisions in Portfolio Management

Objectives
Selection of Investment
Timing of Purchases

Fundamental Analysis for Identifying Industries

TEAM OF PROFESSORS AT KALPESH CLASSES

PROF. KALPESH SANGHAVI (C.A.)

PROF. L.MURALIDHARAN (C.A.)

PROF. SOWMYNARAYANAN (C.A.)

PROF. RAJAGOPALAN (C.A.)

PROF. JAISON (C.A.)

NOW LIVING ~~WORKING~~ TOGETHER.

Statistical Analysis of Past Share Prices

Assessing the Intrinsic Value of the shares

P-E Ratio
% Growth rate of earnings ratio
% growth rate of net blocks

Investment Strategy

1. Active *2. Passive*

Portfolio Theories

1. Traditional Approach ***2. Modern Approach***

Investor
Objectives
Strategy

Diversification
Selection
Dow Jones Theory
Random Walk Theory
Formula Plans
Fundamental Analysis

- *Valuation*
- *Div Growth and PE multiple*
- *Key Variables*

Charting and Technical Analysis

- *Basic Concepts*
- *Chart Types*
- *Chart Patterns*
- *Market Indicators*
- *Interpreting price patterns*
- *Decision using Data Analysis*

PELIMINARY

Portfolio management is growing as a field rapidly serving a broad array of investors – both individual and institutional. Investors feel insecure in managing their investment because of following reasons:

- Volatile nature of securities.
- Difficulty in identifying growth oriented companies
- Requirement of constant reshuffling of portfolio.
- Complicated Trading practices on the stock market.

Here comes the role of the Portfolio Management Service (P.M.S), which helps the investors make **an intelligent** and **informed choice** between alternative investment opportunities.'

What do you mean by the term portfolio?

A. MEANING OF PORTFOLIO

Portfolio means total holdings of securities belonging to any person.

What do you mean by Portfolio Management?

I. B. MEANING OF PORTFOLIO MANAGEMENT

Portfolio management is concerned with efficient management of investments in securities selection & reshuffling of securities to optimise returns to suite the objectives of an investor. The total risk of the portfolio is minimised. It entails choosing one best portfolio to suit the risk-return preferences of the investors and it further involves the evaluation and revision of the portfolio in view of changing risk, return and investor's risk preference. Portfolio Management Services (PMS) is one of the merchant banking activities recognized by SEBI. Authorised merchant bankers or portfolio mangers or discretionary portfolio managers as defined in SEBI (Portfolio Managers) Rules, 1993. Only recognised MBs registered with SEBI are authorised to serve. (To know more about us visit KalpeshClasses.com)

Who is a Portfolio Manager?

II. Portfolio Manager

Any person who enters INTO a contract or arrangement with a client.

Pursuant to such agreement, he advises or undertakes on behalf of the client the management or administration of a portfolio of securities or

- invests and manages the client's fund.

Discretionary Portfolio Manager

He is a portfolio manager who may exercises, under a contract relating to portfolio management any degree of discretion in respect of the

- Investments.
- Management of portfolio.
- Management of funds of the client.

Non-discretionary Portfolio Manager

He is the one who manages the funds in accordance with the directions of the client.

Define the firm "Securities"

Definition of securities

As per Section 2 of Securities Contracts (Regulation) Act, 1956, **securities include** –

(a) Shares, scrips, stocks, bonds, debentures, stock or other marketable securities of a like nature in or of any incorporated company or any other body corporate;

(b) derivatives;

(c) units or any other instruments issued by any collective investment scheme to the investors;

(d) Government securities;

(e) Such other instruments as may be declared by the Central Government to be securities, and

(f) rights or interest in securities

Elaborate on the role played by a portfolio manager

Needs for and Role of Portfolio Manager

- Securities markets in India have developed
- Profit making companies share prices are appreciating.
- So investor in securities are attractive
- But markets are also volatile
- So an experts guidance is needed to earn without losing.
- Portfolio manager also assists NRIs in complying with RBI regulations.

Additional Services to NRIs by Portfolio Manager

- Obtaining permission from the RBI for making investments.
- Opening and handling bank accounts on behalf of such clients.
- Filing statutory returns / reports required by authorities.
- Arranging repatriation of funds as and when it becomes necessary.

Such facilities are available to overseas bodies, corporates, firms, societies, etc.

Remittance of funds

Funds for investment should be remitted from abroad through normal banking channel or withdrawn from the non-resident external (NRE) Account or foreign currency non-resident (FCNR) Account maintained in the name of investor with a bank in India. If the investment is made on non-repatriation basis, funds lying in the investor's ordinary non-resident account with a bank may be utilized for this purpose. Incomes net off Indian taxes are credited to NRO A/cs for repatriation.

Registration as a Portfolio Manager

A person is required to obtain a certificate of registration from SEBI before acting as a Portfolio Manager, A merchant banker, if he desires to function as a Portfolio Manager, has to obtain a certificate of registration from SEBI under the SEBI (Portfolio Managers) Regulations, 1993.

List down the obligations of portfolio managers

Portfolio Manager's obligations

The Portfolio Manager has certain obligations towards his clients, and also certain general obligations:

- He shall transact in securities within the limitation placed by the client himself with regard to dealing in securities under the provisions of the Reserve Bank of India Act, 1934.
- He shall **not derive any direct or indirect benefit** out of the client's funds or securities.
- He shall not pledge or give on loan securities held on behalf of his clients to a third person without obtaining a written permission from such clients.
- He shall invest his client's Funds in money market instruments including commercial paper, trade bill, treasury bills, certificate of deposit and usance bills or as specified in the contract.

  Provided the portfolio manager shall not deploy the same in bill discounting, badla financing or lending or placement with corporate or non-corporate bodies.
- He shall, ordinarily, purchase or sell securities separately for each client. However, in the event of aggregation of purchases or sales for economy of scale, inter se allocation shall be done
  - on a pro rata basis and
  - at weighted average price of the day's transactions. He shall not keep any open position in respect of allocation of sales or purchases effected in a day.
- Any transaction of purchase or sale including that **between his own** accounts **and his client's** accounts or between two client's accounts shall **be at the prevailing market price.**
- While dealing with his clients funds, he shall not induldge in speculative transactions that is, any transaction for purchase or sale of any security in which transaction is periodically or ultimately settled otherwise than by actual delivery or transfer of security.

  He may enter into transactions on behalf of his clients for the specific purpose of meeting margin requirements only if the contract provides for the same and the client is made aware of the attendant risks of such transactions.

- He may hold the securities belonging to the portfolio account in his own name on behalf of his clients only if the contract so provides. In such a case, his records and his report to his client should clearly indicate that such securities are held by him on behalf of his client.
- He shall deploy the money received from his client for an investment purpose as soon as possible for that purpose.
- He shall pay the money due and payable to a client forthwith.
- He shall avoid any conflict of interest in his investment or disinvestment decision relating to his customers.
- Where there is a conflict of interest with such customers, he shall ensure fair treatment to all his customers. He shall disclose to the customers possible sources of conflict of duties and investors, while providing unbiased services.
- He shall not place his interest above those of his clients.
- He shall not make any exaggerate statement, oral or written, to the client about the qualification or the capability to render certain services or his achievements in regard to services rendered to other clients.
- He shall not disclose to any clients, or press any confidential information about his client, which has come to his knowledge.
- He shall, where necessary and in the interest of the client, take adequate steps for registration of the transfer of his client’s securities and for claiming and receiving dividends, interest payments and other rights accruing to his clients. He shall also take necessary action for conversion of securities and for claming and receiving dividends, interest payments and other rights accruing to his clients. He shall also take necessary action for conversion of securities and subscription / renunciation of/or rights in accordance with the client's institutions.
- He shall endeavour to -
  - i. Ensure that the investors are provided with true and adequate information without making any misguiding or exaggerated claims.
  - ii. Ensure that the investors are made aware of attendant risks before any investment decision is made by them.
  - iii. Render the best possible advice to his clients relating to their needs and the environment and his own professional skills.
  - iv. Ensure that all professional dealings are effected in a prompt, efficient and cost effective manner.

Co-ordination with relating authorities - The portfolio manager shall designate a senior of officer as Compliance Officer to

a. coordinate with regulating authorities
b. provide necessary guidance to and ensure compliance internally by the Portfolio Manager of all Rules, Regulations, Guidelines, Notifications, etc. issued by SEBI, Government of India and other regulatory organisations.
c. Ensure that observations/deficiencies pointed out by SEBI the functioning of portfolio manager do not securities.

What functions do portfolio managers perform?

III. FUNCTIONS OF PORTFOLIO MANAGERS

a. To study economic environment affecting the capital market and client investment.
b. To study securities market and evaluate price trends of shares and securities in which investment is to be made.
c. To maintain complete and updated financial performance data of blue-chip and other companies (Blue chip is a large, stable, well-established profit-making company).
d. To keep a track on the latest policies and guidelines of Central Government, RBI and stock exchanges.
e. To study problems of industry affecting securities market and the attitude of investors.
f. To study the financial behaviour of development financial institution and other players in the capital market to find out sentiments in the capital market.
g. To counsel the prospective investors on share market and suggest investment in certain assured securities.
h. To carry out investment in securities or sale or purchase of securities on behalf of the clients to attain maximum return at lesser risk.
i. To have a good infrastructure to render services promptly to the client.
j. To offer value added services such as tax planning, benefit collection, safe custody of securities, registration and transfers etc.

Economic environment

Securities market

Financial performance data

Latest policies

Industry problems

Financial behavior

Counsel investors

Investment sale/purchase

Good infrastructure

Value added services

What are the objectives of portfolio management?

IV. OBJECTIVES OF PORTFOLIO MANAGEMENT

a. **Security of Principal –** The investment should be in such securities so that the principal sum and the purchasing power remain intact.
b. **Stability of Income –** The investment should be made in a manner that the investor gets systematic income for reinvestment or for consumption.
c. **Capital Growth-** The investment should be made in securities which have the feasibility of having capital growth.
d. **Marketability –** Securities should be such that they could be easily purchased or sold.
e. **Liquidity –** The investor should be in a position to take advantage of attractive opportunities up coming in the market (Nearness to money).
f. **Diversification –** The investment should be diversified in such a way as to reduce the risk of loss of both, capital and income.
g. **Tax advantage –** The investment should minimize tax burden.

So the capital needs to be safe firstly. Then we want a stable income, then comes Growth of capital, sale ability & liquidity, minimum losses & taxes. These are the basis objectives.

Elucidate the activities involved portfolio management

V. ACTIVITIES INPORTFOLIO MANAGEMENT

a. Identification of assets of securities, allocation of investment and indentifying asset classes.
b. Deciding about major proportion of different assets/securities in portfolio.
c. Security Selection within the asset classes.

These activities aim at maximizing return and minimizing risk in investment.

What are the various risks (or sources) involved in securities?

Sources of Risk

a. **Interest rate risk –** It is the variability in a security's return resulting from changes in the level of interest rates. Other things being equal, securities's, prices move inversely with change in interest rates. This risk affects bondholders more directly than equity investors.

b. **Purchasing power / inflation risk –** With rise of inflation, there is a reduction of purchasing power. It affects all securities. This risk is directly related to interest rate risk as interest rates go up with inflation. Inflation risk is more in fixed income securities.

c. **Business risk –** This risk refers to the risk of doing business in a particular industry or environment and it gets transferred to the investors who invest in that business or company. Flexible income securities are more affected.

d. **Financial Risk/Leverage Risk –** Financial risk arises when companies resort to financial leverage or the use of debt financing. The more the company resorts to debt financing, the greater is the financial risk.

e. **Liquidity risk –** This risk is associated with the secondary market where the particular security is traded in. Securities which have ready markets like treasury bills have lesser liquidity risk.

f. **Market risk –** It refers to variability of returns due to fluctuations in the securities market. Equity shares are most affected by this risk.

State the two basic principles of portfolio management

VI. BASIC PRINCIPLES OF PORTFOLIO MANAGEMENT

a. **Effective Investment planning for the investment –** by considering fiscal, financial and monetary policies of central government and RBI
   - industrial and economic environment
   - its impact on industry prospects in terms of prospective technological changes, competition in the market, capacity utilisation with industry and demand prospects, etc.

b. **Constant review of investment –** The portfolio managers are required to review their investment in securities and continue selling and purchasing their investment in more profitable avenues.

For this purpose, they should assess the quality of the management, do financial analysis of companies' Balance Sheet / Profit and Loss Account and analysis of securities market and its trend.

What are the various factors to be considered while taking an investment Decision?

VII. FACTORS AFFECTING INVESTMENT DECISIONS IN PORTFOLIO MANAGEMENT

a. Objectives of investment portfolio

This is a very crucial factor. Objectives of making investment may differ from individual to individual and organization to organization. An aggressive investment company may be prepared to take high risk in order to have high capital appreciation, while an organization looking for investment of provident fund of its employees can think of having in its portfolio only such securities which can assure safety of the funds and a steady return. Thus a portfolio manager must be very clear in his objectives before determining his investment portfolio. They objectives are normally expressed in terms of risk & return.

b. Selection of investment

The portfolio manager has to decide the kind of investment in which he has to put the money. In other words, he has to decide "what to buy". This involves deciding about the following:-

i. **Types of securities –** There are a number of securities available in the market for investment viz. debentures, preference shares, equity shares, government bonds, units, capital units etc.
ii. **Proportion between fixed and variable yield securities –** Fixed Interest/Dividend bearing securities ensure a definite return and are less risky. Variable yield securities do no

ensure a fixed return. The return depends upon the earnings of the company. They are more risky but offer opportunities to earn higher returns.

iii. **The relationship between risk and return –** While selecting securities for investment, the investor has to balance the risk and return. In case the return on two securities is same, the investor will prefer the security with a lower risk.

iv. **Selection of industries –** It involves selection of industries with growth potential. This requires a careful analysis of past performances and future prospects of different industries.

v. **Selection of companies –** After identifying the industries with high growth potential, the next step is to select the particular companies. In whose shares or securities investments are to be made.

c. Timing of purchases

The timing of purchase of securities is of crucial significance. It is not only important to buy the right security but it is also equally important to buy and sell it at the right time. This is the most complex and difficult decision for a portfolio manager.

It is deal to buy the securities when the prices are low and sell then when the prices rise to level higher than the normal fluctuations. However, usually the investors hesitate to buy when prices are low because they fear the prices may fall further to the lowest level from which they might not move higher. Similarly, when the prices are exceptionally high, investors usually hesitate to sell since they want to maximize their profits and they feel price may still rise higher. Usually, an ordinary investor is never in a position to determine the ideal time to buy and sell the securities. He starts selling in a falling market and buying in a rising market since the others are also selling or buying, as the case may be.

A careful portfolio manager has to control himself of these psychological factors which may influence an ordinary investor. He has to make a careful analysis of the stock exchange prices and see that he buys cheap and sells dear.

Write a note on fundamental analysis?

VIII FUNDAMENTAL ANALYSIS FOR IDENTIFYING INDUSTRIES

STATISTICAL ANALYSIS OF PAST SHARE PRICES

A reasonable estimate regarding the growth potential of Industry can be made based on the past trends in the share prices of companies belonging to that industry. A comparison of share price index of specific industry with that of all industry can throw a better light over the growth potential of the specific industry in comparison to all industries in general.

The relative changes in the price index of each industry as compared with the changes in the average price index of the shares of all industries would show those industries which are having a higher growth potential in the past few years. An industry may not remain a growth industry for all the time. (For any inquiry or admission to kalpesh classes dial 2382 0676)

The analysis of share price indices over a number of years will enable the investment manager to identify the industries which are rated high by the investors at the time of analysis.

ASSESSING THE INTRINSIC VALUE OF AN INDUSTRY/COMPANY'S SHARES

After identifying the industries with high growth potential, the next step is to assess the value of the concerned industry / company. There would require consideration of -

(a) General factors affecting the value of the industry's shares (Industry analysis) – The value of an industry's shares particularly depends upon its economic prospects, which in turn depends upon the following factors:-

(i) **Demand and supply position –** The gap between the demand and supply of products of the industry is likely to have a significant influence on the future growth prospectus of the industry.

(ii) **Profitability –** The profitability of an industry depends to a great extent upon the cost structure in relation to the selling price of its products. It is not always necessary that an industry with high growth potential will also have a high profitability. Profitability of an industry is of vital significance for the investor since it is a measure not only of the performance of the industry but also of the amount of his possible earnings.

(iii) **Industry's special characteristics –** It is important to study the special characteristics of an industry in order to understand their impact on the working of the industry. For example, certain industries depend, to a great extent, on imported components. A slight increase in the exchange rate will terribly upset the cost calculations.

(iv) **Labour Management relations** – The state of labour management relations greatly influences the working of the company. Bad labour management relations have an adverse impact on profitability. An investor, must therefore see that there is a cordial relationship between labour and management while selecting his investment portfolios.

(b) Special factors affecting the value of a particular company's shares (Company Analysis)

After selecting the industry / Industries, the investor will have to select the companies whose securities should constitute the portfolio. The following factors are considered for this purpose.

(i) **Size and ranking of the company –** A general idea about the size and ranking of the company within the economy and the particular industry to which the company belongs is important in assessing the risk associated with the company. This can be done by comparing the turnover, net profit and capital employed of the company with other companies in the same industry group.

(ii) **Growth record –** An assessment regarding potential growth of the company can be made on the basis of past sales figures, capital employed, return on investment, earning per share. The following three ratios must be particularly looked in to –

1. Price – Earning ratio – This ratio indicates the number of times the earnings of the latest year at which the share price of a company is quoted. It is calculated as follows:-

$$P/E\,ratio = \frac{\text{Current market price per equity share}}{\text{Earnings per share}}$$

This ratio reflects the market's assessment of the future earnings potential of the company. A high P/E ratio reflects the market's confidence in the company's equity. It also helps in knowing whether the shares of a company are over or under valued. The investor by comparing his ratio pertaining to different companies can have an idea about the image of the company and determine whether the share is under-priced or over-priced. Consider the following example-

	Company X	**Company Y**
Market price of the share of Rs. 100	Rs. 300	Rs. 500
Earning per Share (EPS)	50	50
Price Earnings Ratio (P/E)	6	10

It is apparent in the adjacent example (table) that an investor willing to purchase the shares of company X will have to pay Rs. 6 for every 1 rupee of earning while an investor desiring to purchase shares of company Y will have to pay Rs.10 for every 1 rupee of earning. In case, all other factors, such as break-up value of the shares, growth potential, management quality, etc. are quite the same in both the companies, it is advisable to purchase the shares of company X as compared to those of company Y. It may however be noted that P/E ratio is not the sole criterion for purchasing the shares of a particular company. An investor has to consider other factors too.

2. Percentage growth rate of earnings ratio

The financial position of a company greatly depends on the earning capacity of the company. It would result in improvement in the financial position and would push up the value of shares in the stock exchange.

3. Percentage growth rate of net blocks

It shows how the company has been developing its capacity levels. A growth-oriented company will go on expanding its capacity and diversifying its business.

(iii) Financial analysis

It is concerned with critical appraisal of the financial statements to provide adequate information regarding the profitability and financial position of a business. This is done through various tools of financial analysis. viz., comparative or common size financial statement, computation of trend percentages, accounting ratios, etc.

(iv) Quality of Management

Selecting company with good management in considered to be more important than selecting a company in a promising industry. It has been found by experience that companies having a dynamic, professional, honest and experienced managers at the helm of their affairs, fare better in the long-run as compared to the companies, which do not enjoy such privileges. The quality of management is, therefore, an important factor while taking the investment portfolio decisions.

(v) Location and labour-management relations
The location of the company in terms of availability of crucial inputs viz., raw material, power, skilled labourer etc, and nearness to market has a considerable bearing on the economic liability of the company. Cordial labour-management relations has also become an important factor while taking investment portfolio decisions.

(vi) Pattern of existing stockholdings
An analysis of shareholding pattern of a company also has a bearing on the evaluation of company's shares. In case, shares of a company are held by a few family friends of the promoter, the profitability of company's affairs being mismanaged are more and, therefore, it is advisable not to invest in such companies.

(vii) Marketability of shares
In order that the investor can change the investment portfolio, it is necessary that securities constituting the portfolio should be easily marketable. Mere listing of a share on the stock exchange does not automatically mean that the share can be sold or purchased at will. The investor should decide the marketability of the concerned shares through enquiring from stock exchange or study of the transactions effected there.

Discuss in brief the 2 types of Investment Strategy?

IX. INVESTMENT STRATEGY

Portfolio management can be practised by following either an active or passive strategy.

1. **Active Strategy : -** It is based on the assumption that it is possible to beat the market. Active strategy is carried out as follows :-
   (a) **Aggressive security Management –** It involves aggressive purchasing and selling of securities to achieve high yields from dividend, interest and capital gains.
   (b) **Speculation and short-term trading –** The objective is to gain capital profit. The risk is high and composition of portfolio is flexible. The success of active strategy depends on correct decisions as regards the timing of movements in the market as a whole, weightage of various securities in the portfolio and individual share selection.

2. **Passive-Strategy –** It does not aim at outperforming the market. The objective, is to include in the portfolio, a large number of securities so as to reduce risks specific to individual securities. This is basically buy **and hold** strategy. The passive strategy is characterized by long tem **investment horizon** and little **portfolio revisions**.

X. PORTFOLIO THEORIES
Portfolio theories guide the investors to select securities that will maximize returns and minimize risks. Portfolio theory can be discussed under two heads :-

1. Traditional Approach **2. Modern Approach**

Write a note on Traditional approach in Portfolio Management?

1. Traditional approach: -

The traditional approach to portfolio management deals with following –

(a) **Investor:-** Investor's study includes an insight into his -
- age, health, responsibilities, other assets, portfolio needs;
- need for income, capital maintenance, liquidity;
- attitude towards risk;
- taxation status

(b) **Portfolio Objectives :-** These are defined with respect to maximizing the investor's wealth which is subject to risk. The higher the risk, higher the returns.

(c) **Investment Strategy :- It covers**
- i) Balancing fixed securities against equities;
- ii) Balancing high interest dividend payout companies against high earning growth companies as required by investor;
- iii) Finding the income of the growth portfolio;
- iv) Balancing income tax payable against capital gains tax;
- v) Balancing transaction cost against capital gains from rapid switching;
- vi) Retaining some liquidity to seize upon bargains, etc.

(d) **Diversification :-** It reduces volatility of returns and risks.

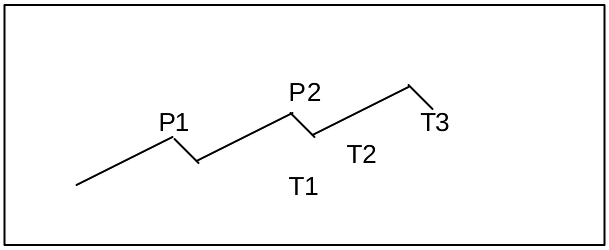
(e) **Selection of individual investment –** It is based on following principles-
- (i) Method for selecting sound investments by calculating the true or intrinsic value of a share and comparing that value with the current market.
- (ii) Expert advice is sought besides study of published accounts;
- (iii) Inside information is sought and relied upon to move to diversified growth companies.
- (iv) Newspapers tipsters about good track record of companies are followed closely;
- (v) Companies with good asset backing, dividend growth, good earning record, high quality management with appropriate dividend paying policies and leverage policies are traced out constantly for making selection of portfolio.

Explain Dow Jones theory. How to determine the timing of investment decision using the theory?

DOW JONES THEORY

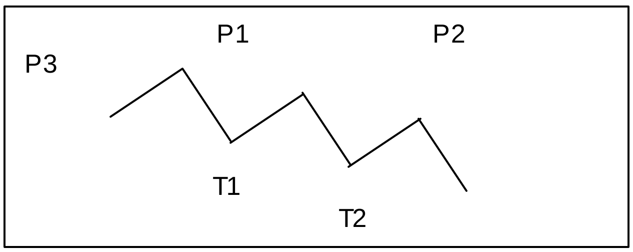
This theory was propounded by **Mr. Charles H. Dow**. According to this theory, the movement of the prices of securities on the stock exchanges has been classified into Haree Major Categories –

1. **Primary Movements –** These represent the long-term movements (from one year to three years or more) of the prices of the securities on the stock exchange. In case the market price shows a rising trend, it is stated that a bull phase is prevailing in the market. Graph 1 shows the behaviour of stock market prices in bull phase.



Graph 1

We can inter that though prices fall after each rise, the basic trend is that of rising prices.
If the market prices show a falling trend, it is stated that a bear phase is prevailing is the market. Graph 2 shows the behaviour of stock market prices in bear phase.



Graph 2

It would be seen that prices are not falling consistently and after each fall, there is a rise in prices. However, the rise is not much as to take the prices higher than the previous peak. **It means each peak and trough is now lower than the previous peak and trough.**

Dow Jones theory states that primary movements indicate basic trends in the market.

2. **Secondary Movements –** These represent comparatively short-term movements in stock exchange prices lasting from 3 weeks to 3 months. They are apposite in direction to primary movements. They retrace from one-third to two-third of the gain or loss in prices recorded in the previous swing.

3. **Daily Movements –** These represent daily irregular fluctuations in the stock exchange prices. They are without any definite trend. These fluctuations do not show any definite trend. They are, as a matter of fact, mainly due to speculative reasons. An investor should not make his investment decisions based on these movements.

Timing of investment decisions on the basis of Dow Jones Theory –
Ideally, securities should be purchased at a time when the prices are at their lowest ebb and sold at a time when they reach the highest peak. However in practice this is seldom possible. This is because it is almost impossible to determine the time when the prices have reached the highest peak or fallen to the lowest ebb. It would be enough if the investor buys the securities when the price starts rising and sell them when they start falling. This means that he should be in a position to identify exactly the beginning of the period when the prices have started rising or falling. This is technically called **identification of the turn** in the stock exchange prices. Identification of the 'turn' of course is a difficult task.

What do you mean by Random Walk Theory?

Random Walk Theory

According to Dow Jones theory, predictions can be made about the future behaviour of stock exchange prices, in case the past trends are carefully studied and analysed. However, many financial analysts hold a different view. According to them, the stock exchange price can be never predicted since they are merely "statistical ups and downs" and are not the result of any basic factors. Thus, according to them, the behaviour of stock exchange prices is almost unpredictable and there can be no relationship between the present stock exchange prices of the securities and their future prices. In other words, successful 'peaks' and 'troughs' in the stock exchange prices are merely statistical happenings. In common parlance, it can be said that according to this theory, stock exchange prices exactly behave in a way in which a drunken person would behave while walking in a blind lane. The viewpoint is popularly called **"Random Theory or Hypothesis"** According to this theory, the stock exchange prices are absolutely independent and they can't form a proper base to take investment decisions.

What do you understand by the term Formula plans?

FORMULA PLANS

Formula plans provide an automatic device for the investor to decide when to buy and sell the securities. These plans are therefore suitable to all types of investors, big or small. The following are the essential features of formula plans –

a. The amount available for investment is pre-determined.
b. A specified % of the investible funds is invested in fixed yield bearing securities and invested in variable yield bearing securities Fixed income securities could be Bank Deposits, Debentures, Preference shares and government securities. Variable yield bearing securities include equity shares.
c. At pre-determined intervals, say 3 months or 6 months, as the case may be, the market value of total investment portfolio (fixed as well as variable yield securities) is worked out. It is then seen whether in the above market value, the pre-determined proportion between fixed and variable yield bearing securities has been maintained. If not, the requisite sales or purchases of the concerned securities are made.

Example – A company has fixed the total amount of investible funds at Rs. 1 lakh. The proportion between fixed yield securities and variable yield securities has been fixed at 60% and 40% respectively. Consequently, Rs.60,000 has been invested in debentures and Rs.40,000 in equity shares.

After the pre-determined interval of 3 months, the market value of investment portfolio is as follows :-

Debentures	Rs. 60.000
Equity Shares	Rs. 60.000
Total	Rs.1,20,000

The market value of the investment portfolio has thus increased by a sum of Rs.20,000 over a period of 3 months. According to pre-determined proportion between fixed and variable yield bearing securities, the investment in fixed yield bearing securities, the investment in fixed yield bearing securities should be of the order of Rs.72,000 and variable yield bearing securities Rs.48,000. The investor will have to sell the equity shares worth Rs.12,000 and invest the money in debentures.

Thus, the formula plans ensure that equity shares are sold at times when the prices are high and thus meet the basic principles of management of investment portfolio.

However, if we presume that after another 3 months, the investor finds that the market value of his investment portfolio is as under:-

Debentures	Rs.70,000
Equity Shares	Rs.20,000
Total	Rs.90,000

In order to maintain the pre-determined proportion of 60% and 40% between fixed and non-fixed yield bearing securities, the investor will dispose debentures of Rs.16,000 (i.e. Rs.70,000 – Rs.54,000) and purchase shares of Rs.16,000. As a result, the total investment portfolio will be as follows –

Debentures	Rs.54,000
Equity Shares	Rs.36,000
Total	Rs.90,000

Hence, the investor automatically buys shares when prices are low. The main advantage of the formula plans is that buying and selling is done automatically and the investor is not swayed by general market sentiment. There is no effort to chart and find out market trends.

What do you understand by value based investing in Fundamental Analysis?

FUNDAMENTAL ANALYSIS

Value Based Investing – The fundamental analysis is based on the assumption that the price of a share is based on the benefits the holders of the share expect to receive in the future in the form of dividends. The Present Value (P.V.) of future dividends, computed at an appropriate discount rate to reflect the riskiness of the share, is called the intrinsic or fundamental value of the share.

Price	>	Fundamental Value	=	Sell
Price	<	Fundamental Value	=	Buy

Valuation of share based on fundamental analysis

(a) **Assuming Constant dividends -**

$$P(0) = \frac{D}{(1+k)} + \frac{D}{(1+k)^2} + \frac{D}{(1+k)^3} + \ldots\ldots\ldots + \ldots\ldots\ldots$$

Where,

P(0) = Price of share in current year.
D = Uniform dividend per share every year.
K = Discount rate or desired rate of return on share.

(b**)** **Assuming growth in dividends per shares (DPS)**

$$P(0) = \frac{D(1)}{(1+K)} + \frac{D(1)(1+g)}{(1+K)^2} + \frac{D(1)(1+g)^2}{(1+K)^2} + \ldots\ldots\ldots + \ldots\ldots$$

P(0) = Price of share in current year.
D(1) = Dividend at the end of first year
g = annual growth rate in DPS
K = discount rate or desired rate of return on equity share.

If growth rate in dividend, g, is less than the desired rate of return on share, k, we can write,

$$P(0) = \frac{D(1)}{(k-g)} \quad \textbf{or} \quad P(0) = \frac{D(0)(1+g)}{(k-g)}$$

Where, D(0) = Dividend per share is the current period, (0).

Note :

1. The above model is not valid if g k, since the geometric series lead to an infinite price. Since the long-term growth in dividends is unlikely to exceed the rate of return, the condition that g be less than k is not very restrictive.
2. The above model is also called **Gorden's dividend growth model** for stock valuation.

Dividend Growth Model and the P/E Multiple

Financial analysts tend to relate price to earnings via the P/E multiplies (the ratio between the market price and earning per share).

If the company pays a fraction 'b' of its earnings as dividends on an average,
the value of equity share is arrived as follows :-

$$P(0) = \frac{bE(1)}{k-g}$$

where,

b = fraction of earnings paid as dividend

E(1) = Earning per share (EPS) of the company at the end of the first period.

Investment strategy

If the P/E multiple or price of a security is higher than the estimated fundamental value (i.e. if the security appears to be overpriced), sell the security, since once the information becomes common knowledge, the price of the security may be expected to fall. If the security's prevailing P/E multiple is lower than the estimated fundamental value, buy the security.

List down the key variables used to carry out Fundamental Analysis?

Key Variables in carrying out Fundamental Analysis

1. Economy Wide Factors.

(a) **Growth rates of National Income and Related Measures –** The estimated growth rate of the economy would be an indicator to the prospects for the industrial sector, and therefore to the returns investors can expect.

(b) **Growth rates of industrial sector –** It is estimated on the basis of the estimated demand for the products.

(c) **Inflation –** Inflation influences the demand in some industries, particularly the consumer products industries.

(d) **Monsoon –** Because of the strong forward and backward linkages, monsoon is of great concern to investors in the Stock Market too.

2. Industry Wide Factors -

(a) **Product Life – Cycle –** An industry usually exhibits high profitability in the initial growth stages, medium but steady profitability in the maturity stage and a sharp decline in profitability in the last stage of growth.

(b) **Demand Supply Gap** – Excess supply reduces profitability, but insufficient supply improves the profitability of an industry.

(c) **Barriers to entry** – Some of the barriers are innate to the product & technology of production whole others are created by existing firms in industry.

(d) Government attitude.

3. Firm Specific Factors -

(a) Net worth and book value

(b) Sources and uses of funds

(c) Cross-sectional and time series analysis

These have been discussed in detail in Section VIII

Write a note on Technical Analysis? What role does a chart play in Technical Analysis?

CHARTING AND TECHNICAL ANALYSIS

Technical analysis is based on the premise that there are persistent and recurring patterns of price movements, which can be identified by analyzing the market data. The technical analyst is concerned with the fundamental strength and weakness of a company or an industry. He studies the investor and price behaviour.

The two basic questions that he seeks to answer are –

(a) Is there a discernible trend in the prices?
(b) If yes, then, are there indications that the trend would reverse?

Chart patterns are used to predict the market movements. The basic concepts underlying the chart analysis are –

(i) persistence of trends,
(ii) resistance between volume and trend, and
(iii) resistance and support levels.

Most analysts use chart at times as a method of keeping track on the price movements of particular shares, or of the market as a whole.

(a) **Line Chart**

This consists of a line connecting the closing prices of a share, (or average prices), to show the price movements over a period.

(b) **Bar Chart**

In bar chart, prices are indicated on the chart's vertical axis and the time on horizontal axis. The vertical part of the line shows the high and low prices at which the stocks are traded or market moves. A short horizontal tick on the vertical line indicates the price level at which the stock or market closed.

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(c) **Point and figure charting**

In this chart, there is no time scale but only price movements are plotted. As a share price rises, a vertical column of crosses is plotted. When it falls, a circle is plotted in the next column, and this continues downward while the price continues to fall. When it rises again, a new vertical line of crosses is plotted in the next column and so on.

Security price (Rs.)

		X		X		X
		X	O	X	O	X
X		X	O	X	O	
X	O	X	O	X		
X	O		O			
X						
X						

Time

Point and Figure Chart

BUILDING A PERSPECTIVE ON TECHNICAL ANALYSIS
Chart patterns

Explain Dow Theory.

DOW Theory

- It is the oldest and the most famous theory
- Developed in 19th century by Charles Dow
- Found that most of the shares move in consonance with the market.
- Three trends identified Primary, Secondary, Minor like tides, waves and ripples

Causes of trends:-

Primary Uptrend

Accumulation of shares by intelligent investors
Arrival of first reports of good earnings by corporates
Widespread report of financial well being

Secondary Uptrend

Rampant speculation in the market.

Primary Down trend

Selling of shares by intelligent investors
Arrival of first report of overvaluation
Widespread report of financial sickness

Secondary Down trend

Distress selling by investors
DOW theory is not interested in minor trends.

How one can use volume of transactions a Market indication?

Market Indicators

A major Indicator of the breadth of the market is the volume of transaction. When interpreted in conjunction with the index or price, it can provide useful clues on how the market would behave in near future.

- A rising index with increasing volume would signal a buy. It reflects on unsatisfied demand in the market.
- A falling market with increasing volume signals a sell and the prices would be expected to fall further.
- A rising market with decreasing volume indicates a bull volume that is running out of stream.
- A falling market with dwindling volume indicates a bear market that is becoming breathless.

What do you mean by the terms Support levels & Resistance level?

Support and Resistance Levels

Resistance level is that price level to which the stock or the market rises and then falls from repeatedly. This occurs during an uptrend or a sideways trend. It is a price level to which the market rallies repeatedly but cannot break through. At this level selling increases which causes the price fall. (For any inquiry or admission to kalpesh classes dial 2382 0676)

A support level is that price level to which the stock or the market prices fall or bottom out repeatedly and then bounces up again. Demand for the stock increases as the price approaches the support level. The buying pressure or demand supports the price of stock preventing it from going lower.
A breach of these levels indicates a distinct departure from → status quo and an attempt to set newer levels.
Explain the various price patterns.

Interpreting Price Patterns

Numerous patterns have been developed to interpret price patterns. Some of these are as follows:-

1. Channel

A series of uniformly changing tops and bottoms gives rise to a channel formation. A downward sloping channel would indicate declining prices and an upward sloping channel would imply rising prices.

2. Wedge

A wedge is formed

- when the tops (resistance levels) and bottoms (support levels) change in opposite direction (i.e., If the tops are decreasing then the bottoms would be increasing and vice versa), or
- when they are changing in the same direction at different rates over time.

3. Head and Shoulders

The head and shoulders pattern indicates the reversal of an uptrend. Here the share prices rise on buying pressure from investors who have specialized knowledge of the company. The formation begins with a price advance (A) which is supported by a high volume of trading. This causes a pause or slight decline (B). This is later reinforced by other investors jumping on the bandwagon. The price then advances to a higher level (c) but supported by lighter trading volume. The price decline to (D). This pause is then followed by a rally to a lower peak (E) than the previous (C) but still on decreasing volume.

4. Gap

A gap is the difference between the opening price on a trading day and the closing price of the previous trading day. The wider the gap the stronger the signal for a continuation of the observed trend. On a rising market, if the opening price is considerably higher than the previous closing price, it indicates that investors, after careful though (?) overnight, are willing to pay a much higher price to acquire the scrip. Similarly, a gap in a falling market is an indicator of extreme selling pressure.

Elaborate on the methods of Data analysis for Decision making.

Decision Using Data Analysis

Some of the popular methods of data analysis for decision making –

Moving averages

Moving averages are frequently plotted with prices to make buy and sell decisions. The two types of moving averages used by chartists are Arithmetic Moving Average (AMA) and Exponential Moving Average (EMA).

1. An n-period AMA, at period t, is nothing but the simple average of last n period prices.

$AMA_{n,t} = ¼ [P_t + P_{t-1} + P_{t-(n-1)}]$
AMA assign equal weight of 1/n to each of the n prices used for computing the average.

2. The Exponential Moving Average (EMA) assigns decreasing weights, with the highest weight being assigned to latest price. The weights decrease exponentially, according to a scheme specified by the exponential smoothing constant,

$EMA_t = qP_t + (1-a)(EMA_{t-1})$
$= aPt + a(1-a) P_{t-1} + a(1-a)^2 P_{t-2} + ...$

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PORTFOLIO THEORIES AND CAPM

Introduction

An important relationship which underpins the majority of modern corporate finance theory is that of the trade-off between risk and return. This trade-off is important both from a company perspective, where companies face the risk of variability in cash flows from projects, and from an investor's point of view, where shareholders' returns vary due to fluctuations in share prices and dividends. The aim of both companies and shareholders will be to minimize the risk they face given the return that they expect to receive. In order for them to do this though, they will need to have a firm understanding of why the risk they face exists in the first place. They may then be able to quantify the risk and hence manage or control it. Traditionally risk has been measured by the standard deviation of returns, the calculation of which will be considered in the analysis. It can be examined how, by the careful combination of different investments, investors can 'trade off' the amount of risk they face given the level of their expected return. This forms the basis of the portfolio theory which was developed by Markowitz (1952). The relationship between risk and return is then taken a step further by considering the capital asset pricing model developed by Sharpe (1964), which provides us with a framework by which to value individual securities according to their level of risk.

1 MEASUREMENT OF RISK

Risk plays a very important role in the decision-making process for both investors and companies, so it is important that the level of risk associated with investment can be quantified. Risk is measured by the standard deviation (ó) of returns of a security, calculated using either the historical returns over time or the expected returns in the futures.

1.1 Calculating risk and return using probabilities

In the following one can see the possible returns and associated probabilities of two securities A and B, where:

P_A = probability of return on A
R_A = the corresponding return on A
P_B = probability of return on B
R_B = the corresponding return on B.

Exhibit - 1

The possible returns and associated probabilities of securities A and B			
A plc		B plc	
P_A	R_A (%)	P_B	R_B (%)
0.05	1	0.05	18
0.20	20	0.25	12
0.50	20	0.4	28
0.20	25	0.25	28
0.05	25	0.05	38
1.00		1.00	

The expected returns and standard deviations of the two securities are given by the following formulae:

$$\text{Expected return of a security } (R) = \sum_{I=1}^{n} P_i \times R_i$$

$$\text{Standard deviation } (\sigma) = \sqrt{\sum_{i=1}^{n} P_i \times (R_i - R)^2}$$

Where: $P_1 \ldots P_n$ = the probabilities of the n different outcomes
$R_1 \ldots R_n$ = the corresponding returns associated with the n different outcomes.
By using the above formulae and the information provided we can calculate both the expected returns and the standard deviations for the two securities.

Expected return of security A
(0.05 X 10) + (0.25 X 20) + (0.50 X 20) + (0.20 X 25) + (0.05 X 25) = 20.75 per cent

Expected return of security B
(0.05 X 18) + (0.25 X 12) + (0.40 X 28) + (0.25 X 28) + (0.05 X 38) = 24 per cent
Standard deviation of security A
$((0.05 \times (10 - 20.75)^2)) + (0.20 \times (20 - 20.75)^2) + (0.50 \times (20 - 20.75)^2)) + (0.20 \times (25 - 20.75)^2) + (0.05 \times (25 - 20.75)^2))^{1/2}$ = 3.27 per cent

Standard deviation of security B
$((0.05 \times (18 - 24^2)) + (0.25 \times (12 - 24)^2) + (0.40 \times (28 - 24)^2)) + (0.25 \times (28 - 24)^2) + (0.05 \times (38 - 24)^2))^{1/2}$ = 7.62 per cent

Here we can see that while security B has a higher expected level of return compared to A, it also has a correspondingly higher level of risk.

1.2 Calculating risk and return using historical data
The mean and standard deviation of the annual returns of a security, calculated over a number of years, can be found using the following equations.

$$\text{Mean return } (R) = \frac{\sum_{i=1}^{n} R_i}{n}$$

$$\text{Standard deviation } (\sigma) = \sqrt{\frac{\sum_{i=1}^{n} (R_i - Ri)_2}{n}}$$

Exhibit2 is a table of data detailing the historic returns of two securities, S and T, over the past five years.

Exhibit 2

The historic returns of two securities, S and T		
Year (t)	**Return S (%)**	**Return T (%)**
-4	6.6	24.5

-3	5.6	-5.9
-2	-9.0	19.9
-1	12.6	-7.8
0	14.0	14.8

Using the historical returns data and the formulae above:

Mean return of security S
(6.6 + 5.6 + (-9.0) + 12.6 + 14.0)/5 = 5.96 per cent

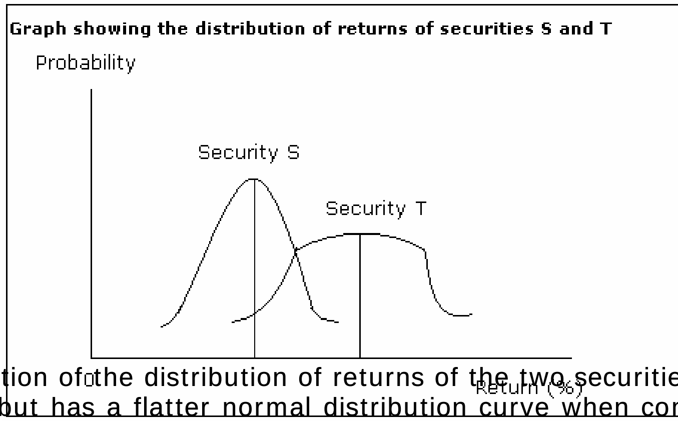
Mean return of security T
(24.5 + (-5.9) + 19.9 + (-7.8) + 14.8)/5 = 9.10 per cent

Standard deviation of security S
$(((6.6 - 5.96)^2 + (5.6 - 5.96)^2 + (-9.0 - 5.96)^2 + (12.6 - 5.96)^2 + (14.0 - 5.96)^2)/5)^{1/2}$ = 8.16 per cent

Standard deviation of security T
$(((24.5 - 9.10)^2 + (-5.9 - 9.10)^2 + (19.9 - 9.10)^2 + (-7.86 - 9.10)^2 + (14.8 - 9.10)^2)/5)^{1/2}$ = 13.39%

One can see that while security T has a higher historic level of return when compared to S, it also has a higher standard deviation. In Exhibit 3 one can see a

Exhibit 3



Graphical representation of the distribution of returns of the two securities. **T** has a higher mean or expected return, but has a flatter normal distribution curve when compared to **S**, due to its higher standard deviation.

BRIEF TIME TABLE FOR NOVEMBER 2005 C.A. FINAL EXAMINATION.
SUBJECT : DIRECT TAX

EXAMINATION	BRANCH	COMMENCING	ADMISSION STATUS
NOV 2005 (A.Y. 2005-2006)	ANDHERI	19-07-2005	In Progress
NOV 2005 (A.Y. 2005-2006)	CHARNI ROAD	24-05-2005	In Progress
NOV 2005 (A.Y. 2005-2006)	GHATKOPAR	17-07-2005	In Progress

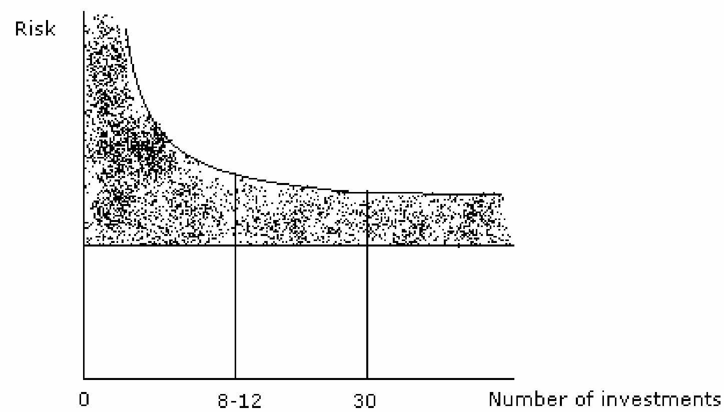
Course Coverage for all the branches is the same.
All lectures are conducted by Professor Mr.Kalpesh Sanghavi Only.

2. THE CONCEPT OF DIVERSIFICATION

Earlier we mentioned that in order for investors to control and manage risk it is important for them to understand why risk exists in the first place. Therefore, it is useful to consider that the overall level of risk that investors and companies face can be separated into systematic and unsystematic risk. Systematic risk (also known as non-diversifiable, non-specific, unavoidable or market risk) represents how an investment's returns are affected by systematic factors, i.e. business cycles, the application of tariffs, the possibilities of war, etc. Systematic risk accounts for roughly 30 per cent of an individual share's total risk. Unsystematic risk (or diversifiable, specific, avoidable or non-market risk) is the risk specific to a particular security, i.e. the risk of the individual company performing badly or going into liquidation. While this type of risk accounts for approximately 70 per cent of an individual share's total risk, investors can progressively reduce unsystematic risk by spreading their investments over a larger number of different securities. It is this possibility of investors reducing unsystematic risk through holding diversified portfolios of shares that forms the basis of Markowitz's portfolio theory. A graphical illustration of the relationship between systematic and unsystematic risk relative to the number of different investments held by an investor is shown in Exhibit 4. If an investor spreads their investment over approximately 12 shares of companies in different industries, about 90 per cent of all unsystematic risk will be eradicated. This increases to 95 per cent if the number of investments is increased to approximately 30 investments.

Exhibit 4

Diagram showing the amount of unsystematic risk diversification obtained as the number of investments increases



2.1 Diversifying unsystematic risk using a two-share portfolio

The simplest form of diversification to consider is that using a two-share portfolio. The extent to which investors will be able to reduce unsystematic risk using a two-share portfolio depends upon the correlation that exists between the two investments' returns. This correlation can be quantified by calculating the correlation coefficient (p) of the returns of the two securities, which can take any value in the range -1 to 1. What does the value of the correlation coefficient imply?

If $P_{x,y}$ = 1 No unsystematic risk can be diversified away.
If $P_{x,y}$ = -1 All unsystemcatic risk will be diversified away.
If $P_{x,y}$ = 0 No correlation between the two securities' returns.

Therefore, when picking a two-share portfolio it is most beneficial to choose two shares whose correlation coefficient is as close to -1 as possible. However, as long as the correlation coefficient is not exactly +1 some unsystematic risk will be diversified away. In practice it may be difficult to find two securities whose correlation coefficient is exactly -1, but the most commonly quoted example is that of an umbrella manufacturer and an ice cream company. During summer ice creams will be sold heavily and the sale of umbrella would be almost nothing. During the rainy season umbrella will be sold heavily with no sale of ice cream. The sales of these two industries would be negatively correlated.

The correlation coefficient ($P_{x,y}$) can be calculated by the formula below:

$$P_{x,y} = \frac{Cov_{x,y}}{ó_x\ ó_y}$$

Where $Cov_{x,y}$ = convariance of returns of securities x and y.

Therefore, if using expected return data, $p_{x,y}$ is given by:

$$\frac{\sum_{i=1}^{n} P_i (R_{ix} - R_x) \times (R_{iy} - R_y)}{ó_x\ ó_y}$$

and if using historical data $P_{x,y}$ is given by:

$$\frac{\sum_{i=1}^{n} P_i (R_{ix} - R_x) X (R_{iy} - R_y)}{n \sigma_x \sigma_y}$$

The formula to calculate the return and risk of a two-share portfolio are given below. The return of a two-share portfolio formula is a weighted average of the two shares' expected returns, while the standard deviation formula is more complex due to the diversification of unsystematic risk that occurs.

Return of a two-share portfolio (R_p):

$$R_p = (W_x R_x) + (W_y R_y)$$

Standard deviation of a two-share portfolio (σ_p):

$$\sigma_p = \sqrt{(W_x)^2 (\sigma_x)^2 + (W_y)^2 (\sigma_y)^2 + 2W_x W_y \sigma_x \sigma_y P_{xy}}$$

Where: W_x = percentage of funds invested in investment x
W_y = percentage of funds invested in investment y
R_x = mean return of investment x (per cent)
R_y = mean return of investment y (per cent)
σ_x = standard deviation of investment X's returns
σ_y = standard deviation of investment Y's returns

$\rho_{x,y}$ = correlation coefficient between x and y's returns.

Using annual returns of the two securities S and T from our earlier example we can calculate the return and risk of a series of portfolios consisting of differing amounts of S and T. First, though, we need to calculate the correlation coefficient between the returns of the two securities:

$$P_{S,T} = ((6.6 - 5.96) X (24.5 - 9.10) + (5.6 - 5.96) X (-5.9 - 9.10) + (-9.0 - 5.96) X (19.9 - 9.10) + (12.6 - 5.96) X (-7.8 - 9.10) + (14.0 - 5.96) X (14.8 - 9.10)/(5 X 8.16 X 13.39) = -0.389$$

We can now calculate the risk and return of two-share portfolios made up of securities S and T. For example, the risk and return of a portfolio consisting of 80 per cent of S and 20 per cent of T are as follows:

Return of portfolio = (0.8 X 5.96) + (0.2 X 9.1) = 6.59 per cent

Risk of portfolio = $((0.8^2 X 8.16^2) + (0.2^2 X 13.39^2) + (2 X 0.8 X 0.2 X 8.16 X 13.39 X -0.389))^{1/2} = 6.02$

The results of these calculations are given numerically in Exhibit 5, where
A = 80 per cent S + 20 per cent T
B = 60 per cent S + 40 per cent T
C = 40 per cent S + 60 per cent T
D = 20 per cent S + 80 per cent T.
The results of the above calculations are also illustrated graphically in Exhibit 6.

In this Exhibit it can be seen that an investor can locate themselves anywhere along the are SABCDT according to how they divide their portfolio between the shares S and T. The points along the arc are superior to those on the straight line between security S and security T due to the diversification of unsystematic risk that occurs when more than one security is held.

Exhibit 5

Diversification of risk in a portfolio containing securities S and T						
	All S	**A**	**B**	**C**	**D**	**All T**
Mean	5.96	6.59	7.21	7.84	8.47	9.10
Variance	66.59	36.18	32.26	54.80	103.81	179.29
Standard deviation	8.16	6.02	5.68	7.40	10.18	13.39

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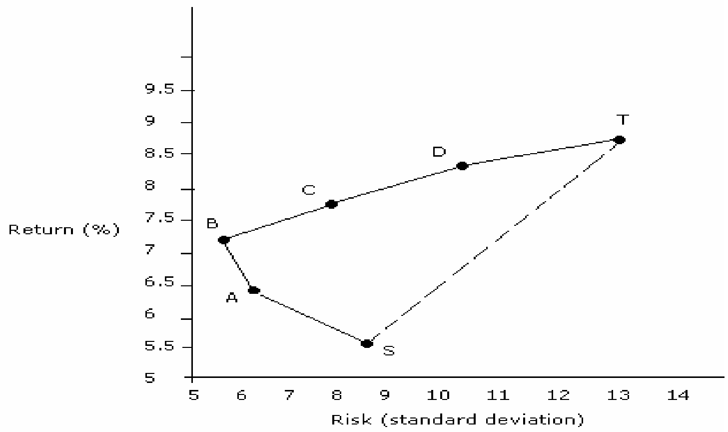
Exhibit 6

A graphical representation of the risk and return of portfolios consisting of different combinations of securities S and T



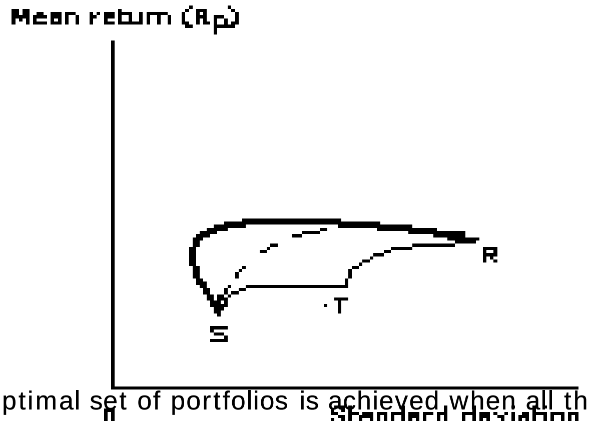
2.2 Diversifying unsystematic risk using a three-share portfolio

With the introduction of an additional share into the portfolio there is even further scope for the diversification of unsystematic risk. The introduction of a higher risk and return share R into the earlier example is represented graphically in Exhibit 7, where:

ST represents portfolios of securities S and T;
SR (dotted line) represents portfolios of securities S and R;
TR represents portfolios of securities T and R;
SR (bold line represents portfolios of securities T, S and R.

Exhibit 7

A graphical representation of the risk and return of portfolios consisting of combination of securities S, T and R



Now we can see that the optimal set of portfolios is achieved when all three shares are invested in (i.e. the bold line SR). This optimal frontier is superior to investing in just S and T due to a greater ability to diversify away unsystematic risk when investing in all three shares. As more shares are added to the investment portfolio, progressively more and more unsystematic risk will be diversified away. This principle forms the basis of Markowitz's portfolio theory, where the investor's choice of investments is not just limited to three shares but includes all available risky securities. Before we go on to consider Markowitz's theory, however, let us first consider investor attitudes to risk and return. (To know more about us visit KalpeshClasses.com)

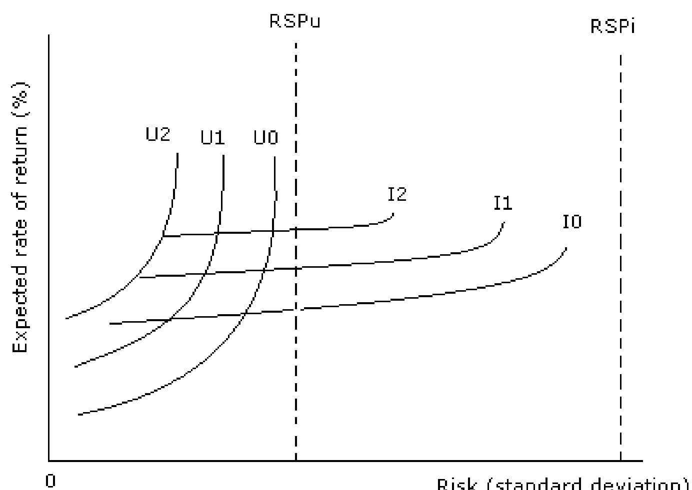
3. INVESTOR ATTITUDES TO RISK

How much risk will an investor accept in the first place? The answer to this question depends upon how much utility an individual investor or company receives from taking risk. The three possible attitudes that investors and companies can have towards risk can be summarised as follows:

- risk loving, where the investor has a preference for high return in exchange for taking a high level of risk;
- risk neutral, where investor is indifferent to the level of risk they face;
- risk averse, where the investor has a preference for low-risk, low-return investments.

While attitudes towards risk may differ, one thing that must be consistent is that investors act rationally and do not expose themselves to higher levels of risk without the possibility of higher returns. A common misconception that is often leveled at risk-loving investors is that they are acting irrationally. This is not the case, however, as investors with a preference for taking risks will only be prepared to incur a higher level of risk if it is accompanied by a correspondingly higher level of possible return. The attitudes of investors to risk will be reflected by the shape of their utility (or indifference) curves, which join up points of equal utility or satisfaction. Two sets of utility curves for two different investors, U and I, are shown in Exhibit 8. Both sets of curves slope upwards from left to right due to the fact that as risk increases an investor will require higher return to keep their utility constant. The utility curves slope upwards at an increasing rate due to an increasing marginal rate of substitution, i.e. in order for an investor to take on progressively more units of risk, progressively higher rates of return are required to compensate them and keep their utility constant. Investors will try to increase their level of utility by seeking the highest return for a given level of risk, or by seeking the lowest risk for a given level of return. The higher the utility or indifference curve, the more satisfied will be the investor. While there are similarities between the utility curves of investor U and investor I, a major difference between them is the rate at which they slope upwards. Investor U's curves quickly steepen at low levels of risk, indicating that this investor is risk averse; the opposite is true for risk-loving investor I, whose curves

Exhibit 8
Utility curves for risk-loving (I) and risk-averse (u) investors



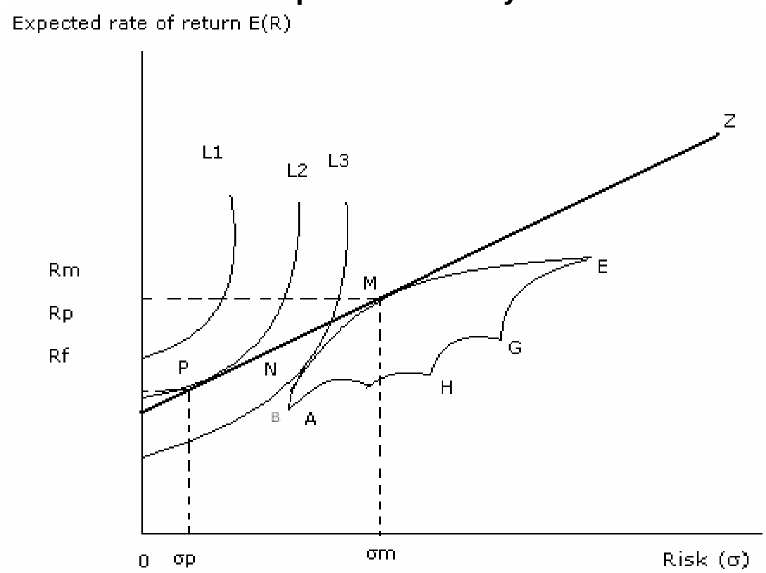
are much flatter. The risk saturation point, i.e. the level of risk that an investor will not go beyond, is much lower for investor U (indicated by the vertical line RSP_u) when compared to that of investor I (RSP_i). Having earlier considered the portfolio choices available to investors in, we are now in a position to combine these choices with the utility curves of investors, thereby allowing investors to select portfolios which satisfy their preference for risk and return.

4. MARKOWITZ'S PORTFOLIO THEORY

The cornerstone of Markowitz's seminal theory, for which he was awarded a Nobel Prize in Economics in 1990, is the ability of investors to diversify away unsystematic risk by holding portfolios consisting of a number of different shares. Markowitz's starting point is to construct what is known as the envelope curve which represents a set of portfolio choices available to investors when investing indifferent combinations of risky securities. The envelope curve is represented by the shaded area AMEGH in Exhibit 9. Investors can construct a portfolio with risk and return characteristics anywhere within the envelope curve, rational investors will only invest in those portfolios on the efficient frontier represented by the arc BME. It is called the efficient frontier because all portfolios on this arc are superior to (i.e. more efficient than) all other portfolios within the envelope curve, giving either the maximum return for a given level of risk, or the minimum risk for a given level of return. For example, if we compare portfolios A and N on the boundary of the envelope curve, which both have the same level of risk, we can see that portfolio N offers a higher return without incurring any additional risk. Portfolio N is said to dominate portfolio A. In fact, all the portfolios on the arc between A and B are dominated by portfolios on the arc BME, and so cannot be regarded as efficient.

Exhibit 9

A graphical representation of Markowitz's portfolio theory



For an investor with utility curves represented by L_1, L_2 and L_3 in Exhibit 9, an optimal portfolio of risky investments will occur at the point N where the utility curve is tangential to the efficiency frontier. Investor choice, however, is not just restricted to risky securities. By assuming that investors can lend and borrow at a risk-free rate of return, we can construct what is known as the capital market line, represented here by the line R_fMZ. The starting point is to locate the rate of return on what is known as the risk-free asset, Rf, and plot it on the vertical axis. This risk-free rate is approximated by the yield on government Treasury bills, which can be assumed to be virtually risk-free. If a line pivoting about R_f is then rotated clockwise until it reaches a point of tangency with the efficient frontier, we can locate the market portfolio M. This portfolio represents the optimal combination of risky securities given the existence of risk-free investments. Investors can now move along the capital market line by splitting their investment between risk-free assets and the market portfolio. Risk-averse investors will locate themselves at R_f by investing all their money in risk-free assets, while an investor putting all their funds into risky securities will locate themselves at M. Where investors locate themselves along the capital market line will depend on their risk preferences and hence the point of tangency of their utility curves with the capital market line. The investor we considered earlier who chose portfolio N in the absence of the risk-free asset will locate at point P by putting the majority of their funds into risk-free assets and the remainder into the market portfolio. Risk-loving investors will locate themselves to the right of M on the capital market line. They do this by putting all their money into the market portfolio and, in addition, borrowing at the risk-free rate and investing their borrowings in the market portfolio. It is particularly important to understand the significance of the risk-free asset in Markowitz's portfolio theory. For a portfolio containing a large number of securities, the calculation of the portfolio risk (in order to facilitate an optimal investment decision for a given investor) involves incorporating correlation coefficients for every possible pair of securities. The number of expressions grows exponentially with the number of securities. However, the introduction of the risk-free asset simplifies enormously the calculation of portfolio risk since no security's returns are correlated with the return on the risk-free asset. All investors will choose to hold a combination of the market portfolio and the risk-free asset, i.e. a portfolio located on the capital market line, since any other portfolio will be dominated by a portfolio on the capital market line.

4.1 Problems with the practical application of portfolio theory

There are problems associated with trying to apply portfolio theory in practice, some of which are summarised below.

- It is unrealistic to assume that investors can borrow at the risk-free rate. Individuals and companies are not risk-free and will therefore not be able to borrow at the risk-free rate; they will be charged a premium to reflect their higher level of risk.
- There are problems associated with identifying the market portfolio, as this will require knowledge of risk and return of all risky investments and their corresponding correlation coefficients.
- Once the make-up of the market portfolio is identified it will then be expensive, from a transaction cost point of view, to construct. These costs will be prohibitive in the case of smaller investors.
- The market portfolio will change over time. This will be due to shifts both in the risk-free rate of return and in the envelope curve and hence the efficient frontier.

One way for smaller investors to get round the problems mentioned above is by buying a stake in a large diversified portfolio, for example by buying into unit trusts or investment trusts and what are called index tracker funds.

5. AN INTRODUCTION TO THE CAPITAL ASSET PRICING MODEL

We discussed how risk can be split into systematic risk and unsystematic risk. We then went on to consider Markowitz' portfolio theory, which provided us with a framework of portfolio selection whereby investors can combine a diversified portfolio of risky securities with risk-free assets in order to maximize their utility. The capital asset pricing model (CAPM), which also considers the relationship between risk and return, is the method of share valuation developed by Sharpe (1964), who in his seminal paper attempted to 'construct a market equilibrium theory of asset prices under conditions of risk', Sharpe, like Markowitz, was in 1990 awarded the Nobel Prize for Economics for his efforts. The CAPM is in fact an extension of Markowitz's portfolio theory. While the 'normative' portfolio theory considers the total risk and return of portfolios and advise investors on which portfolios to invest, in the 'positive' CAPM uses the systematic risk of individual securities to determine their 'fair' price. In order to ignore the influence of unsystematic risk on the valuation of a security, it is required that investors have diversified away unsystematic risk by holding diversified portfolios. As with most academic models, the CAPM is based on a simplified world using the following assumptions:

- investors are rational and therefore maximize their utility and do not take risk for risk's sake;
- all information is freely available to investors and having interpreted it investors arrive at similar expectations;
- investors are able to borrow and lend at the risk-free rate;
- investors hold diversified portfolios, eliminating all unsystematic risk;
- Capital markets are perfectly competitive. The conditions required for this are a large number of buyers and sellers; no one participant can influence the market; no taxes and transaction costs exist; no entry or exit barriers to the market; securities are divisible;
- shareholding occurs over a single standardized holding period;

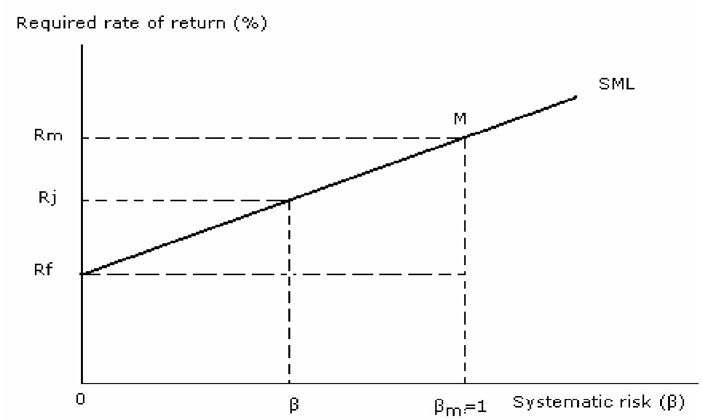
While these assumptions are clearly at odds with the real world, we should refrain from dismissing the CAPM as unrealistic and impractical since, as Sharpe (1964) observed, 'the proper test of a theory is not the realism of its assumptions but the acceptability of its implications'.

6. USING THE CAPM TO VALUE SHARES

Central to the CAPM is the existence of a linear relationship between risk and return. This linear relationship is defined by what is known as the security market line (SML), where the systematic risk of a security is compared with the risk and return of the market and the risk-free rate of return in order to calculate a required return for the security and hence a fair price. A graphical representation of the SML is given in Exhibit 10. From this the equation of the SML can be defined as:

$$R_i = R_f + \hat{a}i\ (R_m - R_f)$$

Where Ri = the rate of return of security j predicted by the model
R_f = the risk-free rate of return
$\hat{A}_i$ = the beta coefficient of security i
R_m = the return of the market.



The beta of a security can be defined as an index of responsiveness the changes in returns of the security relative to a change in the stock exchange or 'market'. It measures the sensitivity of the returns on a company's ordinary share to changes in systematic factors. For example, for a security with a beta of 0.8 (i.e. less systematic risk than the market), if the market return increases by 10 per cent, the security's return will increase by eight per cent. If the market return decreases by 10 per cent, the return of the security decreases by eight per cent. This security represents what is known as a defensive security and is most attractive to investors when the stock exchange is falling. Alternatively, for a security with a beta of 1.5 (i.e. more systematic risk than the market), if the return of the market increases by 10 per cent, the security's return will increase by 15 per cent. If the market return decreases by 10 per cent, the return of the security decreases by 15 per cent. This is what is termed an aggressive security and is most attractive to investors when the market is rising. By definition, the beta of the market is 1 and this acts as a benchmark against which the systematic risk of securities can be measured. The relationship between the beta of a security and the risk and return of the security and the market is given by the following equation:

$$\hat{a} = \frac{Cov_{j,m}}{(\acute{o}_m)2} = \frac{\acute{o}_i \times \acute{o}_m \times P_{j,m}}{(\acute{o}_m)^2} = \frac{\acute{o}_j \times P_{j,m}}{\acute{o}_m}$$

Where: $\acute{o}_j$ = standard deviation of security j's returns

$\acute{o}_m$ = standard deviation of returns of the market

$P_{j,m}$ = correlation coefficient between the security's returns and the market returns

$COV_{j,m}$ = covariance of returns of security j and the market.

The calculation of a share's beta coefficient involves collecting data on the periodic returns of the market and the security under consideration. This data should then be plotted with the returns of the security on the vertical axis and the returns of the market on the horizontal axis. The slope of the line of best fit, or characteristic line, will then give the value of beta. This is illustrated in Exhibit 11. Alternatively beta can be determined from the data by using regression analysis.

If regression analysis is used, the coefficient of variation (R^2) gives us an indication of the extent to which the regression equation, and hence the determined value of beta, explains the distribution of correlated returns. Put another way, the closer R^2 is to 100 per cent, the more of the total variability of a security's returns are explained by systematic factors as opposed to unsystematic factors.

A much easier way to find a security's beta is to leave it up to the experts! The Risk Measurement Service of the London Business School publishes quarterly beta books of companies' beta coefficients. They calculate the betas of all major companies by regressing securities' monthly returns against the monthly returns of the FT actuaries all-share index over the previous five years. An extract from one of the pages of the LBS's beta books is shown in Exhibit 12.

Not only do the beta books give company betas, they also provide other important information. The Variability column indicates the total variability of a share's returns measured by standard deviation. The Specific factors measured by standard deviation. The Standard Error column indicates the reliability of the beta coefficient calculated-the closer this is to zero the better.

Finally, the Resquared column indicates, in percentage form, the amount of a share's total variability of returns that is explained by systematic factors. The relationship that exists between the total variability, the systematic variability and the specific variability of a share's returns is:

total variability of returns = systematic variability + specific variability

$$\sigma_j^2 = \beta_j^2 \times \sigma_m^2 + \sigma_{j,sp}^2$$

Exhibit 11

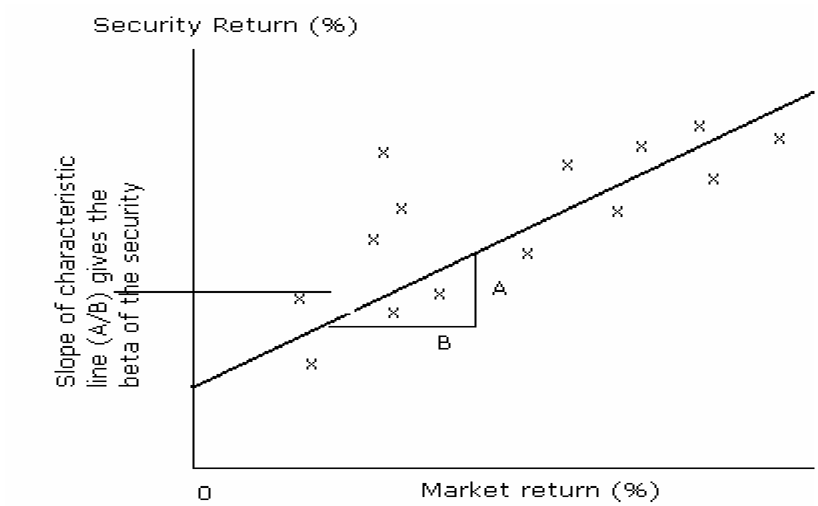


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Exhibit 12

Extract from the beta books produced by the **SREERAM COACHING POINT** students, showing the beta, variability, specific risk, standard error of beta and R squared of the constituents of the 30 company Share Index

Company	Beta	Variability	Specific risk	Std error	R sq.
Andhra Bank	0.79	28	27	0.21	12
Aravind mill	1.24	32	28	0.21	23
Bajaj	0.79	31	30	0.22	10
BOB	1.02	30	27	0.21	17
Bank of India	0.78	23	21	0.18	17
BHEL	0.81	25	23	0.19	16
BPCL	0.91	24	21	0.18	22
Can Bank	1.52	32	26	0.20	35
CIPLA	0.95	29	26	0.20	17
Digital Equip	0.65	23	21	0.18	12
Dr.Reddy	0.89	23	20	0.17	23
GAIL	1.11	36	33	0.23	15
Grasim	1.09	30	27	0.20	21
Gujarat Ambuja	0.76	23	21	0.18	17
HCL	1.23	26	21	0.18	34
HDFC	1.38	33	28	0.21	27
Hero Hond	1.25	37	33	0.23	18
INDALCO	1.50	29	22	0.18	42
Hind Lever	1.10	35	33	0.23	15
HPCL	0.87	27	25	0.20	16
Infosys	1.30	33	29	0.21	23
ICICI	0.85	25	22	0.18	18
JK	1.02	43	41	0.25	9
L & T	1.21	31	27	0.21	24
M & M	1.25	31	27	0.21	25
Maruti	0.65	24	22	0.18	12
MTNL	1.01	25	22	0.18	24
Polaris	1.06	34	31	0.22	15
Reliance	0.84	25	23	0.19	17
TATA	0.74	29	28	0.21	10

Algebraically ‘R-squared’ is represented by:

$$\frac{\hat{A}_j^2 \text{ X } \acute{o}_m^2}{\acute{o}_j^2}$$

It can be seen that the majority of company betas lie in the range between 0.7 and 1.3, with a beta of 1.1 being the most common. While it is mathematically possible for beta to be negative it is very rare in practice as few companies experience increasing returns in time of economic downturn. The most important determinant of a company's beta is the industry in which it operates. Companies with betas greater than one tend to be those in industries such as consumer durables, industries such as food retailers, utilities and other necessity goods producers. A useful exercise is to look through the section of industrial betas that the London Business School includes in its beta books.

An important use of security betas is that they can be used to find the beta of a portfolio of shares. This allows the calculation of the required rate of return from the portfolio as a whole. The beta of a portfolio is obtained by weighting the individual security betas by their relative market value (i.e. the number of shares multiplied by their price and divided by the total market value of the portfolio). In the example in the portfolio beta is 0.945, indicating that the portfolio has slightly less systematic risk than the market portfolio. One factor that must be noted with this example, though, is that a portfolio of only five shares will not diversify away all unsystematic risk, and therefore the risk of this portfolio will not just consist of systematic risk.

Exhibit 13

Bar chart showing the frequency distribution of equity betas for the companies that constitute the NSE 100, July 2000

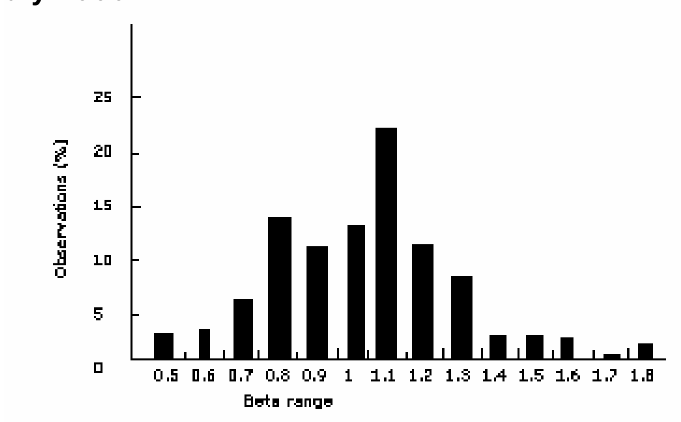


Exhibit 14

An example of how the beta of a portfolio can be calculated by weighting the betas of its constituent securities according to their relative market value			
Security	**Beta**	**Weighting (%)**	**Weighted beta**
BPCL	0.90	20	0.180
Telco	1.25	10	0.125
Reliance	1.10	15	0.165
HPCL	0.15	20	0.230
WIPRO	0.70	35	0.245
Portfolio beta		100	0.945

Having now built up a firm understanding of what beta represents and how it can be determined, we can go on to consider the other variables required to use the CPM.

6.2 Determining the risk-free rate and the return of the market

The risk-free rate, R_f, represents the rate of return earned by investing in risk-free assets. In reality, while no investments are risk free, securities issued by the governments of politically and economically stable countries are generally considered to be free from the risk of default. Therefore, the risk-free rate can be approximated by taking the current rate of return or yield on short-dated government loan stock. In the UK this equates to the current yield on short-dated Treasury bills, which can be easily found in the Financial Times.

The return of the market, R_m, is a little more difficult to calculate. It is usually approximated by using stock exchange indices such as the FTSE 100 or FT actuaries all-share index, as a representation of the market. To find the return of the market, the capital gains of the chosen index over a period, say one year, should be added to the dividend yield of the shares in the index over the same period. This is given by the following formula, which allows us to approximate the return of the market over the period:

$$R_m = \frac{P_1 - P_0}{P_0} + Div$$

Where: P_0 = the stock exchange index at the beginning of the period
P_1 = the stock exchange index at the end of the period
Div = average dividend yield of the stock exchange index over the period.

Due to the occurrence of short-term fluctuations in stock exchange indices it is advisable to make a number of calculations and then take a time-smoothed average in order to estimate the return of the market. Fr instance, if using monthly data, calculate the monthly return of the index over say a three-year period. Alternatively, if using annual data, calculate a moving average by shifting the year period back a month at a time to cover a number of year.

A number of empirical studies attempting to quantify the return of the market or rather the market risk premium (R_m – R_j), which represents the excess of market returns over and above those associated with investing in risk-free assets, have already been carried out.

While the use of a market risk premium of between eight and nine per cent has traditionally been put forward by academics, others have argued, for a variety of reasons, that this represents an overstatement. Jenkinson (1994) showed that if the market risk premium is calculated using a geometric average, rather than the more frequently used arithmetic average, the resulting premium is significantly reduced.

Equity risk

What extra return do investors require for assuming the risk of holding shares rather than gilts? The standard academic answer, based on calculating the actual premium shareholders have received since the First World War, is seven to eight per cent a year.

But this is almost certainly an overestimate. First, the premium previous generations of shareholders were expecting over gilts was probably lower than what they received – no least because the returns on gilts were eroded by unexpectedly high inflation. Second, today's investors are probably looking for a lower premium than their predecessors because they are better able to diversify their risks. Not only have pooled investments like unit trusts and pension funds largely displaced direct private investment which was a prominent feature of the inter-war stock market, but there has been a growing trend to diversification through investment in foreign shares. One could even argue that economic risk has fallen as macroeconomic management has become more responsible.

Why does this matter? Largely because companies typically take academic estimates of the risk premium to calculate their cost of capital, which they then use to judge which investment to approve. An excessive risk premium means overestimating the cost of capital and rejecting good investments. Paradoxically, the search for inappropriately high returns on investment may be holding back shareholder returns.

6.3 A numerical example of the CAPM' use

Now that we have a firm understanding of the components for the CAPM, we can work through an example to illustrate its use. Consider the following data:

Beta of company j ($\hat{a}_i$)	1.23
Yield of short-dated Treasury bills (R_f)	6.5 per cent
Market risk premium (R_m – R_f)	9.1 per cent

Using $R_j = R_f + \hat{a}_i (R_m - R_f)$
We have:

R_i = 6.5 per cent + (1.23 X 9.1 per cent) = 17.7 per cent

From the data provided, the CAPM predicts that the required rate of return of shareholders and hence the company's cost of equity is 17.7 per cent.

6.4 Summary of the implications of the CAPM

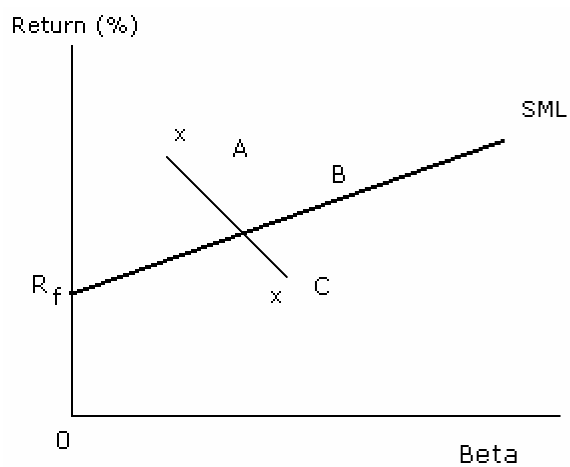
The implications of the CAPM when applying it to pricing shares can be summarised as follows:

- investors calculating the required rate of return of a security will only consider systematic risk to be of relevance, as unsystematic risk can be eradicated by holding diversified portfolios of shares;
- shares that exhibit high levels of systematic risk are expected to yield a higher rate of return;
- on average there should be a linear relationship between systematic risk and return, and securities that are correctly priced should plot on the security market line (SML).

A graphical representation of the final implications is shown in Exhibit 15. Security B is correctly priced and plots on the SML. Security A is considered to

Exhibit 15

The security market line (SML) showing an underpriced share (A), an overpriced share (C) and a correctly valued share (B)



be under priced, giving higher returns compared to those required by investors given its level of systematic risk. Therefore, investors will buy the share, causing its price to rise and its return to decrease, and the share to move on to the SML. Security C is overpriced and hence the opposite situation will occur. If securities take a long time moving on to the SML, the linear relationship between risk and systematic return will be weakened. Therefore, we see the importance of the assumption made by the CAPM that capital markets are perfect, as under these conditions a share's price will tend to move accurately and quickly to reflect information about the share.

7. THE CAPM AND INVESTMENT APPRAISAL

We have only discussed the use of the CAPM from the perspective of share valuation, where the model can be used by shareholders to calculate the required rate of return of a company's equity shares. This equates to the company's cost of equity finance and can therefore be used in the calculation of a company's weighted average cost of capital. The WACC calculated with the assistance of a CAPM-derived cost of equity finance can be used as the required rate of return for

a company's investment projects. However, the CAPM can be used to find a required rate of return which directly reflects the risk of a project and hence replaces the use of WACC in this respect.
The utilization of the CAPM in the investment appraisal process is especially useful when a company is appraising a project which possesses significantly different risk characteristics to that of the average level of risk of the company as a whole. The advantage here is that the CAPM can take into account the risk of projects and therefore lead to better investment decisions. This is something for which the WACC approach makes no allowance.

7.1 Equity betas and asset betas

When applying the CAPM to investment appraisal, it is appropriate to introduce the concept of asset and equity betas. The betas we have referred to so far in this chapter have been what are known as equity betas or 'geared' betas. An equity beta represents the total systematic risk of a company. This systematic risk can be broken down into two components:

1. business risk representing the sensitivity of a company's operating cash flows to changes in the economic climate. This is dependent on the industry within which the company is operating;

2. financial risk, representing the sensitivity of a company's cash flows to changes in the interest payments it has to make on its debt finance. The level of financial risk faced by a company increases with its level of gearing.

Both types of risk are reflected in a company's equity beta. A company's asset beta or 'ungeared' beta, however, reflects only a company's business risk. A company's asset beta, in turn, reflects the asset betas of a company's individual projects. For example, a company with only two projects, both equal in value, one with an asset beta of 1.2 and the other with an asset beta of 0.8, will have an overall company asset beta of 1.

The algebraic relationship between a company's equity and asset betas is given by the following equation:

$$â_e = â_a \times \frac{(E + D(1 - _T))}{E}$$

Where: $â_e$ = equity or geared beta
$â_a$ = asset or ungeared beta
D = value of debt
E = value of equity
T = corporate tax rate

This formula is derived from the expression of a company's asset beta as the weighted average of its equity and debt betas, weighted to reflect the market values of its debt and equity finance. This is represented by the following equation:

$$\hat{a}_a = \hat{a}_e \text{ X } \frac{E}{D(1 - {}_T) + E} + \hat{a}_d \text{ X } \frac{D(1 - {}_T)}{D(1 - {}_T) + E}$$

If we assume that companies do not default on their interest payments we can take the beta of debt, $\hat{a}_d$, to be zero. The last term of the equation therefore disappears and, by rearranging the remaining expression, we arrive at the earlier equation. We can see from this equation that a company's equity beta will always be greater than its asset beta. This is, of course, unless a company is all-equity financed, in which case its equity and asset betas will be identical.

7.2 Using the CAPM to calculate a project's hurdle rate

The process of using the CAPM in investment appraisal is very similar to its use in the share valuation process. In common with share valuation it is assumed that only the systematic risk of a project is relevant. The unsystematic risk is considered irrelevant on the grounds that shareholders of the company will be holding diversified portfolios.

In order to use the CAPM in the investment appraisal process, we again require estimates of the risk-free rate, the market risk premium and, in addition, the beta of the project. It is the last of these three pieces of data which often proves the most difficult to find. We will now address this problem by considering the steps involved in using the CAPM to derive a hurdle rate for appraising a project.

1. Identify quoted companies engaged mainly or entirely in the same type of operation as the project under appraisal. These companies should have similar systematic risk characteristics to the project and so their betas can be used as suitable surrogates or proxies.

2. Once the surrogate companies and their equity betas have been identified, these betas must be adjusted to allow for gearing effects (i.e. financial risk). This is because the surrogate companies' financing will be different from the financing of the company appraising the project and is therefore irrelevant. The formula to 'ungear' a company's equity beta was given earlier.

3. The next step is either to take an average of the ungeared proxy betas, or to select the proxy beta considered most appropriate, and then to regear to reflect the financial risk of the company undertaking the project, using the formula utilized in step 2.

4. The regeared beta will now reflect the business risk of the project under consideration, plus the appraising company's financial risk. This beta can now be inserted into the CAPM in order to yield a required rate of return which accurately reflects the systematic risk of the project.

The required rate of return calculated by this method represents the appropriate hurdle rate of appraising the new project if it is being wholly financed by retained earnings or by newly raised equity finance. If the project is being financed by a mixture of debt and equity finance, however, the required rate of return of equity may need to be used in conjunction with a weighted average cost of capital formula.

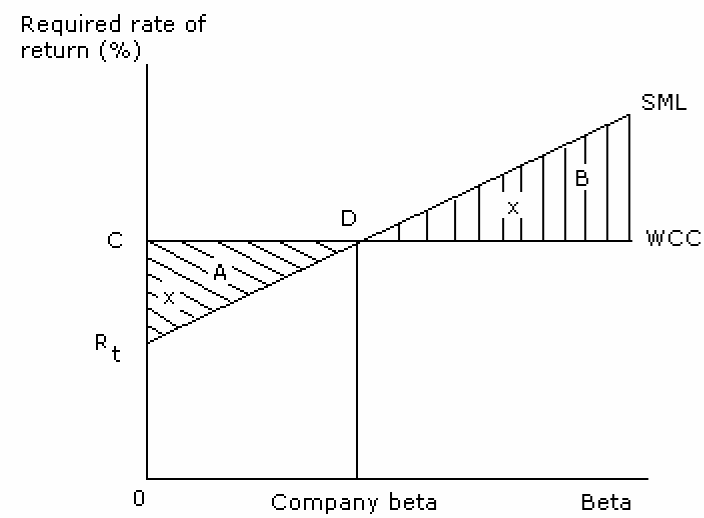
7.3 The benefits of using the CAPM instead of the WACC

As mentioned earlier, the use of the CAPM in project appraisal should lead to better investment decisions. This is illustrated in Exhibit 16.

Consider two projects, A and B, where X marks the plot of their expected level of return and level of systematic risk as measured by beta. Project A would be

EXHIBIT 16

Diagram showing how the use of CAPM in preference to the WACC in the investment appraisal process will lead to better investment decisions



rejected using the WACC due to its expected return being less than the company's WACC. However, using the CAPM, which takes into account the low-risk nature of the project, it would be accepted due to A plotting above the SML. The converse is true of Project B. This would be accepted using eh WACC, but rejected using the CAPM. Therefore, by using the CAPM and taking into account the systematic risk of projects, it will be possible to make better investment decisions in two areas of the diagram:

- the area shaded with diagonal lines, which represents low-risk, low-return projects (previously rejected using the WACC), which will now be accepted;
- the area shaded with vertical lines, which represents low-risk, high-return projects (previously accepted using the WACC), which will now be rejected;

7.4 Problems using the CAPM as an investment appraisal tool

While the CAPM leads to better investment decisions, there are many practical problems associated with using it as an investment appraisal tool, as follows:

- the CAPM's general assumptions are not applicable to the real world and hence may undermine the applicability of the model;
- companies may have difficulty identifying suitable surrogate companies which possess similar levels of systematic risk to the project under consideration. Companies are often involved in

a diversified range of activities rather than in the activity specific to the project being appraised;

- difficulties may be experienced when attempting to identify relevant capital structure data with which to ungear surrogate companies' equity betas;

- the CAPM assumes that transactions take place over a single period of time, which is usually taken to be no more than a year.

Clearly, the last point represents a difficulty, as investments span several time periods. Two problems arise here. First, equity betas calculated using historic data may not be appropriate for making future decisions, as they often exhibit instability over long time periods. This problem can be reduced by taking the betas of a number of surrogate companies and averaging them. Second, using the yield of short-dated government securities to approximate the risk-free rate will no longer be appropriate. The rate used will need to be tailored to the duration of the project under consideration. For example, if the project spans five years, the yield on government gilts maturing in five years could be used to approximate the risk-free rate of return.

Example

The CAPM in the investment appraisal process

Arclight Ltd is a company involved in producing high-quality household lighting products which is currently considering diversifying into the furniture business. It is trying to decide upon an appropriate discount rate in order to appraise the new venture, which has an expected return of 17 per cent. Arclight Ltd will use the CAPM to establish this discount rate and has the following information about suitable surrogate companies.

Furnisure Ltd

This company has an equity beta of 1.23 and is wholly involved in furniture making. It is financed by 35 per cent debt and 65 per cent equity.

Home Furnish Ltd

This company has an equity beta of 1.27 and is also wholly involved in furniture making. It is financed by 40 per cent debt and 60 per cent equity.

Lux Interior Ltd

This company has an equity beta of 1.45 and is financed by 30 per cent debt and 70 per cent equity. It is split into two divisions of equal size; one produces furniture and the other produces luxury wallpaper. The wallpaper division is seen as 50 per cent more risky than the furniture division. (For any inquiry or admission to kalpesh classes dial 2382 0676)

Other information

- Arclight Ltd has traditionally adopted a financing mix of 33 per cent debt and 67 per cent equity – although the project, if accepted, will be financed entirely by equity finance;
- the current yield on Treasury bills stands at seven per cent while the return on the Stock Exchange is 14 per cent;
- the corporation tax rate is 31 per cent for all companies;
- corporate debt can be assumed to be risk-free.

Using the above information, calculate an appropriate discount rate for appraising the project and decide whether it should be accepted.

Step 1: Extract the appropriate asset betas by ungearing the surrogate companies' equity betas using the equation:

$$\hat{a}_a = \hat{a}_e \text{ X } \left[\frac{E}{E + D(1 - {}_T)} \right]$$

Furnisure Ltd

$$\hat{a}_a = 1.23 \text{ X } 65/(65 + 35 \text{ X } (1 - 0.31)) = 0.90$$

Home Furnish Ltd

$$\hat{a}_a = 1.27 \text{ X } 60/(60 + 40 \text{ X } (1 - 0.31)) = 0.87$$

Lux Interior Ltd

$$\hat{a}_a = 1.45 \text{ X } 70/(70 + 30 \text{ X } (1 - 0.31)) = 1.12$$

We have to make a further calculation here as Lux Interior's asset beta partly reflects the business risk of its wallpaper division, which is of no relevance to the project under consideration. Since the wallpaper division is 50 per cent more risky than the furniture division, its asset beta is 1.5 times the asset beta of the furniture division. We can find the asset beta of its furniture division ($\hat{a}_{af}$) as follows:

Lux Interior asset beta = (0.5 X wallpaper asset beta) + (0.5 X furniture asset beta)

$$1.12 = (0.5 \text{ X } 1.5 \text{ X } \hat{a}_{af})$$

Hence: $\hat{a}_{af} = 1.12/1.25 = 0.90$

Step 2: Take an average of the three asset betas:

Surrogate asset beta = (0.90 + 0.87 + 0.90)/3 = 0.89

Step 3: Regear the surrogate asset beta to reflect Arclight's financial risk:

Surrogate equity beta = 0.89 X (67 + 33 X (1 – 0.31))/67 = 1.19

Step 4: Insert the surrogate equity beta into the CAPM to calculate the hurdle rate:

R_i = 0.7 + 1.19 X (0.14 – 0.07) = 0.1533, i.e. 15.33 per cent

8. EMPIRICAL TESTS OF THE CAPM

It is acknowledged that the assumptions of the CAPM are unrealistic from the perspective of the real world. If we refer back to Section 5, for example, we can see that a key assumption of the CAPM is that capital markets are perfect. While capital markets are not perfect, however, as transaction costs and taxes clearly do exist in practice, markets have been found through various empirical tests to exhibit high levels of efficiency. The point we are trying to make here is that although the assumptions do not totally mirror reality, reality may not be so far away from the assumptions as to invalidate the model. The model, therefore, should not be prejudged on its assumptions but assessed on the results of its application.

There have been a large number of tests on the validity of the CAPM's applications and uses. Research carried out has concentrated on two main areas – the first concerning the stability of beta coefficients over time and the second considering the strength and nature of the linear relationship that exists between risk and return.

8.1 Tests of the stability of beta

While the CAPM is a forward-looking model, due to the availability of only past data, betas are calculated using historical returns of shares in relation to the historical returns of the market. Therefore the usefulness of historical betas in both the process of pricing of shares and the appraisal of projects will depend heavily upon the stability of beta coefficients over time. This was the subject of the investigation of Sharpe and Cooper (1972), who examined the stability of US equity betas over the time period 1931-67. They started by splitting up their sample of shares into 10 different risk classes, each class containing an equal number of shares allocated according to their beta at the start of the test period. As a rule of thumb, stability was defined as any share that either remained in its existing class or moved by only one class over a five-year time period. Their results suggested that shares with high and low betas demonstrated higher levels of stability when compared with shares with mid-range betas. Additionally they found that approximately 50 per cent of shares' betas could be considered stable (accounting to their earlier definition) over a five-year time period.

While empirical evidence on the stability of individual betas is inconclusive, there is general agreement that the betas of portfolios of shares exhibit much higher levels of stability over time. The most common reasons put forward to explain this are that any errors associated with the estimation of an individual share's beta or any actual changes in the systematic risk characteristics of individual shares will tend to average out when shares are combines in a portfolio.

8.2 Tests of the security market line

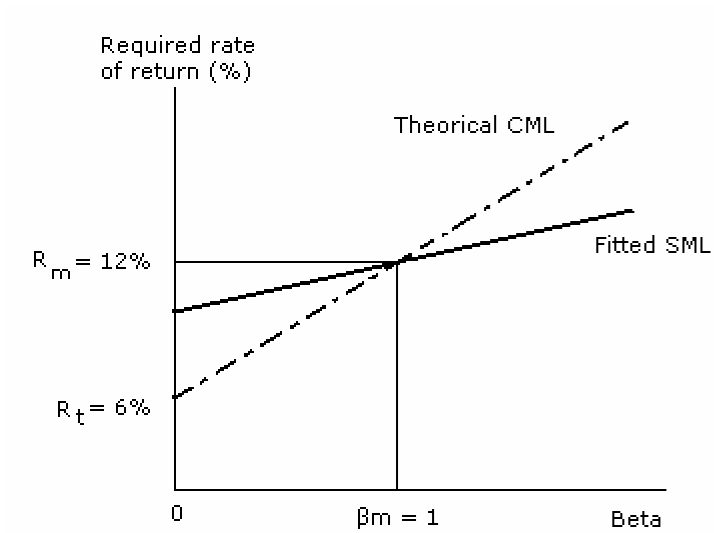
Many empirical tests have used regression analysis to derive a 'fitted' security market line which is then compared to the 'theoretical' SML. Deriving the fitted line involves a two-stage process. The first stage is to select a wide-ranging sample of shares and, by using market returns and security returns over a specified time period (say monthly data over a five-year period), calculate the average return of the securities and their beta coefficients using a series of regression. The second stage is to then regress the individual shares' beta coefficients against their average returns in order to derive a fitted SML. The theoretical SML is located by estimating the risk-free rate of return (Rf) to give the intercept on the vertical axis and then calculating the return of the market (Rm) and plotting it against a beta of one. Some of the best known tests include those carried out by Jacob (1971), Black et al. (1972) and Fama and Macbeth (1973). The conclusions of their tests can be summarised as follows:

- the intercept of the fitted line was above the one derived using the theoretical model, indicating that some other factor in addition to systematic risk was determining securities' rates of return;
- the slope of the fitted line was flatter than that suggested by the theoretical SML;
- the fitted line indicated the existence of a strong linear relationship between systematic risk and return, albeit different from the one suggested by the theoretical SML.

These points are illustrated in Exhibit 17.

EXHIBIT 17

Diagram showing that the fitted SML, while providing strong evidence of a linear relationship between risk and return, suggests a less steep linear relationship when compared to the theoretically derived SML



The board conclusions drawn from these tests is that the CAPM does not fully explain observed data, although systematic risk does go a long way to explaining the expected returns of individual securities. (To know more about us visit KalpeshClasses.com)

While the tests do not support the validity of the CAPM, Roll (1977) argued that the CAPM is difficult, if not almost impossible, to test. The reason is that the stock exchange indices that are used to approximate the market return are poor surrogates. Not only do stock exchange indices fail to include all tradeable shares, they also omit untradeable shares and other financial and non-financial assets (such as bonds, property, land, antiques, etc.). Roll therefore concluded that, without a market portfolio which accurately reflects all risky assets, it is impossible to properly test the validity of the CAPM.

So is the CAPM worthless and are students of corporate finance wasting their time by learning about the model? The answer to this question has to be an unconditional 'no' First, we should only discard a theory or model if there is a better one with which to replace it. A potential 'heir to the throne' of the CAPM, the arbitrage pricing model (APM), is currently only in its early stages of development and has some considerable way to go before it displaces the CAPM. Second, while the CAPM is limited from the perspective of its practical application by companies, it does provide us with a framework with which to quantify and translate risk into an easily understandable required rate of return. Remember that, in Chapter 8, the CAPM was considered to be a more superior way to calculate a company's cost of equity finance that the Gordon growth model.

9. CONCLUSION

We considered the important relationship that exists between risk and return. We started by looking at how the risk and return of individual investments can be measured and then went on to demonstrate that investors, by holding well-diversified portfolios, can eradicate the unsystematic risk they face. This forms the basis of Markovitz's portfolio theory, which combines investing in the optimal portfolio of risky shares (known as the market portfolio) with investing in risk-free assets. The combination of risk and return given by this linear relationship is known as the capital market line. Investors can locate themselves on the line according to their risk preferences.

Sharpe's capital asset pric ing model is a development of Markovitz's portfolio theory. The model identifies a linear relationship between the return of individual securities and their systematic risk as measured by their beta factor. This relationship then allows investors to calculate the required return for a security given its systematic risk and hence determine whether the security is fairly priced or not. The capital asset pricing model can, in addition to being used to price securities, be used to determine risk-adjusted discount rates for appraising new investment projects. While the assumptions upon which the model is based are unrealistic, empirical tests of the model do provide evidence of the existence of a linear relationship between risk and return, albeit one which is slightly different from that suggested by theory.

9

CREDIT RATING

An Overview

Concept of Credit Rating
Benefits of Credit Rating
- *To Investors*
- *To corporate Borrowers*
- *To credit Rating Companies*
- *To Government*
- *To Intermediaries*

Credit Rating Process
- *Steps*
- *Source of information*

Credit Rating Agencies
- *CRISIL LTD*
- *ICRA*
- *CARE*
- *DCR LTD*
- *ONICRA*

Rating Symbols
- *Long term instruments rating*
- *Medium term instruments rating*
- *Short – term instruments rating*

Mandatory Provisions for Credit Rating
- *Commercial Paper Issue*
- *Debenture – disclosure*
- *Public Deposits*

Precautions of Credit Rating

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Explain the benefits of Credit Rating.

I. CONCEPT OF CREDIT RATING:

Credit rating has assumed an important position in the modern developed financial market.

Credit rating is an opinion on the future ability and legal obligation of the issuer to make timely payments of principal and interest on a specific fixed income security. The rating measures the probability that the issuer will default on the security over its life. Ratings, usually expressed alphabetically or alpha-numerically, are a simple and easily understood tool for the investors.

They help investors to distinguish debt instruments on the basis of their underlying credit quality. Credit rating, in essence, indicates the risk involved in debt instrument as well as its qualities.

Higher the credit rating, greater is the probability that the borrower will make timely payment of principal and interest, and vice versa.

List down the benefits of Credit Rating

II. BENEFITS OF CREDIT RATING :

Credit Rating

- **Investors**
- **Corporate Borrowers**
- **Credit Rating Companies**
- **Government**
- **Intermediaries**

1. To Investors

(a) It enables the investors to get superior information at low cost.
(b) It enables the investors to take calculated risk in their investments.
(c) It encourages the common man to invest his savings in corporate securities and get high returns.
(d) It provides the investors with an independent, professional and genuine judgement in the credit quality of the instrument which the investor would not otherwise be able to evaluate.

2. To Corporate Borrowers

(a) It facilitates companies with good rating to enter the capital market confidently and raise funds at comparatively cheaper cost.

(b) It can be used as a marketing tool.

(c) It facilitates foreign collaborations.

(d) It encourages discipline among the corporate borrowers.

3. To Credit Rating Companies

The existence and development of credit rating companies largely depend upon their performance. Honest and impartial credit rating agencies would definitely, thrive as long as they sustain their credibility.

4. To Government

(a) Fair and good ratings motivate the public to invest their savings in company shares, deposits and debentures. Thus, the idle savings of the public are channelised for productive uses.

(b) If facilitates formulation of public guidelines on institutional investments.

(c) Credit rating system plays a vital role in investor protection without casting burden for that responsibility on the Government.

5. To the Intermediaries-

Investment and Merchant bankers, and other market players, use the rating for prices, in placement and marketing the issues.

What are the steps or activities involved in credit rating?

III. CREDIT RATING PROCESS

The steps involved in credit rating activity are given below:-

1. The rating process begins at the request of the company.
2. A team consisting of professionally qualified analysts well-versed in the workings of the industry in which the company operates first visits the company's plants and inspects the operations first hand.
3. Meeting with different levels of management follow, culminating with a meeting with the Chief Executive Officer (CEO)
4. Generally, middle and top management meetings cover the fields of operations, finance, marketing, projects, etc.
5. In completion of the assignment, the team interacts with a back-up team that has separately collected additional industry information and prepares a report.
6. The report is placed before an internal committee consisting of senior executives of credit rating agency who themselves have hands on experience in rating assignments.
7. The internal committee then has an open discussion with the team members and amongst themselves to arrive at a rating.

8. To avoid any sort of bias, the ratings proposed are placed before an external committee of some of the directors who are respected, eminent people unconnected with credit rating agency.
9. The external committee takes the final decision which is communicated to the company.
10. The company may volunteer any further information at this point which could affect the rating, it is passed on to the external committee again for affirmation/change.
11. The company has the option to request the agency to review the rating.

In credit rating, the analytical framework deals with the evaluation of the risk. Risk could be business risk and / or financial risk.

Business risk includes an evaluation of the industry characteristics, performance outlook and the operating efficiencies of the issuer.

Financial risk is the evaluation of the financial management, cash flow adequacy, earning forecasting, accounting quality, cost structure, customer advances, credit worthiness of clients, bank guarantee rates, contingent liabilities, insurance cover, liquidated damages exposure, leverage, etc.

In addition, certain qualitative factors like management capability, group strength and support, business philosophy are also considered.

Sources of Information for the Credit Rating Agencies –

1. Annual and interim reports and other publicity available data on each issuer.
2. Prospectus, letter of offer, etc., of particular securities.
3. Industry, sectoral and economic data from industry groups, etc.
4. Reports and data from government agencies.
5. Primary data collection.

Briefly discuss the role played by the various credit rating agencies in India.

IV. CREDIT RATING AGENCIES

1. CREDIT RATING AND INFORMATION SERVICES OF INDIA LTD. (CRISIL LTD.)

CRISIL was jointly promoted in 1988 by India's leading financial institutions, ICICI and UTI. Other shareholders include LIC, SBI, HDFC, GIC, Standard Chartered Bank, Bank of Tokyo, Uco Bank, Canara Bank, Asia Development Bank, and others. It a matter of fact, CRISIL was the first credit rating agency in India. It is India's only listed credit rating agency.
Services offered by CRISIL

(a) **Rating Services –** It covers ratings of debt obligation of Indian companies. It now rates rupee-denominated credit instruments-long, medium and short term, viz., debentures, deposits, structured obligations, preference shares and commercial paper

(b) **Information Service –** If offers corporate research report and the CRISIL 500 Index.

(c) **Advisory Service –** It provides advisory services to Government, banks, financial institutions and others. It provides counselling on aspects such as privatization of PSUs, debt securitisation, credit evaluation and so on.

2. INVESTMENT INFORMATION AND CREDIT RATING AGENCY OF INDIA LTD. (ICRA)
ICRA has been promoted by IFCI Ltd. and 21 other shareholders comprising foreign and nationalised banks and Indian insurance companies. Established in 1991, ICRA is the second rating agency in India.

Services offered by ICRA

(a) **Rating services –** It covers rating of credit instruments/debt obligation, to award a grade in consonance with the risk associated with them, to reflect the relative capability of timely servicing of the obligations.

(b) **Advisory services –** It includes strategic counselling, general assessment such as restructuring exercise and sector specific services such as power, telecom, ports, municipal ratings etc.

(c) **Information service –** It provides research reports on specific sector, industry and corporate. It also provides equity related services viz., Equity grading and Equity assessment.

(d) **Credit assessment –** It takes up assignments for credit assessment of companies / undertakings intending to use the same for obtaining specific line of assistance from commercial banks, financial institutions, etc.

3. CREDIT ANALYSIS AND RESEARCH LTD. (CARE) LTD
CARE has been promoted in 1992, by IDBI jointly with Canara bank, UTI, Private sector banks and insurance companies. It commenced operations in October, 1993.

Services offered by CARE –

(a) **Rating Service –** Same as CRISIL

(b) **Credit assessment –** It undertakes credit assessment of companies for use for banks, financial institutions, etc. It is without reference to any particular instrument.

(c) **Performance Rating –** It undertakes ‘performance rating’ of parallel marketers of Liquified Petroleum Gas (LPG) and Superior Kerosone Oil (SKO), as per the scheme notified by Ministry of Petroleum and Natural Gas, Government of India.

(d) **Equity research.**

4. DUFF AND PHELPS CREDIT RATING INDIA PRIVATE LTD. (DCR LTD.)

DCR is a joint venture between Duff and Phelps, USA and Alliance Capital Ltd., Kolkata. This is the latest credit rating agency of all the credit rating agencies in India. Its expertise is in rating of structural obligations with international standards.

Services offered by DCR

(a) **Rating Service –** Same as CRISIL
(b) **Rating of Companies and Countries.**

5. ONIDA INDIVIDUAL CREDIT RATING AGENCY (ONICRA) LTD.:-

It is the first rating agency in India, which seeks to rate the credit worthiness of non-corporate individual borrowers. It is sponsored by ONIDA Finance Ltd. (OFL). Its concept of rating is the rating not of individual but of the risk associated with entering into a transaction with an individual at a particular point of time, i.e. default risk. Its benefit is that the user of the rating is able to measure the credit risk involved and consequently assess the default rate. This type of credit rating has applications is credit cards, housing finance, leasing, hire-purchase, rental agreement, personal loans and bank finance.

V. RATING SYMBOLS

Long-term Instruments Ratings

	CRISIL	ICRA	CARE
Highest safety or timely payment of Principal and interest	AAA	LAAA	CARE AAA
High Safety	AA	LAA	CARE AA
Adequate Safety	A	LA	CARE A
Moderate Safety	BBB	LBBB	CARE BBB

Inadequate Safety	BB	LBB	CARE BB
High Risk	B	LB	CARE B
Substantial Risk	C	LC	CARE C
Likely to Default	D	LD	CARE D

The suffix

- Suffix (+) (-) : Comparative position within group.
- LAA + : One notch above LAA
- Letter (P) : Debt instrument is issued the raise resources by new company to financing a new project. Rating here assume successful project completion.

Medium – term Instruments Ratings

	CRISIL	ICRA	CARE
Highest Safety	FAAA	MAAA	CARE AAA
High Safety	FAA	MAA	CARE AA
Adequate Safety	FA	MA	CARE A
Inadequate Safety	FB	MB	CAREBB
High Risk	FC	MC	CARE B
Default	FD	MD	CARE D

The plus (+) minus (-) signs may be applied for ratings to reflect the comparative standing within the same grade or category.

Short-term Instruments Rating

	CRISIL	ICRA	CARE
Highest Safety	P1	A1+/A1	PR-1
High Safety	P2	A2+/A2	PR-2
Adequate Safety	P3	A3+/A3	PR-3
Inadequate Safety	P4	-	PR-4
High Risk	-	A4+/A4	-
Default	P5	A5	PR-5

Crisil may apply '+' (plus) sign from P1 to P3 to reflect a comparative higher standing within the category.

What are the issues for which credit rating is mandatory?

VI. MANDATORY PROVISIONS FOR CREDIT RATING

1. Commercial paper issue.
2. Debenture – Credit rating disclosure is mandatory
3. Public deposits.

What are the points to be kept in mind in case of use of credit rating?

VII. PRECAUTION OF CREDIT RATING

1. Credit ratings are not recommendations to buy or sell or hold a specified rated security nor are they offered as guarantees or protections against default. They are opinions only.
2. Specific credit rating opinions are not intended to measure many of the other factors that fixed-income investors must consider in relation to risk-such as liquidity risk, pre-payment risk, interest rate risk, risk of secondary market loss, or exchange loss risk.
3. The rating is specific to the instrument and is not the rating of the issuer.
4. Rating may differ with respect to different instruments of the same organisation. Also, different ratings assigned to two different instruments of two different organisation does not indicate the superiority or inferiority of the organisations.

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10 CONSUMER FINANCE

An Overview

I. Preliminery
II. Meaning and Types of Consumer Finance
III. Sources of Credit
IV. Advances against Financial Services
V. Credit Cards
VI. Cash in future rentals
VII. Variations in Fixed Deposit
VIII. Consumer Credit in India

Regulation of Consumers credit in India

1. *Regulation for Banks*
2. *Regulation for NBFCs*
3. *Nidhis or Mutual Benefit Societies*
4. *Regulation of Money Lending Firms*

Prospects of Consumer credit in India
Procedure involved in Financing Consumer Credit

1. *Consumer needs and resources*
2. *Financier's Policies and preferences*
3. *Consideration in selection*
4. *Information requirements in application*
5. *Documentation*

Receivables Management System

Credit Policy

Credit Evaluation Methods
Monitoring Receivables
Collecting Receivables

Strategic Issues in Reveivables Management

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I. PRELIMINARY

What do you mean by consumer finance?

Consumer Finance deals with providing finance to household sectors and individuals. It is concerned with finance to consumers & not businessmen for purchase of consumer durables primarily through hire – purchase. Consumer finance has witnessed a boom in the recent period. It has also resulted in growth in the consumer goods industry.

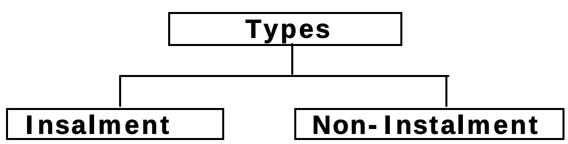
A. Why is there a need for consumer finance?

II. NEED FOR CONSUMER FINANCE

The increase in the disposable income of the households has given way for increase in consumer credit segment. For meeting the growing demands of the households for maintaining a higher standard of living and procuring the capital goods, the finance companies are always on the look-out for providing the consumers new services to meet their demands for the funds for purchasing durable goods. This is done through consumer credit facilities offered by the finance companies.

B. What are the types of consumer credit?

Types of consumers credit



1. Instalment Credit

a. This is provided to the consumers to buy durable goods.
b. The credit is the repaid by the consumer in convenient instalments.
c. It covers mainly credit segments like automobiles, and other consumer goods, repairs, modernization and personal loans. Personal loan covers servicing doctor bills, travels, education, etc.

2. Non – Instalment Credit

This credit includes single-payment loans, where no payment through instalment is involved. It also covers the charge accounts and service credit.

What are the sources of consumer credit?

III. SOURCES OF CREDIT

1. **Main suppliers of consumers credit –** Commercial banks, Sales Finance Companies, Retail Stores, Credit Unions, Consumer Finance Companies.
2. **Main suppliers of non-instalment credit –** Commercial banks, other financial institutions, retail stores, credit cards, service cards, etc.

Explain how advances are offered against financial securities

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IV. ADVANCE AGAINST FINANCIAL SECURITIES -

a. Many individuals today have a very sizeable part of their savings locked in various kinds of financial securities like shares, debentures, NSCs, Units, etc.,
b. Banks and financial institutions now offer advance against the pledge of these financial securities along with signed transfer form.
c. The amount of advance offered is different for different kind of securities. For equity-shares, 45% to 60% of current market value, for government securities like NSCs, Unit, etc., 75% to 90% of face value.
d. The main advantage of this advance is that for short-term temporary requirements, an individual need not forego the gains arising from holding the security for long-term such as capital gains, dividends, rights, bonus, etc.

What role do credit cards play in consumer finance?

V. CREDIT CARDS

Credit cards are a convenient and easy way for everyday shopper to make his payments for all kinds of goods and services without the use of cash. Credit cards are mainly issued by the public sector commercial banks and some foreign banks. They are not only a substitute for cash but also a short-term source of finance.

There is an element of free credit granted to the cardholders because –

a. The accounts are settled monthly covering purchases of goods or services since the last monthly instalment.
b. The card holder is allowed, say, 15 days from the date of his monthly statement to settle the outstanding amount.
c. Some banks offer the facility under which a card holder may be required to pay as low as 10% of the amount due in a month.

Advantages of Credit Card to Cardholder

1. A card is a convenient method of payment as an alternative to cash or cheques. It is simple to operate, convenient to carry and reasonably immune to financial loss compared with losing cash or a cheque book.
2. It is a convenient source of credit if desired, involving no formalities. Owing to the revolving nature of the credit, the consumer can take advantage of it as and when he pleases, within the credit limit sanctioned.
3. It reduces the activity on the customers, banking account considerably because all monthly purchases are covered by one payment.
4. It is an aid to budgeting because the card holder can pay a fixed amount each month according to his circumstances and plan accordingly.
5. The monthly statement is in narrative form and are of a great help to domestic and even business book-keeping.
6. The acceptability of leading credit cards in many other countries is an aid to business and holiday travels.

What do you mean by cash in future rentals?

VI. CASH – IN FUTURE RENTALS

Individuals owning big residential/commercial properties rented out to reputable organisations like banks, Government undertakings, etc. can take a loan against their future rental income. An assignment of future rent to the bank/financing company by the tenant and an equitable mortgage would be required.

- The amount of loan could be around 70 percent of the rental value adjusted for interest.
- The number of years for which rentals would be encashed under this scheme could be upto **six years.**

Explain how fixed deposits can be used as consumer finance?

VII. VARIATIONS IN FIXED DEPOSIT

Now, the banks offer fixed deposit schemes under which the deposits made are not really fixed. They can be actually withdrawn by drawing cheque against the deposits. These new schemes of fixed deposits are called **'Unfixed Deposit', 'Multi Deposit'** etc.
In Unfixed Deposit, one can withdraw upto 75% of the amount deposited by paying 2% above fixed deposit rate. The interest is charged on the amount and for the period for which withdrawal is made. (For any inquiry or admission to kalpesh classes dial 2382 0676)

In Multi Deposit, the money deposited is considered as comprising of no. of blocks of deposits of, say, Rs. 1,000/-. The depositor can withdraw any number of blocks at any time without any compulsion to put back the money withdrawn. The premature withdrawals earn a lower rate of interest.

What are the forms of consumer credit in India?

VIII. CONSUMER CREDIT IN INDIA

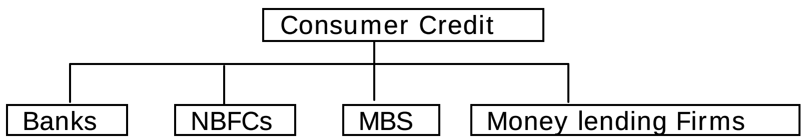
In India, consumer credit has witnessed a boom in the recent period. The reason for this boom is the rise in disposable income of the households. Consumer's credit in India is available in following ways –

1. Consumers' credit in the form of direct personal loans is available from indigenous money lenders regulated under the Money Lenders Act. Such loans are available for purchase of consumer durable goods. These loans are generally secured.
2. Dealers provide credit by way of instalment sale or conditional sale.
3. Hire-purchase companies have been providing consumers' credit to acquire the durable household goods, e.g. cars, TCS, etc.
4. Concessional short-term loans are provided by employers in the organized sector to their employees to acquire durable goods.
5. Employees' co-operative societies are also in line with providing the consumers' credit for financing the acquisition of durable goods and retail requirements of the members.
6. Banks provide direct loan to purchase durable goods against hypothecation of the acquired goods, personal guarantees, etc.

7. Credit cards issued by bank.
8. ‘Nidhis’ deal with members and provide finance at lower rate of interest to members.
9. ‘Chit – Funds’ serve as a saving device by pooling the subscription to the funds by members.

How are the suppliers of consumer credit regulated?

IX. REGULATION OF CONSUMERS CREDIT IN INDIA



1. Regulation for Banks

B. For providing consumers’ credit, banks are required to obtain the permission from RBI u/s 6(1)(a) of Banking Regulation Act, 1949

C. As per RBI’s direction, banks should not themselves setup hire-purchase business, but do this business through subsidiaries (in which they hold not less than 51%), which have been set up for merchant banking, equipment leasing and other such purposes through a subsidiary.

D. Banks may also set up subsidiaries exclusively for transacting hire-purchase business or for doing both leasing and hire-purchase.

E. Banks are banned from promoting a hire-purchase company, though they may invest in shares of such companies within the limits specified in section 19(2) of the Banking Regulation Act.

RBI has also prevented them from financing companies or concerns engaged in hire-purchase if they themselves take up such business through their subsidiaries.

F. RBI has also stipulated that a banks investment in the shares of its subsidiaries (which are engaged in hire-purchase, leasing or both), together with the bank’s investment in shares of other companies carrying on such business, should not in the aggregate, exceed 10% of the paid-up capital and reserves of the bank.

2. Regulation for non-banking companies (NBFCs)

NBFCs are regulated by RBI under the RBI Act. RBI brings out circular instructions from time to time under the said regulations to monitor the activities of these companies.

3. Nidhis or Mutual Benefit Societies

a. Nidhis are registered under the Companies Act, 1956 and notified u/s 620A thereof.
b. They are subject to such restrictions as may be imposed by the Central Government.
c. RBI has exempted Nidhis notified u/s 620A of the Companies Act from the compulsory registration norms but they continue to be regulated by the provisions of RBI Act, 1934 as applicable to them or any directions issued by RBI or the Central Government or any other allied Acts.

4. Regulation of Money Lending Firms
Different States, as permitted under clause 30 of List II of the VIIth Schedule of the Constitution of India have enacted money lending legislations to control activities of the money lenders. A person who is in this activity should have a licence from the State Government authorities under the respective Acts. The law provides for maximum limit of the interest to be charged in such loan and maintain the proper books of accounts and file the returns to the concerned authorities within stipulated time. The main objective of the legislation is to safeguard the interest of the small borrowers.

X. PROSPECTS OF CONSUMER CREDIT IN INDIA
India is a vast market for consumer durables. Finance Companies or banks, which may take up consumer credit activity are found to be benefiting if they are able to penetrate in the untapped market. With the rise in standard of living of people and increase in the desire to lead a better life, the future of consumer credit is promising in India.

Explain the procedure involved in financing consumer credit.

XI. PROCEDURE INVOLVED IN FINANCING CONSUMER CREDIT

1. Consumers' needs and resources

The consumer makes application in the prescribed manner for the type of assistance that the needs and the purposes for which funds are needs are specified therein. The requisition for funds must confirm with the applicant's own resources to pay back the same.

2. Financier's policies or preferences

The consumer financing firms have their own set of strategies, policies and preferences which influence their mode of financing the consumer needs and selection criteria.

3. Consideration in selection

a. Individual merits of the applicant, e.g., reputation, introduction given for the consumer, past experience, etc.
b. Earning capacity of the individual.
c. Sureties or guarantors, their social standing, grade of networth and credit worthiness.
d. Income generating capacity of the asset to be financed, if any.
e. Repayment schedule and liquidity.

4. Information requirements in application

a. Amount of funds required.
b. Purpose
c. Term of repayment.
d. Description of collateral security offered.
e. Personal information about applicant, e.g., name, address, employment status, telephone, fax, numbers, etc. financial data, income tax – status or returns filed, etc.
f. Details of applicant debts and encumbrances on properties.

5. Documentation

The client (applicant) is required to execute different documents, which may, depending upon the finance, differ. But, generally, the documents which are executed are agreement, hypothecation, pledge agreement, promising note and guarantee from the third party.

A. What do you mean by Receivables Management?

XII. RECEIVABLES MANAGEMENT SYSTEM

Meaning:-

1. Finance department monitors the credit offered
2. Sales department is involved in credit granting
3. Here receivables management system is an important system that synchronises the credit policies with the strategies of the firm.

It can be further defined as a process of making decisions relating to investment of funds in receivables so as to maximise the return from such investment.

B. State the primary objectives of Receivable Management System. Also explain how they can be achieved.

a. Obtain maximum (optimum) **volume of sales** and profit that maximize the overall return on investment.
b. Maintain **proper control** over the quantum or amount of **investment in debtors.**
c. Exercise control over the **cost of credit** and collections.
d. **Synchronize the policies** with the strategies of the company.

C**. Explain the activities involved in a receivables management system.**

The above objectives can be achieved by developing appropriate policies, models and systems on the following–

a. Credit Policy
b. Assessing customers' credit worthiness to grant credit.
c. Monitoring the level of accounts receivables and improving collection efficiency.

Investment in receivables cost to the company but no direction come from the asset arises. But it may lead to losses in receivables are not properly managed.

a. Credit Policy

The credit policy of a company can be regarded as a kind of trade-off between increased credit sales leading to increase in profit and the cost of having a larger amount of cash locked in the form of the receivables and the loss due to the incidence of bad debts. In a competitive market, the credit policy adopted by a company is considerably influenced by the practices followed by the industry.

A change in credit policy, for example, by extending credit period to 30 days, when the other companies are following a credit period of 15 days can result in such a high demand for the company's products that it cannot cope with. Further, other company may also fall in like in the long run.

The various variables associated with credit policy are

Credit Policy

Credit Standards **Credit Period** **Cash Discount** **Collection Program**

All these variables underlying a company's credit policy influence sales, the amount locked up in the form of receivables and some of the receivables turning into bad debts.

Thus, designing a suitable credit policy is the first step in receivable management.

b. Credit Evaluation Models

Investigating potential customers before extending credit is an important step, though there is no sure guarantee against loss. The credit worthiness of customers is established by their debt-paying experience in the past and capability in the future. There are two factors that limit the extent of search for information to judge the credit worthiness viz. time and cost. It is a matter of matching the incremental costs and revenues.

The help of credit reporting agencies may be taken in this connection. Unfortunately credit rating organisations, agencies and facilities are not developed to that extent in India.

There are 2 models used.

1. Decision tree model
2. Multi variate statistical model.

c. Monitoring Receivables

Managing receivables does not end with granting of credit as dictated by the credit policy. It is necessary to ensure that the customer makes payment as per the credit term and in the event of any deviation, corrective actions are required.

Several measures can be employed to monitor the receivables –

1. **Days' Sales Outstanding –** It shows the average number of days' sales outstanding at any time, say end or the month of end of the quarter.

Days' sale outstanding-

$$(DSO) = \frac{\text{Accounts receivable at the time chosen}}{\text{Average Daily sales}}$$

2. **Ageing schedule or Age Analysis –** A comparison of ageing schedule at periodic intervals helps to identify the changes in payment behaviour of the customer.
3. Collection Matrix.
4. Investment in receivables.
5. Collection period
6. Ratio of receivables to original sales
7. Receivables variance analysis

d. Collecting Receivables

Collection of receivables begins with timely mailing of **invoices.** Management of collection activity should be based on careful comparison of likely benefits and costs.

A well – established collection policy should have clear-cut guidelines as to the sequence of collection efforts. After the credit period is over and payment remains due, the firm should initiate measures to collect them. The effort should in the **beginning be polite,** but, with the passage of time, it should **gradually become more strict and stern.**

The steps usually taken are –

a. letters, including reminders to expedite payment,
b. telephone calls,
c. personal visits,

d. help of collection agencies, and
e. **legal action** – The firm should take resource to legal action only after all other avenues have been fully exhausted. This not only involves cost but affect the relationship with the customers. The aim should not be to collect as early as possible, genuine difficulties of the customers should be given due consideration.

Discuss the strategic issues in Receivables Management.

XIII. STRATEGIC ISSUES IN RECEIVABLES MANAGEMENT

- A suitable credit policy should be a part of overall strategies adopted by a firm to gain competitive advantage.
- If a firm is trying to achieve cost leadership through economies of scale of production, then it has to generate a large volume of sales. This means, the firm may have to offer more days of credit particularly for those who buy in large quantity. Thus, a liberalized credit policy helps to achieve economies of scale.
- Firm pursuing strategies to acquire product differentiation have limited customer base. In order to gain access to this segment, the firm may have to pursue liberal credit terms but once the brand acquires the desired value, credit terms can be made tight.
- Firms with a large market share in a low growth industry would not invest additional capital in receivables since the strategy is to harvest the benefit. In other words, instead of allowing the market to decide the credit terms of the company, it is possible for the firm to influence the market through credit policy.
- Credit policies can also be used to change the product life cycle and investment pattern.
- Credit policies and its terms assume strategic importance if a firm is primarily supplying its products or services to select firms.
- Companies of a group, facing difficulty in managing the receivables can set up a separate subsidiary to manage the receivables of the group. Also, the group companies can centralize the credit rating service of the customers through subsidiaries.
- Another important strategic issue involved in receivables management is outsourcing their receivable management to factoring agencies or / and credit rating agencies. It not only helps to convert many of the fixed costs into variable costs but also keeps the organisation lean.

XIV. Explain Decision tree model. Using an example

Suppose a firm uses three credit information

1. Characteristics
2. Capital
3. Collateral

If all three are strong	-	**Grant:** Large amount of credit
Collateral is weak	-	Limited credit to be granted
Characteristics is weak	-	Credit to be limited to collateral
All three are weak	-	Reject.

XV. Explain Multivariate statistical model.

A series of variables are used here. A credit scoring system considers these simultaneously. Even non-numerical measures are considered. Coefficient values of discriminant variables are produced. From an application record the discriminant score is obtained as a product of these coefficients & values of variables. This is compared with the point of separation (Say 5)

> 5 Fair gp applicant

< 5 Risky

Chapter 11

11

MUTUAL FUNDS

An Overview

Preliminary

Advantages of Mutural Fund Investing

Professional Management
Low cost high value portfolio diversification
Reduction/ Diversification of Risk
Reduction on Transaction cost
Liquidity

Investor's Investment Goals

Regulations

- ***Definition of Mutual Fund***
- ***ConstitutionzTrustee***
  - *Definition*
  - *Eligibility*
  - *Rights and obligations*
  - *Details of securities transacted*
  - *Due diligence*
- ***AMC***
  - *Eligibility*
  - *Conditions to be fulfilled*
  - *Obligations*
- ***Custodian and Depositories***
- ***Bankers***

Mutual Fund Schemes

1. *Open-ended and closed ended funds*
2. *Load and no load funds*
3. *Tax exempt and non tax- exempt funds*
4. *Balanced funds*
5. *Tax saving funds*

Operations of Mutual Fund

Investment valuation norms
Pricing of units
Dividend Distribution
Apportionment of Expenses

Advertisement of schemes *Investment Approaches*
Offer Document

Net Asset Value

Restriction on Investment of Mutual Fund Money

Investor's Rights and Obligations

Criteria for Evaluating Performance

Sharpe Ratio
Treynor ratio
Jensen's alpha
Expenses Ratio

Checklist for compliance – Important Points

Mutual fund *AMC*
Custodian *trustees*

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IN ASSOCIATION WITH KALPESH CLASSES

I. PRELIMINARY

A mutual fund is a financial intermediary which acts as an instrument of investment. It collects funds from different investors to a common pool of investible funds and then invests these funds in a wide variety of investments opportunities. The investment may be diversified to spread risk and to ensure a good return (dividend and or capital gains) to the investors. The mutual funds employ professionals, experts and investment consultants to conduct the investment analysis and then to select the portfolio of securities where the funds are to be invested.

What are the advantages of mutual investing?

II. ADVANTAGES OF MUTUAL FUND INVESTING

1. **Professional management:** Mutual funds employ expert investors' analysis and professional knowledge and expertise for selection and supervision of their investment portfolio.
2. **Low cost high value portfolio diversification:** An investor gets an opportunity to be a part of owner of a diversified portfolio, which an individual cannot.
3. **Reduction/Diversification of Risk:** When an investor invests in a mutual fund, he is actually investing in a pool of funds. These funds will be in turn invested in securities. So, the individual investor will share the losses with other investors.
4. **Reduction in transaction cost:** A mutual fund offers economies of search and verification due to size and scale of operations.
5. **Liquidity:** Mutual funds provide liquidity to the investor as he can dispose off his investment in mutual fund whenever he requires the funds.

How do mutual funds cater to various investment goals?

III INVESTOR'S INVESTMENT GOALS

- Different investors have different investment goals. While somebody wants security, others might give more weightage to returns alone.
- Indian mutual fund industry offers different kinds of schemes to take care of various needs of the investors.
- The range of products includes equity funds, debt, liquid, gilt and balanced funds. There are also funds meant exclusively for young and small and large investors. Moreover, the setup of

a legal structure, which has enough teeth to safeguard investor's interest, ensures that the investors are not cheated out of their hard-earned money.

- An individual investor is generally risk averse.
- Mutual funds help such investors through open-ended debt fund schemes where they get benefits of better return with benefits of anytime liquidity at lower risk. Specific goals like career planning and retirement plans are also catered to by mutual funds. The mutual fund industry also serves the investors' objective of tax-saving by offering equity-linked saving scheme as well. Similarly, liquid funds offer liquidity as well as better returns. Many funds provide for anytime withdrawal enabling a big investor to take maximum benefits.

Thus, we see that mutual funds cut across investor classes.

IV REGULATIONS

Define the term mutual fund.

Definition of Mutual Fund

A fund established in the form of a Trust, by a sponsor, to raise monies by the Trustees, through the sale of units to the public (or a section) under one or more schemes, for investing in securities including Money market instruments in accordance with the SEBI Regulations.

Explain how to constitute a Mutual Fund.

Constitution of a mutual fund

A mutual fund in India is constituted in the form of a trust created under the Indian Trusts Act, 1882.

The fund sponsor acts as the settler of the trust, contributing to its initial capital and appoints a Trustee to hold the assets of the trusts for the benefit of the unit holders, who are the beneficiaries of the Trust. The trustees hold the unit holders money in a fiduciary capacity. A fund sponsor can be compared to a promoter of a company.

An Asset Management Company (AMC) is appointed by the spread to act as the investment manager of the trust under the Board's Supervision and the direction of the Trustees. AMC would in the name of the Trust, float and then manage the different investment schemes as per SEBI guidelines. (To know more about us visit KalpeshClasses.com)

Define Trustees.

Trustee

Who can be appointed as trustees? List down their rights & obligations?

Definition of trustee

Trustees mean the Board of Trustees or the Trustee Company who hold the property of the Mutual Fund in trust for the benefit of the unit holders.

Eligibility for appointment as Trustee

(a) He should be a person of ability, integrity and standing ;
(b) He has been not found guilty of moral turpitude;
(c) He has been not convicted of any economic offence of violation of any securities laws; and
(d) He has furnished particulars as specified in form C specified in SEBI Regulations.

1. An AMC or any of its officers or employees shall not be eligible to act as a trustee of any mutual fund.
2. No person who is appointed as a trustee of a mutual fund can be appointed as a trustee of any other mutual fund unless–
   (a) such a person is an independent trustee, and
   (b) prior approval of the mutual fund of which he is a trustee has been obtained for such an appointment.

Rights and Obligations of the Trustees

1. The trustee have right to obtain from the AMC such information as is considered necessary by the trustees.
2. If the trustees have reason to believe that the business of the Mutual Fund is not conducted in conformity with the SEBI Regulations, they shall take remedial steps to rectify the situation and keep SEBI informed of the violation and the action taken by them.
3. The trustee shall ensure that the transaction entered into by the AMC are in accordance with the provisions of the SEBI Regulations.
4. The Trustees shall be accountable for and be the custodian of the property of the respective schemes and shall hold the same in trust for the benefit of the unit holders in accordance with the SEBI Regulations and provisions of the trust deed.
5. The Trustees shall be responsible for calculation of any income due to be paid to the Mutual fund and also of any income received in the Mutual fund for the holders of the units of any scheme in accordance with the SEBI regulations and the Trust deed.
6. The trustees shall every quarter review all transaction carried out between mutual funds, AMC and its associates.
7. The trustees shall every quarter review the net worth of the AMC and in case of any shortfall, ensure that the AMC makes up the shortfall as per SEBI Regulations.
8. Each Trustee shall file the details of his transactions of dealings in securities with the Mutual fund on a quarterly basis.
9. **Report to SEBI :** The Trustees shall furnish to SEBI on an half yearly basis –

   (a) a report on the activities of the Mutual fund.
   (b) A certificate regarding taking care of the interests of the unit-holders.
   (c) The independent trustees referred to shall give their comments on the report received from the AMC regarding the investments by the mutual fund in the securities of group companies of the sponsor.

Write a note on Due Diligence to be observed by Trustees.

Due Diligence by Trustees

A. General Due Diligence

(i) The Trustees shall be discerning in the appointment of the Board of the AMC.
(ii) The Trustees shall review the desirability of continuance of AMC if substantial irregularities are observed in the schemes and if necessary they shall not allow the asset management to float new schemes.
(iii) The trustees shall ensure that the trust property is properly held and administered by proper persons and by a proper number of such persons.
(iv) The trustees shall ensure that all service providers are holding the registrations from SEBI or concerned regulation authority.

(v) The trustees shall arrange for test checks for service contracts.

(vi) The Trustees shall immediately report to SEBI of any special development in the mutual fund.

B. Specific Due Diligence

The trustees shall

(i) obtain internal audit reports at regular intervals from independent auditors appointed by the Trustees;

(ii) obtain compliance certificates at regular intervals from the asset management company;

(iii) hold meeting of trustees more frequently;

(iv) consider the reports of the independent auditor and compliance reports of asset management company at the meetings of trustees for appropriate action;

(v) maintain records of the decisions taken of the minutes of the meetings;

(vi) prescribe and adhere to a code of ethics by the Trustees, asset management company and its personnel;

(vii) communicate in writing to the asset management company of the deficiencies and checking on the rectification of deficiencies.

Define AMC. What are the conditions to be fulfilled by an AMC?

Asset Management Company (AMC)

Eligibility: A company formed and registered under the companies Act, 1956 and which has obtained the approval of SEBI to function as an Asset Management company (AMC) may be appointed by the sponsor of mutual fund as such. If the trust deed of a mutual fund authorises the trustees, the latter shall appoint the AMC. Any change in the appointment of AMC shall be subject to prior approval of SEBI and unit holders.

Conditions to be fulfilled by an AMC

1. Any director of the AMC shall not hold the place of a director in another AMC unless such person is an independent director referred to in clause (d) of sub-regulation (1) of regulation 21 of the Regulations and approval of the Board of AMC of which such person is a director, has been obtained.
2. No appointment of a director of an asset management company shall be made without the prior approval of the trustees.
3. The AMC shall forthwith inform SEBI of any material change in the information or particulars previously furnished which may have a bearing on the approval granted by SEBI.
4. The AMC undertake shall to comply with SEBI (Mutual Funds) Regulations, 1996.
5. No change in the controlling interest of the AMC shall be made without the prior approval of the trustees and SEBI is obtained :

(i) a written communication about the proposed change in sent to each unit holder and an advertisement is given in one English daily having nation wide circulation and in a newspaper published in the language of the region where the head office of the mutual fund is situated.

(ii) the unit holders are given an option to exit at the prevailing Net Asset Value without any exit load.

(iii) the AMC shall furnish such information and documents to the trustees as and when required by the trustees.

What are the obligations of an AMC?

Obligations of the Asset Management Company

- The AMC shall manage the affairs of the Mutual Fund and operate the schemes of such fund.
- The AMC shall take all reasonable steps and shall exercise due diligence to ensure that the investments of the mutual funds pertaining to any scheme are in accordance with SEBI Regulations and the Trust-Deed.
- The AMC shall exercise due diligence and care in all its investment decisions as would be exercised by other persons engaged in same business.
- The AMC shall be responsible for the acts of commissions and omissions by its employees or other persons whose services have been obtained by that company.

What is a custodian? Who is a Depositor? Explain.

Custodian and Depositories

Custodian is a person appointed for safe keeping of the securities. Mutual funds deal with buying and selling of large number of securities. AMC appoints a custodian for safe keeping of those securities and for participating in clearing system on its behalf. In case of dematerialised securities, holdings will be held by Depository through a Depository Participant.

Mutual fund shall appoint a custodian to carry out the custodial services for the schemes of the fund and send intimation, to RBI within 15 days of the appointment of the custodian.

Mutual fund shall enter into a contract with the custodian. The contract shall contain the clauses for the efficient and orderly contract of the affairs of the custodian.

Who shall appoint Bankers to a mutual fund?

Bankers

AMC shall appoint Bankers to the mutual fund. They provide banking facilities like receiving the proceeds of investments, enchasing high value cheques, giving multi city cheque book facilities etc.

V. MUTUAL FUND SCHEMES

Mutual Fund Scheme

Open | **Load** | **Tax exempt**

Broadly, Mutual Funds can be classified under the following 3 heads –

I. Basic classification

1. Open – ended and Close-ended funds

Under the open ended mutual fund scheme the units of mutual fund are sold & repurchased to the mutual fund on a continuous basis. These sales and repurchases of units take place at a price called Net Assets value (NAV), which is calculated periodically on the basis of market value of the portfolio of the mutual fund.

The US-1964 is an open – ended mutual fund scheme.

On the other hand, close-ended mutual fund scheme is one in which the limited number of units are sold to investors during a specified period only. Thereafter, any transaction in these units can take place only in secondary market i.e. stock exchanges. So, after the initial public offering (IPO), the mutual fund goes out of the picture and subsequent sale and purchase takes place among the investors.

The market price of a closed-ended mutual fund scheme is determined by the market forces of demand and supply. (For any inquiry or admission to kalpesh classes dial 2382 0676)

The liquidity to the investors is provided by the market. However, all the close-ended schemes are redeemable at the end of a specified period when all the investments of the scheme are sold and the proceeds are distributed among the unit-holders on a proportionate basis. The UTI-Master gain scheme – 1992 was started initially as a closed-ended mutual fund.

2. Load Funds and no Load Funds

A mutual fund can recover the initial marketing expenses (loads) in any of the following ways –
(a) by deducting front end or entry load.
(b) by deducting deferred load.
(c) by deducting back end or exit load.

The load amount charged to the scheme over a specified period is called deferred credit.

SEBI has fixed the maximum amount of load that can be charged by the fund managers.

There are some no-load funds also. It means that the fund will not charge any sales expenses. However, they still charge management fee and other recurring expenses. The investors in a no load fund enters or exists at the net NAV of the fund.

3. Tax Exempt vs. Non Tax Exempt Funds

If a fund invests in a tax exempt security it is called as a Tax exempt fund.

II. Further

Mutual funds are distinguished from each other or classified on the investment objective as following basis –

(a) **Growth funds –** Growth fund is one which offers capital appreciation as well as a variable dividend opportunity to the investors. The investors may get dividend income from a mutual fund on a regular basis and the capital appreciation is available in the form of increase in market price.

(b) **Income funds –** The mutual funds are called income funds when they promise a regular and/or guaranteed return in the form of dividends to the investors. For example, UTI has launched several monthly income schemes. The portfolio of these schemes is usually consisting of fixed income investments such as bonds/debentures etc. They are also called as **debt funds.** Debt funds are again divided into the following categories–
   (i) Money market funds – The funds collected by these mutual funds are invested exclusively in money market instruments.
   (ii) Gilt funds.
   (iii) Bond funds.

(c) **Balanced funds –**These funds combine the objectives of earning current income and capital appreciation. Their portfolios consist of both equities and bonds.

(d) **Tax Saving Funds –** These schemes are basically growth schemes which offer rebates to investors under the Income Tax Act. These funds help in tax planning to the investors.

III. Further classification is based as follows:-
Investment type

- A mutual fund may invest in either money market instruments, equity funds or bonds. Accordingly they are called money market funds, gilt funds, debt funds and equity funds.
- Money market funds invest in short-term securities. It means securities of less than one year maturity. These include Treasury Bills, commercial papers, certificate of Deposits, etc.
- Gilt Funds are government securities with medium and long range maturity. These funds have low default risk.
- Debt Funds invest in debt instruments issued not only by governments, but also by private companies, banks, financial institutions and other entities such as infrastructure companies.

- Equity Funds have high level of risk. These funds invest a large part of their corpus in equity shares acquired IPO or in the secondary market.
- Bond Funds invest in corporate bonds, etc.

Explain the various aspects relating to the operation of a mutual fund.

VI. OPERATION OF MUTUAL FUND

The operation of mutual funds generally includes the following heads –

1. Investment Valuation:

Traded securities – Traded securities should be valued at the last quoted closing price on the stock exchange. If the securities are traded on more than one stock exchange then the valuation should be as per the last quoted closing price on the stock exchange, where the security is principally traded. When on a particular valuation date, a security has not been traded on the selected stock exchange, the value at which it is traded on another stock exchange may be used.

Untraded securities – Untraded securities are valued by the SEBI's principles of valuation.

Non-traded securities – When a security in not traded on any stock exchange for a period of sixty days prior to the valuation date, the scrip must be valued as a non-traded scrip i.e., They should be valued in 'good faith' by the AMC on the basis of an appropriate valuation method. The method must be approved by the Board of the AMC.

2. Pricing of Units:

The mutual fund shall provide the investors the price at which the units of the scheme may be subscribed. In case of open-ended scheme, the mutual fund shall publish at least once in a week in a daily newspaper national, the sale and repurchase prices of units. Every mutual fund shall compute the NAV of each scheme by dividing the net assets of the scheme by the number of units outstanding in the valuation date. The NAV shall be calculated and published at least in two daily newspapers at intervals not exceeding one week.

3. Dividend Distribution:

Every mutual fund and AMC shall dispatch to the unit holders the dividend warrants within 42 days of the declaration of the dividend. It should dispatch the redemption or repurchase proceeds within 10 working days from the date of redemption or repurchase. It is liable to pay interest to the unit holders @ 15% per annum, in case of any default.

4. Apportionment of Expenses:

An AMC incurs various expenses such as initial expenses, recurring expenses and investment management and advisory fees. Whatever be the expenses, it should clearly identify all the expenses and apportion them in the individual schemes.

5. Advertisement of schemes

The advertisement relating to any scheme of the Mutual Fund must comply with the provisions of Advertisement code prescribed by SEBI. The advertisement shall be submitted to SEBI within 7 days from the date of issue. The Advertisement for each scheme shall disclose investment objective of each scheme.

Some of the important points of the Advertisement code are –

(a) It should be truthful, fair and clear.

(b) It shall not contain a statement, promise or forecast which is untrue or misleading.

(c) It shall not contain statements which directly or by implication or by omission may mislead the investor.

(d) It shall not be framed so as to exploit the lack of experience or knowledge of the investors.

(f) It shall not contain information, the accuracy of which to any extent depend on an assumption.

(g) It should not contain comparisons of one fund with another, unless the comparison is fair.

(h) If it gives the Mutual Fund's guarantee or assurance of any minimum rate of return or yield to prospective investors, it should also indicate the resourc es to give such a guarantee.

(i) All advertisements shall clearly state all the risk factors associated with Mutual Funds and Securities.

6. Investment Approaches

Top-down approach – It begins by analysis of the national and international market environment through quantitative forecasting and scenario planning. Top-down approach helps in long term investment goals.

Bottom-up approach – It begins with the analysis of the concerned company. Bottom-up approach is utilised for short-term or speculative gains.

Institutions like mutual funds would benefit by top down approach because –

(a) They have long-term investment goals, and

(b) Their portfolio includes a variety of assets with different degree of risks.

7. Offer Document

Before launching any scheme, such scheme should be approved by the trustees and then a copy of offer document should be filed with SEBI.
In case of close-ended scheme, the offer document is issued only once at the time of issue whereas in the case of open-ended scheme, it is valid for all the time or till amended. It is called as **key information memorandum** and it is a most important document for investors. It contains details of AMC, sponsors, bankers, registrars, etc along with the terms and conditions of the issue.

Define NAV

VII. NET ASSET VALUE (NAV)

The NAV of a mutual fund scheme may be calculated by dividing the net assets of the scheme by the number of outstanding units under that scheme on the date of valuation. The investors' subscription is treated as the unit capital in the balance sheet of the fund and the investments on their behalf are treated as assets.

Fund's Net Assets = Assets less liabilities

$$\text{NAV} = \frac{\text{Net Assets of the scheme}}{\text{Number of units outstanding}}$$

Net Assets of the scheme = Market value of Investments + Receivables + other accrued income + other assets – Accrued expenses – other payables – other liabilities.

State the restrictions & limits subject to which Mutual fund money can be invested.

VIII. RESTRICTION ON INVESTMENT OF MUTUAL FUND MONEY

1. The moneys collected under any scheme of the Mutual Fund can be invested only in transferable securities in – (a) the money market (b) the capital market (c) privately placed debentures and (d) securitised debts.
2. Moneys collected under any money market scheme of a mutual fund shall be invested only in money market instruments.
3. In case of securitised debts, such fund may be invested in asset-backed securities and mortgage – backed securities.
4. A mutual fund scheme shall not invest more than 15% of its NAV in debt-instruments issued by a single issuer which are rated not below the investment grade by a credit-rating agency.
5. A mutual fund scheme shall not invest more than 10% of its NAV in unrated debt instruments issued by a single issuer and the total investment in such instrument shall not exceed 25% of the NAV of the scheme.

6. No mutual fund shall invest more than 10% its NAV in the equity shares of any company. (The limit is not applicable for investments in case of index fund or sector or industry specific scheme).
7. A mutual shall not invest more than 5% on its NAV in the unlisted equity shares in case of open-ended scheme and 10% of its NAV in close-ended scheme.
8. No mutual fund scheme shall make any investment in -
   (a) any unlisted security of an associate or group company of the sponsor.
   (b) any security issued by way of private placement by an associate or the group company of the sponsor.
   (c) The listed securities of group companies of the sponsor which is in excess of 25% of the net assets.
9. Investment in ADR/GDRS : All mutual funds will be permitted to invest in ADRs/GDRs upto 10% of the net assets managed by them as on the date of the last Balance sheet, subject to maximum of US $50 million per mutual fund. They will have to obtain prior approval from RBI to invest in overseas market.
10. Index Funds – The investment by index fund shall be in accordance with the weightage of the scrips in the specific index as disclosed in the offer document.

Limits on Investments

The mutual funds have the following maximum investments limits

(a) The mutual funds under all the schemes should not own more than ten percent of any company's paid up capital carrying voting rights.

(b) Aggregate inter scheme investment made for all schemes under the same management or in scheme under the management of any other AMC shall not exceed 5% of the NAV of the mutual fund.

(c) A mutual fund can invest in short term deposits of scheduled commercial banks, pending deployment of funds of a scheme in terms of investment objectives.

What are the rights & the obligations of a Mutual fund investor?

IX. INVESTORS RIGHTS AND OBLIGATIONS

Investor Rights:

1. The unit holders have a proportionate right in beneficial ownership of the schemes assets as well as any dividend or income declared under the scheme.
2. They have the right to information regarding any adverse happening.
3. They are entitled to receive dividend warrants within 42 days of the date of dividend declaration.
4. AMC can be terminated by 75% of the unit holders of the scheme present and voting at a special meeting.
5. The holders have the right to inspect major documents of the fund.
6. With the consent of 75% of the unit holders they have the right to approve any changes in the close-ended scheme.
7. Every unit holder has to receive a copy of the annual statements and periodic statements regarding his transaction.

Investor's Obligations

1. An investor should carefully study the risk factors and other information provided in the offer document.
2. It is the responsibility of the investor to monitor his schemes by studying the reports and other financial statements of the funds.

What are the steps to be taken by mutual funds to improve disclosure and compliance standards?

Steps to be taken by all mutual funds for improving the disclosure and compliance standards

1. All mutual funds should disclose full portfolio of their schemes in the annual report within one month of the close of each financial year. Mutual funds should either send it to each unit holder or publish it by way of an advertisement in one English daily circulating in the whole of India and one Regional language.
2. The AMC must prepare a compliance manual and design internal audit systems including audits systems before the launch of any schemes. The trustees are also required to constitute an audits committee of the trustees which will review the internal audit systems and the recommendation of the internal and statutory audit reports and ensure that the rectifications ad suggested by internal and external auditors are acted upon.
3. The AMC shall constitute an in house valuation committee consisting of senior executives including personnel from accounts, fund management and compliance departments. The committee would on a regular basis review the system and practices of valuation of securities.
4. Trustees shall review all transactions of the mutual fund with the associates on a regular basis.

X. CRITERIA FOR EVALUATING PERFORMANCE

Explain:

a. Sharpe Ratio
b. Treynor Ratio
c. Jensen's Index
d. Expenses Ratio

1. SHARPE RATIO

$$\text{Sharpe ratio(S)} = \frac{\text{Returns of Portfolio} - \text{Return of Risk-free investment}}{\text{Standard Deviation of Portfolio (Portfolio's total risk)}} \quad \textbf{OR} \quad \frac{rp - rt}{\sigma_P}$$

The sharpe ratio is often used to rank the risk-adjusted performance of various portfolios over the same time. Higher the sharpe ratio, the better the portfolio's returns have been relative to the amount of investment risk.

Advantage of Sharpe ratio:

It uses the volatility of portfolio return instead of measuring the volatility against a benchmark (i.e. index).

Disadvantage of sharp ratio:
It is just a number and is meaningless unless compared with several other types of portfolios with similar objectives.
Example: In one year time period an index fund earned 11%, Treasury bills earned 6% and the standard deviation of the index fund was 20%.

Sharp Ratio (S) = (11-6)/20 = 25%

2. TREYNOR RATIO

$$\text{Treynor Ratio(T)} = \frac{\text{Return of Portfolio} - \text{Return of Risk-free investment}}{\text{Beta of portfolio}} \quad \textbf{OR} \quad \frac{rp - rt}{\beta_p}$$

This ratio is the ratio of fund's average excess return to the Fund's beta. It measures the returns earned in excess of those that could have been earned in a riskless investment per unit of market risk assumed.

The absolute risk adjusted return is Treynor + Risk free rate

Example:

	Portfolio A	Portfolio B
Return	12%	14%
Beta	0.07	1.2
Risk-free rate	9%	9%
Treynor Ratio (t)	$\frac{0.12-0.09}{0.07}$ = 0.043	$\frac{0.14-0.09}{1.2}$ = 0.04
Risk adjusted rate of return	0.043 + 0.09 = 13.3%	0.04 + 0.09 = 13%

Hence, on the basis of risk adjusted rate of return, portfolio A is better.

3. JENSEN'S ALPHA

This is the difference between a fund's actual return and those that could have been made on a benchmark portfolio with the same risk – i.e. beta. It measures the ability of active management to increase returns above those that are purely a reward for bearing market risk.

Example:

	Portfolio A	Market Return
Return	12	12
Beta	0.7	1.0
Risk-free rate = 9%		

Expected return on portfolio A = Risk free return + Beta portfolio (Return of market – riskfree return)
= 0.09 + 0.7 (0.12 – 0.09)
= 11%

Alpha = Return of portfolio – Expected return
= 0.12 – 0.11 = 1%

4. Expenses Ratio

It measures the percentage of expenses that were spent to run a mutual fund it includes expenses like management and advisory fees, travel costs, consultancy fees, etc. It does not include brokerage costs for trading the portfolio. It is also referred to as Management Expenses Ratio (MER).

Give the checklist for compliance by Mutual funds, AMC, Trustees & Custodian.

XI CHECKLIST FOR COMPLIANCE – IMPORTANT POINTS

The following schedule may help a Mutual Fund, Asset Management company, Trustee or Custodian in complying with the SEBI (Mutual Funds), regulations, 1996.

Mutual Fund

1. Is it established as a Trust by a sponsor i.e., a body corporate alone or in combination with another body corporate and having a sound track record and experience?
2. Has the Mutual Fund appointed a Trustee to manage the Fund? Has the sponsor executed trust deed in favor of the trustees?
3. Has it or the Trustees, if authorised by trust deed, appointed an Asset Management Company approved by SEBI to manage its affairs and operate the Fund's schemes?
4. Does the sponsor hold at least 40% of the networth of the Asset Management Company?
5. Does the Trustees fulfil the requirements stipulated by SEBI?
6. Has it appointed a custodian approved by SEBI to carry on the activity of safe keeping of the securities or participating in any clearing system on behalf of the Fund?
7. Has it distributed surplus to its unit holders in accordance with the regulations?
8. Has it published its scheme wise Annual Report or an abridged summary by means of an advertisement within six months from the date of closure of its financial year?
9. Has it published its half-yearly results through an advertisement within two months of close of each half-year?
10. Whether such an advertisement has been published in one english newspaper circulating in the whole of India and in a newspaper published in the language of the region where the Head Office of the Mutual Fund is situated?
11. Has it sent to SEBI a copy of the Annual Report and details of investments and deposits held by the Mutual Fund, within six months from the closure of each financial year?

Asset management company

1. Is it a Company registered under the Companies Act, 1956?
2. Does it comply with SEBI requirements?

3. Has it obtained SEBI's approval?
4. Have the Trustees of the Mutual Fund entered into an Agreement with the AMC to regulate the investments of the Mutual Fund?
5. Has it got the schemes of the Fund approved by the Trustees and SEBI?
6. Has it obtained SEBI's approval for the Offer document or brochure or any advertisement material relating to the schemes of the fund?
7. Whether the investments made by the Fund comply with the stipulations laid down by SEBI?

Custodian

1. Whether the SEBI requirement as regards custodian been complied with?
2. Whether SEBI's approval for such an appointment been obtained?

Trustees

1. Does the appointment as Trustee of a Mutual Fund meet with SEBI's requirements?
2. Has a trust deed been executed by the sponsor of the Mutual Fund in favour of the Trustees?
3. Have they appointed the Asset Management Company of the Fund, if authorised by the trust deed?
4. Have they entered into an agreement with the AMC called Investment Management Agreement to regulate the investment of funds of the Mutual Funds?
5. Have the Trustees approved the schemes of the Fund proposed by the AMC?

In case of winding up of a scheme of a Mutual Fund, has the Trustee given a notice to SEBI and in two daily newspapers circulating all over India and in a vernacular newspaper circulating in the place where the mutual fund is established?

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12

BUSINESS VALUATION

An Overview

Preliminery

Golden Rules of Valuation

Key Drivers of Valuation

1. *Purpose of valuation*
2. *Industry and company for valuation*
3. *Macro factors related to business*
4. *Micro factor related to business*
5. *Valuation for buyer/seller*
6. *Time for valuation*
7. *Regualation*

Types of Values

- *FMV*
- *Investment /Opportunity value*
- *Replacement/ cost to create value*
- *Intrinsic value*
- *Relative value*
- *Going concern value*
- *Liquidation value*
- *Brand/Godwill value*
- *Book value*
- *Net assets value*
- *Ball park/Ball Mark value*
- *Benchmark value*
- *Salvage Value*
- *Scrap value*

Valuation flow

Types of Property that can be valued

Tangible asset

Intangible asset
Business

Principles of valuation theory

Principles of Alternatives
Principle of Replacement
Principle of Substitution
Principle of Future Benefits

Methods of valuation

Income based Approach

Capitalisation
Profit Earning Capacity value
Discounted cash flow - WACC – cost of equity and terminal value

Theoertical approaches

- *Replacement value*
- *Liquidation value*
- *Practical approach*
- *Growth based*

Market Related Approach

Market value
Comparable company

Assets based Valuation

1.Replacement
2.Liquidation
3.Net Assets Value

Relative strengths and weaknesses of valuation methods

I. PRELIMINARY

Why is business valuation important in today's commercial scenario?

Liberalisation has compelled many business houses to realign their activity focusing on their core competence established over the years by practice. In wake of aligning business activities in line with the prime objective of creating shareholders value has propelled large organizations to make strategic decisions like acquisitions, takeovers, mergers, hive offs, divestitures, strategic investments etc., (For any inquiry or admission to kalpesh classes dial 2382 0676)

In all these strategic decisions one common thing that assumes a very critical proposition at the heart of all processes is called "Business Valuation". Many deals just could not be carried to their logical conclusion due to differences over valuation matter.

E.g. MRPL-AV Birla sale of share deal hanged over years, TATA Hughes Telecom merger was called off for valuation differences.

Jot down the Golden Rules of Valuation

II. GOLDEN RULES OF VALUATION

Following are some golden rules of valuation to be noted before touching the vast subject of valuation-

- It is an art and not science.
- It is subjective in nature and depends upon the perceptions & skills of valuer.
- It is in reference to time and even single person can have different values at different times.
- More the objective data lesser the subjectiveness.
- Price and value are not the same even though sometimes wrongly inter-changed. Price is what paid for deal and valuation is what lies in the eyes of payer.
- It is a tool and used as a basis in strategic decision.
- It involves application of theory and practice.

Above golden rules are applicable in all the circumstances of business valuation and the gravity may differ from one valuation to other.

Explain the key Drivers of Valuation

III. KEY DRIVERS OF VALUATION

Valuation is not an independent concept as such and depends upon number of factors related with the business unit.
Following are key drivers of valuat ion.

1. Purpose of valuation
The purpose of valuation will affect the whole valuation process and application of methodology.

i. Majority stakeholders Vs. Minority
ii. Buyer Vs. Seller
iii. Acquisition Vs Treasury Investment
iv. Legal Vs commercial

2. Industry and company for valuation

i. New economy Vs Old economy
ii. Emerging Vs Dying Sector
iii. Structured business models Vs Traditional outfit
iv. Manufacturing Vs Service sector

3. Macro factors related to business.

i. Economic scenario
ii. Investment patterns in sector
iii. Governments' role
iv. Financial Institutions' and Bankers' Roles

4. Micro factors related to business.

i. Cycle of business
ii. Matured /saturated
iii. Growing
iv. Stable
v. Non-predictable

5. Valuation for buyer/seller.

i. Future benefits Vs past profits.
ii. Forced Vs Commercial

6. Time of Valuation

Boom period Vs Gloomy industry scenario.

7. Regulation

i. Listed company share acquisition-Takeover Regulations
ii. Listed company-Buyback-SEBI Buyback Norms.
iii. Banking Mergers-RBI Role

What are the types of values used in Business Valuations?

IV. TYPES OF VALUES OR VALUATION JARGONS

- **Fair Market Value**
  Referred to as exchangeable value between knowledgeble buyer and seller at arms length prices (more relevant in developed economy where markets are more developed and informed)

- **Investment Value / Opportunity cost Value**
  In buyers' eyes, it is value of losing an opportunity to invest in other similar investment. It is also referred as value to be paid for obtaining future benefits.

- **Replacement value / cost to create value**
  It is the replacement value of similar asset in same condition. It is also referred to as cost to create approach in valuation jargon. (highly theoretical and limited application in practice).

- **Intrinsic value**
  It is total value of business after taking into account all hidden and latent facts into account. In practice it is misinterpreted with investment value.

- **Relative Valuation**
  Relative Valuation is a commonly used term in merger valuation. It is not an absolute value of shares but a relative value to the merger of two companies where value is placed in terms of **exchange ratio** and not in terms of cash outflow or absolute cost.

- **Going concern value**
  It refers to valuation carried out under the apparent assumption that business will never die regardless of period. The procedure of establishing the going concern value usually consists of two steps –

  (i) projection of maintainable income
  (ii) maintainable income is translated into a going concern value by applying a suitable capitalization factor.

- **Liquidation value**
  It is valued in the course of liquidation and future benefits are irrelevant from valuation angle, even though buyer may have future benefits. From the standpoint of the value of a business, the lowest possible value is its liquidation value.

- **Brand / Goodwill Value**
  It is the value of intangible whether appearing in the books or not. In strategic deal it is one of the factors while determining the premium to be paid for transferring controlling stake. The value of goodwill is calculated as the difference between the price paid for an acquired business and the fair market value of assets acquired net of the liabilities.

- **Book Value**
  It is simply the book value as per audited accounts of company. It may not reflect the true economic value of assets and may be affected by accounting policies and management thinking. In an accounting sense, it is also called networth or book equity.

- **Net Assets Value**
  It is Net asset value of company and all accounted and non-accounted items affecting valuation are taken into account. e.g., Contingent liabilities are to be estimated for deducting from net worth available for equity stakeholders.

- **Ballpark / Ball mark Value**
  It is a rough value based on the judgment and perception of valuer. It is an estimated valuation range done before starting actual precise valuation. It is frequently used in initial stages of valuation process.

- **Benchmark Value**
  This term is referred to as the comparative company valuation approach, where comparative companies are used for justifying the values placed on valuing company. It is adjusted for a number of reasons and for the differences between two companies. It is more frequently used in developed market and a lot depends upon the availability of comparable companies.

- **Salvage Value :** It is the amount realisable upon sale or other disposition of an asset after it is no longer useful to the current owner and is to be taken out of service.

- **Scrap Value:** In this case the asset is no longer useful at all (for current owner & others too) Accordingly amount realisable from its disposal is scrap value.

V. VALUATION FLOW HIGHEST TO LOWEST

In valuation one may keep in mind that in general circumstances valuation flows in following manner from highest to lowest.

Replacement
↓
Profit Based
↓
Assets Based
↓
Liquidation Value

Above flow is indicative one and a guide to avoid wrong conclusion. But it should be noticed that this may not hold true in all conditions and in peculiar circumstances flow may be broken.

E.g. If company like RPL commissioned in 1998 valued on 1.4.1999, then in those circumstances it was highly probable that profit based value would have been much lower than the assets value due to longer break even, gestation period and huge assets value in initial years.

What are the properties for which values can be assigned?

VI. TYPES OF PROPERTIES THAT CAN BE VALUED

1. **Tangible Asset –** These are “hard” assets that have physical shape and substance e.g., buildings, equipment.
2. **Intangible Asset –** These assets have no physical existence, but an important contributor to success of business.
   e.g., Goodwill, brand, etc.

3. **Business –** It is a combination of the tangible and intangible assets. While valuing business, it is valued as a combination of tangible and intangible assets functioning with unity of use. Value of business > sum total of value of Tangibles & Intangibles.

Explain the principles of Valuation.

VII. PRINCIPLES OF VALUATION THEORY

1. **Principle of Alternatives –** It states that in any contemplated transfer of ownership, both the buyer and the seller have alternatives to consummation of the transaction. In other words, a seller is not forced to sell to a given buyer and a buyer is not forced to buy from a given seller.

2. **Principle of Replacement –** It states that a prudent buyer will pay nothing more for a property or asset than cost necessary to reproduce one of equal utility. The application of this principle to a total business is much more difficult, since the estimation of costs required to replace a business would be very complex.

3. **Principle of Substitution –** It states that the value of property or asset tends to be determined by the cost that would be incurred to acquire an equally desirable substitute. It is an extremely important concept of valuation and forms the theoretical base for market approach to valuation.

4. **Principle of Future Benefits –** It states that the value of a property or asset reflects anticipated future economic benefits from ownership or control of that property or asset. It means value of a business is the NPV of all the benefits attained as a result of ownership of that business.

Explain the approaches of valuation

VIII. APPROACHES/METHODS OF VALUATION

As we have discussed any particular valuation method or approach is not standardized as industry specific or objective specific, using a particular approach is circumstance specific. There are following three broad approaches followed in practice-

1. INCOME BASED APPROACH

Fundamental logic behind this concept is that values of businesses are determined by their profitability and not by the underlying assets. It has three prime methodologies-

a. Capitalisation Method -

- Based on past profitability normally three-four years.
- Remove extraordinary/exceptional items/years while considering normal profits/years. e.g., exceptional year due to losses, extraordinary expenses like VRS.
- Assign proper weightage in ascending order if profits are growing/falling
- Consider the effective average tax rate applicable to company.

- Deduct the preferential claims like preferential dividend from profit after tax.
- Surplus assets or non-trade investments to be valued and net gain shall be considered before capitalization.
- Take the proper capitalisation rate as denominator or P/E multiple as numerator applicable to industry or comparative companies.

It is to be noted that capitalization factor or P/E is most critical in above method and any slight variation will give huge differences in the results.

Capitalisation factor or P/E multiple denotes that potential buyer is willing to invest a particular sum to earn particular profit.

b. Profit Earning Capacity Value (PECV)

It is more or less similar to capitalization method and preferred over capitalization method for its superiority-

- Future profit is considered, which is more relevant to potential buyer.
- Estimating future profit is key to use this method.
- Assigning proper weightage.
- Appropriate average tax rate applicable during projected years.
- Reducing preferred right from profit after tax.
- Non-trade investments and surplus assets to be valued separately as on date of valuation. (It is called unlocking the value and take hypothetical gain- net of tax)
- Capitalisation or P/E multiple applicable to industry or comparative companies.

c. Discounted Cash Flow (DCF) Approach

It is most admired and used method of valuation in practice. It is superior to other two profit based methods as it considers the time value of money.

Key factors in Valuation

- Estimating future cash flows.
- Estimating changes in requirement for working capital/regular fixed assets on either side (that is, increase or decrease.)
- Estimating capital expenditure plans during projected period.
- Estimating the cost weighted average of capital for total capital.
- Estimating terminal value
- Estimating surplus assets/non-trade investment (Hypothetical gain net of tax)

Steps from chap M&A

All above steps will give you enterprise value and after deducting long term debt will give your shareholders value. Further to get quality shareholders value preference share capital is to be deducted. (To know more about us visit KalpeshClasses.com)

All above factors are sensitive and mistake in judging any single factor may lead to wrong conclusion.

Two approaches the find Discounting rate (from Chap M&A)

(a) Weighted Average cost of Capital (WACC)

Total capital structure comprises of different instruments carrying different costs on them. Cost of each capital is relative to each other in total capital structure and varies with different capital mix.

I. Cost of equity

In practice while calculating cost of equity Capital Assets Pricing Model (CAPM) is used.

Cost of equity = rf+(rm x â) Ce = rf + (rm x b)

Risk free rate of Return (rf) – Returns on risk free securities are taken into account. Generally interest rate on government securities or central bank securities is taken as risk free by assuming that sovereign risk of country is least in relation to any other security.

Interest rate differs with maturity period and depends upon purpose of valuation. e.g., for general investment valuation 90 days treasury bills of RBI can be used, whereas for strategic investment valuation 10 years treasury bonds of RBI are more relevant.

Risk Premium (rm) – It considers the risk associated with individual investment decision, company and industry. Generally it is taken as difference between expected returns (opportunity cost of capital) from particular investment and risk free rate of return.

E.g., - Risk in IT or IT enabled services differ from the one in cement industry.

Beta (â) – It considers the sensitivity associated with the particular company, that is, how & to what extent a company's stock reacts to standard stock exchange index.

Generally to reduce the speculation effect (unsystematic risk) from particular scrip, industry beta or comparative companies' composite beta is taken into account.

If sensex moves up by 10% and particular stock moves only by 5% then its beta will be 0.5. Generally previous one year movements are considered for calculations.

II. Cost of Debt

Explain Terminal value.

What do you understand by the term? Give 4 approaches of calculating the Terminal Value.

Limitation of DCF

Four ways of Calculating of Terminal Value (Chap M&A)

(i) Estimating the capital expenditure (capex) is subjective with management perception.
(ii) Assumption of same debt equity ratio will prevail in future year is a theoretical concept.
(iii) Judging the explicit period is again subjective, even though it doesn't affect the actual valuation.
(iv) Calculation of terminal value with correct approach is again subjective and depends upon authentic objective data about future.

Terminal Value

It is to be noted that no projection can be made for an infinite period even though corporates are immortal in nature. In fact considering ever changing business dynamics will never allow projecting beyond 10 years. At the same time DCF assumes going concern assumption. Terminal value is improvisation to take care of this aspect.

It is to be noted that in 99% cases terminal value will be more than total net present value of explicit/projected period in total value available for capital providers.

There are four approaches of calculating terminal value –

Theoretical Approaches

1. **Replacement Value –** This value probably would prevail at the end of explicit period in case new similar kind of business/plant is to be erected at that time. It is highly

theoretical aspect of terminal value and can be used only in case of standard cyclic industry.

2. **Liquidation Value –** This value would prevail at the end of explicit period in case business is liquidated. But it does not assume any importance in DCF approach as it violates basic principle of going concern assumed while calculating value under DCF approach.

3. **Practical Approach - Price Earning Multiple -** It is a most commonly deployed method for arriving at terminal value in DCF approach due to suitability and availability of multiple.

   But it has its own limitation, as judgment is required to adjust the current P/E to the tune of end year in explicit period. e.g. P/E of 10 prevailing on valuation date may go to 15 at the end of explicit period and very much depends upon growth. Then 15 will be right P/E for getting the terminal value.

4. **Growth Based –** This is most sound approach of terminal value as it is based on stable growth rate, which can be maintained beyond explicit period and cost of capital of company.

Terminal Value = (NPV + 1)/ (WACC-Sg)

This formula work on concept of super growth rate in cash flow. It is assumed that company will be able to maintain growth at least to the extent of its cost of capital (WACC) and industry will be growing at stable growth (Sg). Difference between these two signifies that super growth maintained by the company over industry as whole.

Net present value (NPV) at the end of explicit period is capitalized from immediately next year (1 is added for the same) with super growth.

To use this formula it is very critical that stable growth of industry after explicit period is required to be predicted.

2. MARKET RELATED APPROACH

It comprises fundamentally of two methods

a. Market Value Methods -

This method is applicable in case of listed companies and frequently used in practice. Generally stock prices of previous 52/26 weeks are used by averaging high and low during the weeks selected. It is further refined with weighted average high and low prices by using stock volume in given week.

It is most frequently used method in practice for following reasons-

- Prices are determined by masses and hence take away the subjectivity of value involved in other method.
- Market prices are drivers by future expectation and hence valuations are based on projection only.

b. Comparable company Approach

In this method of valuation certain parameters of comparable companies are used. This method is more used for negotiation purpose rather than actual valuation. It acts as benchmark valuation.

Sometimes comparable transactions are also used for negotiation as benchmark for the past accepted transaction. e.g., growing IT company may refer to market capitalization of grown company in same business segment for valuing their own future valuations. Or Premium paid in Grasim-L&T deal can be used as benchmark for other similar transactions in future.

3. ASSETS BASED VALUATION

It comprises mainly three methods-

a. Replacement Value –
b. Liquidation Value –
c. Net Asset Value -

This is a frequently used method in conjunction with profitability and market value method.
It gives the minimum negotiation basis in deal structuring although profitability methods are main drivers of valuation.

While valuing assets under this approach they are divided in to operating assets and non-operating assets (surplus assets). Non-operating assets are valued at their realizable value whereas operating assets are valued at their book values E.g. In VSNL disinvestment surplus lands of almost 700 acres and real estates have been valued separately as those were surplus from the point of view of potential bidder.

Make a critical assessment of strengths & weakness of valuation methods.

IX. RELATIVE STRENGTHS AND WEAKNESSES OF VALUATION METHODS

1. Discounted Cash Flow

Strengths
Most sound approach and widely accepted in industry.
- Based on cash flow and not on accounting profits.
- Considers time value of money.
- Sets apart the capital required in business from the free cash flow available to shareholders.
- It is the only method where going concern principle is applied.

Weaknesses
- Subjective to future predictions and assumptions
- Perceptions of valuer play very big role rather than objectives/standardized data.
- Management plan about growth like setting aside capital outlay for future may inflate the valuation.
- Difficulty of using in emerging industries due to voiatility or banking industry where cash flows are not defined clearly.

2. Assets Based

Strengths
- It is a realistic value and based on present conditions & so it may not differ much from valuer to valuer due to their subjectivity.
- It gives the minimum valuation and protects from poor deals.

Weaknesses
- Value may not be true with different accounting policy and overvaluation.
- It does not consider the synergy created by the combined assets deployed together.
- It is not a right method of valuation and may give the same value for the two entities producing different returns over the years.

3. Past Profit Based (capitalization)

Strength
- Past profit capitalization indicates that some profit can be maintained at given rate of returns on investment.

- It acts as catalyst between assets based methods and future profit based methods.
- It removes the exceptional items or years to consider the average returns maintained by business unit hence it is very much sound and near to realistic value.

Weaknesses

- Time value of money is ignored
- It is more significant for seller and not for buyer who look for future benefits to be derived with potential investment.
- Based on accounting profit, which may not be true profit belonging to shareholders for variety of reasons.
- Selection of weight order to past profitability may require valuer's skill and judgment.

In practice no method is used in isolation due to inherent limitations of each method, hence consolidated valuation is arrived by applying different methods. To minimize the subjectivity of valuation valuer gives the range of valuation as basis for determining the price and hence generally no valuation reports carry a single value.

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13 MERGERS & ACQUISITIONS

An Overview

Introduction

Important terms

Mergers
Reverse Mergers
Financial Mergers
Horizontal Mergers
Vertical Mergers
Conglomerate Mergers
Circular Mergers
Amalgamation
Acquisition
Spin Off
Demerger
Hive Off/ Divestiture
Friendly Takeovers
Hostile Takeovers
Corporate Restructuring
Leveraged Buyouts
Management Buyouts
Take over Defence

Synergy Value
Objectives of Merger
Merger schemes
Provisions of Income tax act
S.I.C.A
SEBI Takeover code
Reasons for failure of mergers
Highlights of recent developments
Valuation of target

The DCF Approach - SIX steps

Methods of payment

Cash
Payment in Equity Shares
Payment in convertible debentures of acquiring firm

Steps in Merger transactions

Screening an investigation of Merger proposal
Negotiation Stage
Approval of proposal by Board of Directors
Approva l of Shareholders
Approval of Creditors /Financial Institutions/banks
Approval of respective High Court(s)
Approval of Central Government
Approval of RBI
Integration Stage

I. INTRODUCTION

Globalisation and liberalization was the most whispered subject in the last one-decade. It has taken its toll in the nature of changing composition in Indian corporate structure by way of most happening event of mergers and acquisition.

It is a most talked but least understood concept from legal as well as commercial angle due to the complexities involved in any such strategic transaction. As far as India is concerned this concept is still evolving and is in its nascent stage as conducive environment is slowly created with reforms in pipeline to ease out the complex legal structure.

II. IMPORTANT TERMS

Before touching the complexities of mergers and acquisition, it is imperative to understand certain terms frequently used in the context of this subject. These terms have been explained in commercial sense and hence legal definition may differ from country to country and law to law.

1. Mergers
It is sheer blending of two companies into separate company where two merging companies lose their identity to new company. This term is more referred in cases where there are two equal candidates are merging.

A classic example of merger is Daimler and Chrysler to form Daimler Chrysler AG.

India is still not matured to witness the real merger happening for variety of reason and expected to increase after giving full effect to liberalization.

2. Reverse merger
In following kind of cases it is termed as reverse merger-

- Profit making company is merging with loss making company.
- Holding company merging with subsidiary company. A classic example is ICICI merged with ICICI Bank to create maiden Indian universal bank.
- Unlisted company merging with listed company with ultimate objective of listing through backdoor.

Above three kinds of mergers have been treated as reverses mergers. As far as Indian income tax is concerned, it considers only first case as reverse merger.

3. Financial merger
A merger of this type is sought to achieve financial savings like reduction in interest and administrative costs, increased borrowing capacity of the merged entity and higher return on capital employed. In India most of the mergers are of this type particularly in case of mergers among companies of the same group or under the same management.
We come across many small companies going for such type of merger since they are mainly interested in reducing their cost.

4. Horizontal Merger

Also refer “Types of Financial” chapter

When merger of two equal companies takes place in the same industry then it is referred to as horizontal merger. This kind of merger takes place to increase the geographical presence, network, product portfolio etc.

5. Vertical Merger
When merger take place as backward integration or forward integration in the same industry then it is referred to as vertical merger. These kinds of mergers are phenomenal in nature and result as strategic decision of cost reduction, risk diversion, growth prospectus etc.

Merger of Reliance petroleum into Reliance Industries is the latest example in this category, where RPL is crude oil refining company and RIL is petrochemical company.

6. Conglomerate Merger
When merger of two giant companies in different industries takes place then it is referred to as conglomerate merger. It is a very rare kind or merger as prime objective of this merger is in the nature of diversification of business segments.

Where presently focus is on core competence, conglomerate mergers are exceptional in nature.

7. Circular merger
It is a merger in which companies producing distinct products seek merger to share common distribution and research facility and to obtain economies of scale by elimination of duplication of cost.

8. Amalgamation
Amalgamation is said to have taken place, when one company is merging into other company where the merging company loses its identity. In Indian practice mergers and amalgamations are used interchangeably

9. Acquisition
It is a very wide term and extends to business acquisition, brand acquisition, share acquisition, portfolio acquisition, distribution network, circle etc.

Spates of transaction one will come across in near future and brand acquisition in pharma sector, circle acquisition in cellular industry, distribution network acquisition in FMCG sector, portfolio acquisition in banking sector etc.

10. Spin off
It is spin off of one of the identified business units into separate company.

Here division is separated to segregate the return associated with capital employed. After spin off it forms part of investment in the Balance sheet of company.

Much talked case under this term was potential spin off of L&T cement division into separate company.

11. Demerger

It refers to transferring one of the division of the company into separate company. It get legal recognition in Income tax by way of Finance Act 1999.

It differs from the spin off in respect of consideration where it is given to shareholders of Demerged company instead of forming part of investment of transferor company.

Recent examples are Godrej Industry into food and consumer products, Wockhard into formulation/R&D and pharmaceuticals

12. Hive off / divestiture

In this case a separate business unit is totally hived off to a third party for an economic interest.

This is fallout of focusing on core competence from diversification.

Recent global case in hiving off agro-chemical division of Aventis Crop Science AG to Bayer Science AG on global scale during the year 2000-01.

Presently in India major pharmaceuticals companies are hiving off their agro chemical business to focus on life science business as core business.

13. Friendly takeovers

It is takeover in the form of negotiated deal and not the other way round. Presently this mode is most commonly adopted and operated in Indian condition by inviting strategic partner by giving preferential allotment to raise the funds for growth.

14. Hostile Takeovers

These are in the nature of uninformed targeting of a lucrative company by accumulating the stock through market operations. As far as India is concerned, it is still in the nascent stage due to lack of expertise on the part of companies and poor corporate governance for informed decisions.

15. Corporate Restructuring

It is also a wide term like acquisition. It encompasses wide spectrum and loosely used for any kind of capital restructuring, business restructuring, assets restructuring, financial restructuring/Compromise/arrangement/settlement etc.

16. Leveraged Buyouts (LBO's)

When in the process of acquisition, acquisition financing is availed by the acquirer by leveraging the balance sheet of target company.

It is resorted to when acquirer is equal or smaller than the target company. In the present scenario where more and more big time deals are taking place focus is shifting from the project financing to acquisition financing.

17. Management Buyouts (MBO's)

When the company is acquired by the existing management itself to become owner of the company from the employers, MBO is said to have sateen place.

It is phenomenal in the case of family managed companies where professional management is inducted and after sometime business is sold to management itself.

In future much more such instances are expected where most of the Indian business are family owned and controlled due to globalization and competition.

18. Takeover defence

In the process of hostile takeover, to thwart the move of raider, a number of measures are initiated by existing owners, are known as takeover defence.

Takeover defences range from legal to commercial and at particular time multiple defences may be deployed.

What do you mean by Synergy?

III. SYNERGY VALUE

It is additional value generated by the combination of acquirer and target company over the mere addition of values of acquirer and target company as individual operations.

In merger it is always said that 1+1>2 to let merger become successful.

Above definition can be reduced to following formula-
Merger Value= stand alone value of acquirer + stand alone value of target + synergy value.
Synergy value helps to determine the maximum premium to be paid on either market price or intrinsic value of target company.

Example - Value of company A (VA) = Rs.100
Value of company B (VB) = Rs.50
V(AB) = Rs.175

Synergy = V(AB) – (VA + VB) = 25
If synergy premium is Rs10,
Net gain = 25-10 = Rs.15

What are the objectives of Merger?

IV. OBJECTIVES OR VALUE DRIVERS OF MERGER

With growing competition and globalization it becomes imperative to size the benefits of early entrants. To achieve the inorganic growth mergers and acquisitions are frequently resorted to. Mergers and acquisitions can be used for following prime objectives-

- Shareholders' value creation, by improving dividend yield, earnings or book value.
- Synergies of operating economies by increasing the size to become more competitive in operational cost. (Vertical or Horizontal integration)
- Diversifications of business by acquiring ready wear outfits.
- Taxation benefits like sales tax, income tax, transfer pricing etc.
- Restructuring of existing business in line with core competence
- Inorganic growth-time factor to create competitive advantages.
- Compulsory or regulatory reasons e.g. sick units
- Geographical expansion to enter in new markets.
- Survival option. e.g., many small companies merger to survive rather than dieing.
- Specific assets like brands, copyrights, intellectual property rights (IPR's).
- Forestalling the company's own takeover by a third party.
- Eliminating a competitor by buying it out.

What do you understand by Merger schemes?

V. MERGER SCHEMES

It is to be noted that the scheme or any arrangement or proposal for a merger is the heart of any merger. It is a document governing the transition of any merger, Demerger, restructuring of two companies. In other language it can be the memorandum of understanding between two companies. There is no prescribed form for a scheme and it is designed to suit the terms and conditions relevant to proposal and should take care of any special feature peculiar to the arrangement.

It governs the following while effecting mergers

- Effective date and appointed date of merger.
- Critical reasons for the merger/restructuring.
- Transfer of assets and liabilities.
- Transfer of employees.
- Exchange ratio and shareholding patterns.

VI. LIST THE PROVISIONS OF INCOME TAX ACT 1961 GOVERNING MERGERS

It is also one of the most important law and requires important consideration in the process of any restructuring or merger. Following brief provisions of the Act affects merger, demerger, restructuring etc.

- Definition of Amalgamation-2 (1B)
- Demerger-2 (19 AA) & (19AAA)
- Resulting company - 2 (41A)
- Slump sale – 2 (42C)
- Newly established undertakings- 10A, 10B, 10C
- Depreciation- 32
- Expenditure on patents, copyrights- 35A
- Expenditure on know-how- 35AB
- Expenditure incurred for amalgamation – 35DD
- Capital gains on purchase of own securities- 46A
- Transaction not treated as transfer for capital gains -47.
- Capital gain in case of slump sale-50B
- Carry forward of losses-72A
- Continuity of deductions available under Chapter VI-A
- Special provisions governing certain companies- chapter XII-B
- Post merger new PAN application
- Continuity of all assessment against Transferee Company.
- Filing revised returns if required.

What the provision is SICA relating to M&A

VII. SICK INDUSTRIAL COMPANIES ACT, 1985 (S.I.C.A.)

- In a nutshell the provisions apply to only 5-year-old manufacturing company and when the net worth of the company is fully wiped out.

- The Board under the act has wide powers and it can override all the Laws except FERA (however, now FERA is repealed and replaced by FEMA), Urban and ceiling Act etc. and in fact can give relief much more than that is provided in the Income tax Act.
- The act provides for rehabilitation of potentially viable sick industries & winding up of non – viable companies. Provisions of Sections 18(2) (a), (b), (d), (e), (f), & (g) are relevant.

Demerger and Sick Industrial Companies Act, 1985
The SICA contains a reference to demerger, Section 18 (1) (d) provides that BIFR may pass order for sale or lease of a part or whole of any industrial undertaking of the sick industrial company. (For any inquiry or admission to kalpesh classes dial 2382 0676)

Section 18(2) further provides that the scheme referred to in section 18(1) shall provide for the following

1. Sale of industrial undertaking free from all encumbrances and all the liabilities of the company or other such encumbrances.
2. Lease of the industrial undertaking of the sick company to any person
3. Method of sale of assets of the sick industrial undertaking.

VIII. SEBI Takeover Code

After liberalization in 1991 and number of MNC entering in to Indian market takeovers and acquisition became common phenomenon, therefore in order to protect the interest of small shareholders SEBI initiated the code by appointing Bhagwati committee to formulate the takeover code to regulate the activities of takeovers and acquisition. In1994 SEBI (Substantial acquisition of Takeovers and shares) has been promulgated, thereafter it has been revised in 1997 to remove the loopholes of erstwhile regulation of 1994, now it is proposed to be revised again. Salient Features and regulation of Code-

- Applicable to listed companies in India and acquisition of voting share capital and management control in these companies only.
- Procedure is defined in the code itself for various disclosures, public announcements, and open offer.
- Open offer takes four months to complete.

- Different limits are given to trigger the code like 5%, 15% 75%. Under the code different limits carry different procedure.
- Pricing formula in open offer has been provided in code itself.
- Pre deposit in the nature of escrow account provisions.

List down the major causes of Merger Failures.

IX. REASONS FOR FAILURE OF MERGERS

Recent KPMG research study completed in the year 2001 reveals that 80% of the mergers fail to create any shareholders value. Instead of creating the shareholders' value for both companies they destroy it for a number of reasons, which may be as follows-

- Overpayment in enthusiasm
- Cultural issues in integration
- Inadequate planning
- Legal barriers
- Ignoring human aspects.
- Ignoring the importance of due diligence (a detailed analyzed report on all aspect of company)
- The value of synergy is overestimated.
- Poor-post merger integration.

X. HIGHLIGHTS OF RECENT DEVELOPMENT

- DCA proposes to put valuation norms in mergers to protect the minority interest
- It is proposed that High courts' approval shall be transferred to proposed National Company Law Tribunal.
- De-listing committee of SEBI has submitted the draft regulation for de-listing.

XI. VALUATON OF TARGET IN MERGERS AND ACQUISITION

Valuation of the target company is one of the essential steps in Mergers and Acquisitions. The most popular approach is the Discounted Cash Flow Method (DCF approach)

The DCF Approach
The are six steps involved in this method of valuation

Step 1 - Determine Free Cash Flow

Free Cash flow is the cash flow available to all investors in the company – both shareholders and bondholders after consideration for taxes, expenditure and working capital investment.

Free Cash Flow = Net Operating Profit After Tax (NOPAT) + Depreciation – Capital expenditure – Working Capital Investment.

Step 2 - Estimate a suitable discount rate for the acquisition

The discount rate can be based on the weighted average cost of capital (WACC) based on its target capital structure. The discount rate should reflect the capital structure of the company after acquisition.

Step 3 - Calculate the present value (PV) of cash-flows

The value of the company in case of a going concern is = PV of cash flows during the forecast period + Terminal Value

The forecast period should be set in such a way that the company reaches a stable phase after that period. In other words, it is assumed that the company will grow at a constant rate after the forecast period.

Step 4 - Estimate Terminal Value (TV)

The terminal value is the present value of cash flows accruing after the forecast period. It is assumed that the company has attained stability i.e. stable growth rate.

There are Four ways to calculate the terminal value :-

Alternative 1: Terminal value of a growing perpetuity:

$$TV = \frac{CFt(1+g)}{k-g}$$

where, CFt = Cash flow in the last year
g = constant growth rate
k = Discount rate

The above formula is used if we assume that cash flows grow at a constant rate after the forecast period

Alternative 2: Terminal value of a stable perpetuity

If there is no capital expenditure or capital expenditure equals depreciation after the forecast period, it means that the total capital does not grow any more, cash flows equal profit after tax.

$$TV = \frac{\text{Free Cash Flow}}{\text{Discount rate}} = \frac{FCF}{K}$$

Alternative 3: Terminal Value as a Multiple of Book Value

The TV can also be estimated by applying the forecasted book value of capital by an appropriate Market –to- Book ratio. Normally, the current market to book (M/SO) ratio is taken as proxy for future.

Alternative 4: Terminal Value as Multiple of earnings –

The TV under this method is established by multiplying the forecasted terminal year profits by an appropriate price earning multiple (P/E multiple). Normally, the current P/E multiple can be used for future.

Step 5 - Add present value of terminal value.
Step 6 - Deduct the value of Debt and other obligations assumed by the Acquirer.

In this valuation model, the main problem is to estimate the future cash flows and the determination of appropriate discount rate.

Ascertaining the discounting rate to be applied while using DCF model
The discounting rates used to apply to free cash flows during the period is the cost of capital to the company.
There are two approaches to determine the cost of capital of the company :-

a. Weighted Average Cost of Capital (WACC)
b. Cost of capital is the Weighted Average cost of capital relating to the company under valuation.
c. Cost of capital to company is expected return to investor.
d. Adjusted Present Value approach (APV)

Step 1: The CAPM is used to find cost of capital. Though CAPM which is usually used to determine the expected return on portfolio, is extended to calculate the expected return of the investor (i.e. now the acquiring company). As the acquiring company is acquiring the shares of the target company, we will get the cost of capital of only the shares of the target company. Thus one care has to be taken that unleveraged Beta has to be taken, because we are calculating the expected return of an all equity firm. (i.e. first we will determine the expected return of an unlevered firm and then make adjustments for debt component.)

Discounting rate / expected return / cost of capital under APV method = r_1 Unlevered = r_1 + Beta (rm) (This is CAPM)

One has to note that while using APV method one has to take unlevered beta i.e. beta of all equity firm rather than levered beta.

Applying the discounted rate calculated above to Free Cash Flows and using the formula already stated :-
Valuation = FCF (discounted) for definite period + FCF (discounted) for Indefinite period (Terminal value)

We get valuation of an all equity firm.

Step 2: Now if the firm is a levered firm then we have to adjust the unlevered valuation.
The main difference between debt and equity is returns to the equity holder are non tax deductible.
Thus if we give a particular return to equity as well as for debt the return to debt will be tax deductible. Hence we will have to consider the value of tax shield for such debt.

Tax Shield = (Interest Y Debt outstanding X Tax rate)

Thus total tax benefit forgoing concern = PV of tax shield + PV of tax shield.

$PV\ (I \times D \times T)_1 + PV\ (I \times D \times T)_2$
$+ \ldots\ldots.PV\ (I \times D \times T)$ Definite Period

Terminal value of tax shield = $\dfrac{(I X D X T)}{KD(11 + Kd)^5}$

Therefore Value of levered firm = Value calculated under
Step 1 + Value of Tax shield calculated under step 2

What are the methods of payment in M&A? Make a critical analysis of the implication?

XII. METHODS OF PAYMENT IN M AND A

1. CASH

In this case, the value per share of the target firm is paid in cash to the shareholders of the target firm.

Implications

(a) It does not result in dilution of ownership.
(b) Its value is more certain and therefore, may be more acceptable to the shareholders of the target firm.
(c) Cash payments result in less dilution of the EPS.
(d) It will result in reduction of liquidity of the acquiring firm.
(e) It will attract tax liability for the shareholders of target firm, as it is equal to selling of the shares.

2. Payment in Equity Shares of Acquiring Firm

In this method, the shares of the target firm are exchanged for shares in the acquiring firm i.e., the present shareholders of the target firm will get the share in the acquiring firm hence become shareholders of the acquiring firm.

Implication –

(a) Dilution of control of the acquiring firm.
(b) No tax liability arises for the shareholders of the target firm.

(c) Conserves the liquidity of the acquiring firm.
(d) Gives existing shareholders a continued interest in the new firm.
(e) The acquiring firm has to offer more than the current market value of the target firm.

3. Payment in convertible debentures of acquiring firm.
In this case, the shares of the target company are exchanged for convertible debentures / loan in the acquiring company.
(a) It saves liquidity of the acquiring firm.
(b) The shareholders of the target firm get a guaranteed return in the form of interest for a certain period from the acquiring firm.
(c) The dilution of control will ultimately result when the debentures are converted into shares.
(d) The acquiring company will get tax benefits on interest on debentures.

Generally the merger transaction includes the following steps

XIII STEPS IN MERGER TRANSACTIONS

a. Screening of Merger proposal:
When there is an intention of acquisition or merger of other business unit, the primary step is that of screening. The motive needs to be judged against three strategic criteria i.e., business fit, management and financial strength. Once the proposal fits into the strategic motive of the acquirer, then the proposed acquirer will collect all relevant information relating to the target company about share price movements, earnings, dividends, market share, management, shareholding pattern, gearing, financial position, benefits from proposed acquisition, etc. This form of investigation will bring out the strengths and weaknesses of both one's own company and the prospect merger candidate. The acquirer company should not only consider the benefits to be obtained but also be careful about the attendant risk. If the proposal is viable after thorough analysis from all angles, then the matter will be carried further.

b. Negotiation stage:
The negotiation is an important stage in which the bargain is made in order to secure the highest price by the seller and the required is acquirer keen to limit the price of the bid. Before the negotiations start, the seller needs to decide the minimum price acceptable and the buyer needs to decide the maximum he is prepared to pay.
After the consideration is decided then the payment terms and exchange ratio of shares between the companies will be decided.
The exchange ratio is an important factor in the process of amalgamation. This has to be worked out by valuing the shares of both, transferor and transferee company as per norms and methods of valuation of shares. Approved valuer or a firm of Chartered Accountants will evaluate the shares on the basis of audited accounts as on the transfer date.

c. Approval of proposal by Board of Directors
After deciding upon the consideration of the deal and terms of payment, the proposal will be then put for the Board of Director's approval.

d. Approval of Shareholders

As per the provisions of the Companies Act, 1956, the shareholders of both seller and acquirer companies hold meeting under the directions of the respective High Court(s) and consider the scheme of amalgamation. A separate meeting for both preference and equity shareholders is convened for this purpose.

e. Approval of Creditors/Financial Institutions / Banks

Approvals from the constituents for the scheme of merger and acquisition are required to be sought for as per the respective agreement/arrangement with each of them and their interest is considered in drawing up the scheme of merger.

f. Approval of respective High Court(s)

Approval of the respective high Court(s) of seller and acquirer, confirming the scheme of amalgamation are required. The court shall issue orders for winding up of the amalgamating company without dissolution on receipt of the reports from the official liquidator and the Regional Director that the affairs of the amalgamating company have not been conducted in a manner prejudicial to the interests of its members or public.

g. Approval of Central Government

Declaration of the Central Government on the recommendation made by the specified Authority under section 72A of the Income-tax Act, if applicable.

h. Approval of Reserve Bank of India

In terms of section 19 of FERA, 1973 as amended, when the amalgamated company issues any shares to the non-resident shareholders of the amalgamating company or any cash option is allowed to be exercised, it is required to obtain the permission of RBI. Further, provisions of section 29 of FERA also restrict the acquisition of the whole or any part of any undertaking in India in which non-residents' interest is more than the specified percentage.

i. Integration stage

The structural and cultural aspects of the two organizations, if carefully integrated in the new organization will lead to the successful merger and ensure that expected benefits of the merger are realized.

Chapter 14

14 FOREIGN COLLABERATIONS & JOINT VENTURES

An Overview

PART -I

Preliminary

Principal reasons for Joint Ventures and Collaberations

Economies of Scale
Risk Sharing
Technology
Market Access

Regulations on Foreign Collaberations
Foreign Collaberations – Policy and Procedures

- *Evolution of Policy*
- *Guidelines to Entrepreneurs*
- *Foreign Collaberations – Procedures*
- *Streamlining of Procedures*

Tax Aspects of Foreign Collaberations

Purchase of Technical know how
Licensing of Technical Know how
Lack of provision for return of drawings
Technical Assistance in setting up a factory etc. – Partial disallowance
Exclusive Right granted to Indian Party

Manufacture of New Items
New Company
Travelling Expenditure: Revenue / Capital?
Allotment of shares
Taxability of Annual or lump sum royalties etc., received by the foreign company
Supply of know how with restrictive covenants

DTAA

PART – II

Concept of Joint Venture
Characteristics of Joint Venture
Industrial Policy in India
...Industrial Policy, 1991
Foreign Investment
Foreign Technology Agreements
Public Sector
MRTP Act

India's Policy framework towards joint venture
Objectives in undertaking JVs abroad
Growth and Nature of JVs

- *Problems of Indian JVs*

Suggestion for successful operation of JVs
Indian Direct Investment outside India

a. *Investments by corporates*
b. *ADR Issues*
c. *Block Allocation of Foreign Exchange by RBI*
d. *Investments by firms*
e. *Acquisition of Foreign Securities by resident individuals under ESOP etc.,*

I. PRELIMINARY

Liberalisation of Indian economy has accorded significant prominence to Joint ventures and collaborations in the secondary (manufacturing) and the tertiary (service) segments. With the growth in disposable income, there is a demand for better quality products and services. In order to effectively tap this growing demand, the entrepreneurs require not only capital but also skills and technology to effectively service the needs of the customer. Also, the role of private sector is increasing as the public sector is slowly moving out of business. On account of these, the corporates/entrepreneurs are seriously examining joint ventures (JVs) and collaborations for their future business strategy. In JVs and collaborations, the partners pool their resources to achieve mutual gain. In today's business, the corporates build differentiated strengths and capabilities in more areas than permitted by the limited time and resources which are available to an organization.

With the fast changing technology and need for continuous innovations, the managers have to act faster and smarter with fewer resources. JVs and collaborations provide the means to leverage existing investments in the capabilities of the partners to achieve higher growth with higher returns. (To know more about us visit KalpeshClasses.com)

What makes Indian concerns to enter in to Joint Ventures & Foreign Collaborations?

II. PRINCIPAL REASONS FOR JOINT VENTURES AND COLLABORATIONS

1. **Economies of Scale:** It helps to overcome high fixed costs, or the large up-front development costs associated with new ventures.
2. **Risk sharing:** Risk is shared between the partners. A single entrepreneur himself may not be able to take such risk which would endanger his future itself.
3. **Technology:** It leads to technology access in order to bridge critical technology gaps.
4. **Market Access:** It provides market access to provide the relationships and the infrastructure needed to service the customers and to distribute the product.
   On account of the above, the JVs and collaborations provide an attractive option to Indian corporates in their quest for business success as well as to foreign enterprise seeking an entry into the market.

What are the restrictions subject to which foreign collaborations must be entered into?

III. REGULATIONS ON FOREIGN COLLABORATIONS

1. Foreign collaborations are required to be approved by the Government.
2. Foreign collaborations are allowed in high priority industries, where foreign technology in demand is necessary.
3. The government has issued illustrative list of industries where foreign investment may be permitted with or without technological collaboration, or where only technical collaboration is permitted. An industry, not on these lists, would be considered on individual merit.
4. There is generally a ceiling on foreign equity participation in new ventures. In certain industries, 100% equity participation is allowed.

5. There is also limit on royalty payment to the foreign collaborator.
6. According to FEMA, general or special permission of RBI is required to pursue business activities or shares of Indian companies. The Act applies to all non-residents, non-citizens of India, branches of foreign companies and Indian companies having non-resident shareholding of more than 40%.

What does our foreign collaboration policy state?

IV. FOREIGN COLLABORATIONS-POLICY AND PROCEDURES

Evolution of Policy:

The foreign collaboration policy lists the conditions under which the foreign capital would be welcome –

(a) Conformation to Indian Government's Industrial policy by all undertakings, Indian or foreign.
(b) Foreign enterprises would be treated at par with Indian enterprises.
(c) Freedom to foreign enterprises to remit profits or repatriate capital subject to foreign exchange considerations.
(d) Where foreign enterprises were compulsorily acquired, fair and equitable compensation would be paid.
(e) The major interest, ownership and effective control should be in Indian hands.
(f) The employment of foreign personnel to posts requiring technical expertise may be permissible when Indian nationals of requisite expertise are not available. However, the local personnel should be trained to facilitate indianisation within a reasonable period.

The government of India has been selectively allowing Indian entrepreneurs to go for foreign collaboration to achieve fast industrialization and realize the socio-economic objectives. The number of technical collaboration agreements has increased considerably in recent times. A number of tax concessions have been extended to foreign enterprises. Industrial licencing procedures have been amended to avoid delay in approval of foreign collaboration agreements. Foreign Investment promotion Board (FIPB) was set up to deal with foreign investments in India.

What are the guidelines to be followed by the Entrepreneurs in the context of foreign collaborations?

GUIDELINES TO ENTREPRENEURS

The Government of India has published the following instructions to be complied with by the entrepreneurs:

(i) Foreign equity participation upto 40% (although exceptions can be considered on merits) is guided by the justification of priority, nature of technology involved, and possibility of exports;
(ii) Foreign share capital should be by way of cash without being linked or tied to imports or to payments for knowhow, trade marks or brand names;
(iii) The lumpsum payment together with royalty should not be more than 8% of total expected sales calculated on ex-factory value basis over a period of not exceeding 10 years. The royalty should not be more than 5% for other cases;
(iv) Lumpsum payments are to be paid in three standard instalments – the first to be paid after the agreement is filed with the RBI; the second on delivery of technical documents and the last instalment to be paid on the commencement of commercial production of four years

after the filing with RBI of the agreements with RBI. All lumpsum payments are subject to Indian income tax;

(v) The royalty (not exceeding 5%) should be calculated on the basis of net ex-factory sale price of the product exclusive of Central excise duties, the cost of standard bought out components and landed cost of imported components plus ocean freight, insurance and custom duties;

(vi) There should not be any minimum guaranteed royalty;

(vii) There should not be any clause binding the Indian party regarding procurement of capital goods, components, spares, raw materials, etc.

(viii) Remittance to foreign party at the prevailing rate of foreign exchange on the date of remittance is applicable;

(ix) The Indian company should be free to sub-license;

(x) Export is to be made to all countries except the countries where the foreign party has existing arrangements

(xi) Import of capital goods and raw materials will be as per existing import policy;

(xii) The proposal should conform to locational policy of the Government;

(xiii) Deputation of technicians either way will be subject to prior approval of RBI;

(xiv) The agreement is subject to Indian income tax law; and

(v) In case consultancy is required, that should be obtained from Indian consultancy firm.

Give the steps involved in a foreign collaborations?

FOREIGN COLLABORATION - PROCEDURES

(a) First of all ascertain whether foreign collaboration is permissible by referring to the negative list available with the Secretariat for Industrial Approvals (SIA), Ministry of Industry, Government of India.

(b) Initiate dialogue with the proposed foreign party and frame the items and conditions keeping in view the instructions already stated;

(c) Draw-up a draft collaboration agreement;

(d) Obtain a letter of intent from SIA wherever necessary.

(e) However a composite application in prescribed form (without fee) (From 7 c) (15 copies) for foreign collaboration and letter of intent is to be submitted to SIA.

(f) Obtain approval letter which will form the basis of foreign collaboration agreement of SIA and within six months of receipt of approval letter, submitten copies of the agreements duly signed by the parties concerned to the Administrative Ministry and a copy to RBI through Department of Economic Affairs and a copy to SIA;

(g) If the terms and conditions as per approval letter are not acceptable, a representation can be made to the Administrative Ministry with a copy to SIA;

(h) The Indian party, during the currency of foreign collaboration, is under obligation to submit in prescribed form an Annual Return as on December 31 each year to Administrative Ministry, DGTD, SIA, Department of Economic Affairs and Ministry of Finance;

(i) If necessary obtain guidance from the Entrepreneurial Assistance cell of Secretariat for Industrial Approvals;

(j) If necessary, the assistance of India Investment Centre, Jeevan Vihar, Sansad Marg, New Delhi 110 001 may be obtained.

(k) The Technology Development Cell of DGTD, New Delhi also renders necessary guidance.

STREAMLING OF PROCEDURES

The Central Government has delegated powers to the Administrative Ministries to accord approvals upto Rs.1 crores foreign exchange outgo on lumpsum payments. It will ensure expeditious disposal of foreign collaboration proposals. The conditions for granting approvals are-

(a) There should not be any foreign equity participation with proposal.

(b) The applicant is not a company with foreign equity investment.

(c) The items proposed to be manufactured are consistent with priorities given in Industrial policy statement.

(d) Excessive outgo of foreign exchange would not be permitted.

(e) Regarding royalty and lumpsum payments same conditions as already stated in the original instructions would be applicable.

Write a note explaining briefly, the various taxation aspect involved in foreign collaborations?

V. TAX ASPECTS OF FOREIGN COLLABORATIONS

Tax liability of the Indian and foreign parties in a foreign collaboration agreement has assumed great significance. In foreign collaborations, the tax aspect will have to be looked into from the Indian and foreign perspectives. In Income Tax Act, the important section dealing with foreign collaborations are section 9, 44AD, 115A, 163 and 195. Also, the provisions of Double Taxation Avoidance Agreement (DTAA), which have an overriding effect over the Income Tax Act, 161, also have an important bearing on foreign collaboration.

1. Purchase of Technical Knowhow

If there is an outright purchase of technical know how, the expenditure is capital in nature so far as the Indian counterpart is concerned. Under section 35 AB of Income Tax Act, for expenditure incurred upto 31.3.1997, for acquisition of knowhow, the expenditure can be written off in six equal instalments. After 31.3.1997, the expenditure on technical knowhow is treated as separate block of assets under the intangible assets and depreciation @ 25% is allowed.

The Supreme Court has held that technical knowhow in the shape of drawings, designs, charts, etc is “plant” and the assessee is entitled to depreciation thereon.

2. Licensing / use of Technical knowhow

In many cases of foreign collaboration agreements, the Indian concern gets only the right to use the technical knowhow for a particular period and pays royalty to the foreign concern.
The usual practice is to divide the payment into two parts–

(a) a lumpsum payment made initially, and

(b) an annual payment based on a fixed percentage upto 5% of the exworks price and the latter is based on the annual turnover. The lumpsum payment is further divided into two or three instalments and is usually payable on the approval of the agreement, on the handing over of the documents and when commercial production commences. These instalments have to be paid in the manner approved by the concerned authorities.

It has been held repeatedly that annual royalty is a revenue expenditure. However, the dispute is only regarding the lumpsum payment, i.e. whether, the amount will be allowed as revenue expenditure or disallowed as capital or only partly allowed as revenue. The decision will depend on the facts and circumstances of each case. Several of the cases on this issue is pending in Supreme Court.

3. Lack of Provision for Return of Drawings

In CIT V Southern Structural Ltd (110 ITR 890), The Madras HC observed that it was expressly provided in the foreign collaboration agreement that after expiry of the agreement, the assessee will be free from any further obligations to pay any amount to the foreign company and at the same time, the assessee will have the right to continue using, free of charge, all information made available by the foreign company during the period of validity of the agreement. In other words, whatever information was acquired by the assessee during the period of agreement would endure to its benefit without limitation of any period of time.

It was held that the assessee had acquired an enduring benefit under the agreement and 25% of the payment was disallowed. Similar decision was given in Fenner wood – roffe and co. Ltd. v CIT (102 ITR 665) where there was no prohibition regarding the use of technical data by the assessee after the period of 10 years, nor was there any clause requiring the assessee to return the technical data.

However, contrary decision was given in CIT V Tata Engineering and Locomotive Ltd. (123 ITR 538) by Bombay High court on the ground that know how does not remain stagnant and that in such cases, the assessee cannot be said to have acquired a benefit of enduring character.

It is advisable for an Indian concern to make a provision for return of drawings at the end of the foreign collaboration agreement, and as far as possible, avoid express provisions regarding the use of the know how after the agreement period.

4. Technical Assistance in setting up a factory etc., – Partial Disallowance

Any provision for technical assistance in setting up of the factory, selection of plant and machinery, design and layout of the factor etc., would render a portion of the lumpsum payment to be disallowed as capital expenditure. The disallowance may vary from case to case.

5. Exclusive Right Granted to Indian Party – Partial Disallowance

In several foreign collaboration agreements, there is a provision that the Indian concern would have exclusive rights to sell the products in India and often this is also coupled with a restrictive covenant on the part of foreign company that they will not be entitled to sell the goods to any other person within India.

In CIT V Southern Switch-gear ltd. (148 ITR 272), It was held that conferment of exclusive benefit to manufacture and sell cannot be said to be a part of mere knowhow agreement and the assessee had thereby secured benefit of an enduring nature.

6. Manufacture of New Items

In M.R. Electronics v CIT (136 ITR 305), the assessee had entered into a foreign collaboration agreement and the agreement was for manufacture of new items. The Madras HC observed that as per the terms of the agreement, the foreign party was to provide technical assistance for fresh items of manufacture. This amounted to an element of acquisition of a right exploitable in future and was not related to running business. Therefore, 25% of the expenditure was held to be capital.

7. New Company

The nature of the expenditure is not dependent upon the time at which the agreement comes into existence. Where the foreign collaboration agreement was entered into when the assessee was starting the business and that there was no clause stating that the foreign company must render assistance in setting up the factory, the payments could not be treated as capital expenditure as it was a mere license for use of technology (CIT V Sundaram Clayton Ltd. (136, ITR 315)

8. Travelling Expenditure: Revenue or Capital?

The taxability of travelling expenditure incurred in connection with the foreign collaboration agreement depends primarily on the nature of the foreign collaboration.

Expenditure incurred on travelling to negotiate changes in the collaboration agreement would be revenue expenditure, whereas, travelling expenditure for acquiring technical knowhow for the new products would be capital expenditure.

However, the SC in Challipalli Sugars Ltd. V CIT (96 ITR 196) held that the travelling expenditure can also be capitalized and the various allowances claimed on such increased expenditure.

9. Allotment of Shares

In several cases of foreign collaboration, a foreign collaborator has an equity participation in the Indian company. The shares allotted to the foreign company or the formation of the new joint venture will not be allowed as a deduction. [CIT V EIMCOKCP Ltd. (147 ITR 603)]

10. Taxability of Annual or Lumpsum Royalties or Technical knowhow fees received by the foreign company

The computation of income by way of royalties or fees for technical services chargeable to tax in the case of foreign companies is done as per section 44 D superseding sections 28 to 44 C.

They would be taxed at 30% regardless of the place where the knowhow is transferred and this rate is uniform for lumpsum and annual payments. U/S 44D, tax is levied on the gross amount of royalty or fees for technical services and no deduction is allowed in respect of any expenditure or allowance incurred to earn the royalty or fees for technical services.

Outright sale of knowhow:
An outright sale of knowhow would not be liable to Indian Income tax as the payment received by the foreign party is treated as capital receipt.

Systematic sale of knowhow:
If the foreign collaborator has a systematic pattern of supply of know how to various parties for consideration, then the receipt in the hands of foreign party would be 'revenue'.

11. Supply of knowhow with Restrictive Covenants

If there is a supply of knowhow coupled with a restrictive covenant, the consideration received can be treated as capital receipt. CIT V Ralliwolf Ltd. (143 ITR 720)

DOUBLE TAXATION AVOIDANCE AGREEMENT (DTAA)

The Provisions of DTAA override the provisions of Income Tax Act. Therefore, they must be carefully studied while drafting and finalizing the foreign collaboration agreement. Where the provision of DTAA are more beneficial to the assessee than those of Income Tax Act, the assessee will be entitled to the beneficial provision.

Example : Section 44 D states that no deduction will be allowed in respect of expenses incurred to earn royalty or fees for technical services. However, Article XVI of the DTAA with France stipulates that the amount paid for technical services would be subject to tax only after deduction of expenses. It means that the fees paid for technical services would be taxable only on the net amount.

PART II – JOINT VENTURES (JV)

What do you understand by the Term Joint Venture?

I. CONCEPT OF JOINT VENTURE

A joint venture is an association of two or more persons to carry out a single business enterprise for profit. It connotes a legal entity in the nature of a partnership engaged in the joint undertaking of a particular transaction for mutual profit or

An association of persons or companies jointly undertaking some commercial enterprise wherein all contribute assets and share risk. A joint venture may also take the form of a corporation wherein two or more persons or companies may join together.

There has been growth of joint ventures in our country wherein foreign companies join with Indian counterparts and contribute towards capital and technical knowhow for the success of the venture. Joint Ventures are also undertaken to face the international competition.

What are the Characteristics features of JV?

II. CHARACTERISTICS OF JOINT VENTURE

(a) Two or more investors participate in any activity or activities.
(b) The investors are bound by a contractual agreement.
(c) Decision in all areas essential to the accomplishment of a joint venture require the consent of two or more of the investors, as provided by the contractual arrangement, so that no one investor is in a position unilaterally to control the joint venture.
(d) The joint venture activities are an extension of the investor's other activities.
(e) Some investors contribute resources other than cash, such as other current assets, bng-term assets, technical expertise and human resources.
(f) Each investor may have a right to take its share of production from joint venture in kind.
(g) JVs may be incorporated or unincorporates. Some joint ventures are partnerships or other legal entities.
(h) Some JVs have limited lives whereas others may have indefinite lives.

Write a note on Industrial Policy in India?

III. INDUSTRIAL POLICY IN INDIA

The Government of India, has from time to time, announced industrial policies to achieve industrial growth and to realize the goal of planned development. First, Industrial policy was announced in 1948. The Industrial Policy of 1956 puts emphasis on-

(a) the development of heavy and machine-building industries,

(b) the expansion of the public sector,

(c) the establishment of a large and growing co-operative sector, and

(d) encouragement to the diffusion of ownership and management in private sector.

However, the major shift in industrial policies came with the New Industrial Policy, 1991 which envisaged a greater role for private sector.

NEW INDUSTRIAL POLICY, 1991 (NIP, 1991)

Main features of NIP, 1991 are as follows:

- licensing has been abolished for all projects except for a short list of industries related to security and strategic
- social reasons, hazardous chemicals and over-riding environmental reasons and items of elitist consumption
- four industrial groups where security and strategic concerns predominate will be reserved exclusively for the public sector.
- projects where imported capital goods are required, automatic clearance will be given:
- foreign exchange availability is ensured through foreign equity.
- the CIF value of imported capital goods required is less than 25% of the total value of plant and equipment, up to a maximum value of Rs.2 crores.
- there is no requirement to obtain industrial approvals from the Central Government (except for industries under compulsory ….) for location not falling within 25 kms. of cities having population of more than one million.
- those of non-polluting nature such as electronics, computer software and printing can be located within 25 kms of the
- of cities with more than one million population. Other industries are permitted only if they are located in designated areas.
- mandatory convertibility clause will no longer be applicable for term loans from the financial institutions for new projects.
- existing registration schemes will be abolished.
- industries will henceforth only be required to file an information memorandum on new projects and substantial expansion.
- A system of phased manufacturing programmes run on an administrative case-by-case basis will not be applicable to new industries.
- exemption from licensing will apply to all substantial expansions of existing units.

Foreign Investment

- Automatic approval is available to FDI in almost all sectors except a few sensitive ones. Automatic approval is available for 50%, 51%, 74% and even 100% in specified industry groups.

- To provide access to international markets, majority foreign equity holding up to 51 per cent equity will be allowed for trading companies engaged in export activities.
- The Foreign Investment Promotion Board has been constituted to negotiate with a number of large international firms and approve direct foreign investment in selected areas.

Foreign Technology Agreements

- Automatic permission will be given for foreign technology agreements in identified high priority industries up to a lumpsum payment of \$ 2 million, 5 per cent royalty for domestic sales and 8% for exports, subject to total payments of 8 per cent of sales over a 10-year period form the date of agreement or 7 years from commencement of production.
- In respect of industries other than those included in (i) above, automatic permission will be given subject to the same guidelines as if no foreign exchange is required for any payments.

Public Sector

- Portfolio of public sector investments will be reviewed with a view to focus the public sector on strategic, high-tech and essential infrastructure. Whereas some reservation for the public sector is being retained there would be no bar for areas of exclusivity to be opened up to the private sector selectively. Similarly, the public sector will also be allowed entry in areas not reserved for it.
- In order to raise resources and encourage wider public participation, a part of the government's share holding in the public sector would be offered to mutual funds, financial institutions, general public and workers.

MRTP Act – Abolished new companion Act with more liberal provisions introduced.

IV. INDIA'S POLICY FRAMEWORK TOWARDS JOINT VENTURES (JVs)

The policy framework toward joint ventures abroad has gradually developed. Several guidelines governing Indian participation in JVs abroad were formulated for the first time and announced in January, 1970. These guidelines have been modified subsequently. The guidelines seek to give "liberal access to Indian business for technology sourcing or market seeking as strategic responses to the emerging global opportunities for trade in goods and services."
RBI has also set up a fast track route for clearing proposals for setting up of joint ventures and wholly-owned subsidiaries (WDS). The fast-track route is available subject to the following conditions-

(i) Overseas investment does not exceed \$ 75 million;

(ii) The investment amount does not exceed 25% of the annual average export earnings of the Indian promoter during the proceeding 3 years;

(iii) The invested amount will have to be fully repatriated by way of dividend and royalty within a period of 5 years from the time of investment.

What are the objectives behind Foreign Joint Ventures?

V. OBJECTIVES IN UNDERTAKING JVs ABROAD

The objectives in undertaking JVs abroad can be listed as follows:

- Sharing of experience and expertise in fields where adequate capabilities have been developed in the home country.
- Setting up enterprises of a comparatively medium/small size in industries in which multinational corporations did not evince interest.
- Safeguarding of market to which goods have been exported and using the venture for promoting exports.
- Expectation of a reasonable return on investment coupled with technical know-how, fees and royalties.
- Participation as a means to secure larger orders for machinery and components.
- An assured supply of raw materials.
- Diversification of business risks among two or more countries.

Write a note on problems faced of Indian JVs?

VI. GROWTH AND NATURE OF JVs

The Indian JVs are predominantly in other developing and middle income countries, like Malaysia, Indonesia, Singapore, Srilanka, Nigeria, Kenya, Uzbekistan, UAE and Thailand. They have made some inroads into developed countries also, like the USA, Germany, etc. About 2/3rd of these units are engaged in manufacturing activity. The new areas where JVs are being established include tea blending and packaging, tea auction centre, book publishing and distribution, real estate, travel and tours, phosphate fertilizers, etc.,

JVs abroad have been undertaken both by private entrepreneurs and PSUs.

Problems of Indian JVs

(a) There has been a high mortality rate of these JVs because of factors like –
   (i) Lack of acclimatization to new environment,
   (ii) too small a size to be profitable,
   (iii) lack of adequate study of economic environment,
   (iv) lack of cash remittance from home country due to restrictions.

(b) There has been an excessive gestation period as between date of according approval and that when the ventures came into operation;

(c) Lack of proven track record of Indian entrepreneurs.

(d) The proposals to establish such ventures were not always complete in their operative details, levels of technology to be adopted and the manner of operations, and the objectives behind establishing ventures abroad are not in many cases been clearly defined.

Suggest a few measures to free the JVs from the above problems

VII. SUGGESTIONS FOR SUCCESSFUL OPERATION OF JVs

For successful operation of JVs it would be essential to consider different aspects of these ventures when promoters from India submit their proposals to the government.

Factors to be considered
Line of activities chosen for this purpose, the country in which such ventures are sought to be established and the foreign collaborators identified along with such important details as their growth rationing, reputation, capacities for investment, etc., Government – to – government understanding about the conditionalities that such ventures should be present in the creation of both implementation and operation these ventures.

Feasibility studies and project reports prepared for this purpose detailing all important aspects of these enterprises. (For any inquiry or admission to kalpesh classes dial 2382 0676)

Political and economic climate in the country of operation so that at any stage the ventures do not come under a cloud of uncertainty.

Preference should be given to export of Indian capital goods and also the initial requirements of other inputs while emphasis would remain on exploitation of local raw materials and marketing products in the local markets at the first instance and then exporting to India and other countries. Exporting to India becomes relevant in cases where such products are in short supply, on the one hand, and are much costlier in the case of imports from other countries, on the other.

It appears that adhocism and so called 'on merit' considerations still rule the roost spelling undesirable uncertainties which affect the degree of confidence of Indian entrepreneurs seeking to sail in foreign waters.

What are the provisions introduced by RBI, governing Indian direct investment abroad?

VIII. INDIAN DIRECT INVESTMENT OUTSIDE INDIA

RBI has amended Foreign Exchange Management (Transfer or issue of any foreign security) Regulations 2000 to liberlise overseas direct investments by Indian parties. The salient features of the amendment are-

(a) **Investments by corporates – Joint Ventures (JVs) / wholly owned subsidiaries (WOS) – Limits and eligibility**
   (i) Indian parties may invest in Joint Ventures (JVs)/WOS outside India, an amount not exceeding $ 50 million or its equivalent in a financial year.
   (ii) The existing 3 years profitability has been dispensed with.

(iii) The total financial commitment by Indian parties can be upto Rs.350 crores in a financial year in respect of direct investment in Nepal and Bhutan.

(b) **ADR/GDR Issues – Utilisation**

(i) Indian parties can utilize 100% of proceeds of ADR/GDR for overseas investment.

(ii) Indian party who has already made an ADR/GDR issue, may now acquire shares of foreign companies engaged in some core activity, upto an amount of us $ 100 millions.

(c) **Block allocation of Foreign Exchange by RBI**

Block allocation of forex to Indian parties with proven track record may be made by RBI, who have exhausted the limits available under the automatic route as indicated in (a) above.

(d) **Investments by firms**

Firm registered under the Indian Partnership Act, 1932 have been permitted to make direct investments outside under both automatic and non-automatic routes.

(e) **Acquisition of Foreign securities by resident individuals under ESOP**

The employees/directors of its Indian office, branch, joint venture or subsidiary can acquire equity shares offered by the foreign parent company upto US $ 20,000 or its equivalent.

(f) Companies allowed to invest 50% of GDR proceeds in foreign JVs.

(g) Investments upto $ 15 million to be cleared automatically from EEFC account, (Export Earners Foreign currency Account)

(h) Special committee will clear non-GDR, non EEFC investment.

(i) In respect of investment proposals in excess of $ 15 million, the company can use a combination of its GDR funds and EEFC balances.

(j) Any investment proposal bigger than what is automatically allowed by GDR and EEFC roué would be considered by the special committee keeping in view the export track record of the company.

Chapter 15

15 INTRODUCTION TO INTERNATIONAL FINANCIAL MANAGEMENT

An Overview

I. ***Preliminary***
II. ***Sources of International Financing***
III. ***Instruments of International Finance***
1. *Euro Bonds*
2. *Foreign Bonds*
3. *Fully Hedged Bonds*
4. *Floating Rate Bonds*
5. *Euro Commercial papers*
6. *Foreign Currency Options*
7. *Foreign Currency Futures*

IV. ***Financial Sector Reforms In India***
V. ***International Financial Instruments and Indian Companies***
1. *Foreign Currency Convertible Bonds*
2. *GDRs*
3. *Euro – Convertible bonds*
4. *ADRs*
5. *Other sources*
   - *Euro – Convertible Zero bonds*
   - *Euro bonds with equity warrants*
   - *Syndicated bank loans*
   - *Euro – bonds*
   - *Foreign bonds*
   - *Euro commercial papers*
   - *Credit Instruments*
6. *FIIs*

VI. Euro Issues

1. *Eligibility of Companies*
2. *Advantages of Euro Issues*
3. *Disadvantages of Euro Issues*
4. *Structuring*
5. *Pricing the issue*
6. *Methodology for the issue*

- *CHECKLIST FOR GDR ISSUE*

I. PRELIMINARY

The International Capital Markets are important sources of finance. As the business grows in size, funds are raised not only from the domestic sources but also from the international sources.

Raising funds from international market require compliance to certain regulations. In modern times, many Indian companies are tapping international sources to raise finance to expand their operations.

What are the sources of International Financing?

II. SOURCES OF INTERNATIONAL FINANCING

1. Commercial Banks.
2. Development Banks and Financial Institutions
3. Discounting of Trade bills.
4. International Agencies, e.g., International Finance Corporation (IFC). The International Bank for Reconstruction and Development (IBRD), Asian Development Bank (ADB), IMF, The Aid INDIA Club, etc.
5. International Capital market – In International capital market, the availability of foreign currency is assured under the four main systems, viz.,
   (a) Euro-currency market
   (b) Export credit facilities
   (c) Bonds Issues
   (d) Financial institutions

What are the various instruments dealt with in International Market?

III. INSTRUMENTS OF INTERNATIONAL FINANCE

The various financial instruments dealt with in the international market are briefly described below :

1. Euro Bonds:

Euro Bonds are debt instruments denominated in a currency issued **outside the country of that currency** e.g. A Yen floated in Germany; a yen bond issued in France.

2. Foreign Bonds

These are debts instruments denominated in a currency which is foreign to the borrower and is **sold in a country of that currency.** A British firm placing $ denominated bonds in USA is said to be selling foreign bonds.

3. Fully Hedged Bonds

In foreign bonds, the risk of currency fluctuations exist. Fully hedged bonds eliminate that risk by selling the entire stream of interest and principal payments in forward markets.

4. Floating Rate Notes

These are issued upto 7 years' maturity. Interest rates are adjusted to reflect the prevailing exchange rates. They provide cheaper money than foreign loans. Currently they are not very popular.

5. Euro Commercial Papers

Euro Commercial Papers (ECPs) are short-term money market instruments. They are for maturities for less than a year. They are usually designated in US dollars.

6. Foreign Currency Options

A Foreign currency option is the right to buy or sell, a specified foreign currency. It provides a hedge against financial and economic risks.

7. Foreign Currency Futures

Foreign Currency futures are obligations to buy or sell a specified currency in the present for settlement at a future date. The common period for a futures contract may be a week, a month or two months. (To know more about us visit KalpeshClasses.com)

Give a brief note on Reforms Financial Sector in India

IV. FINANCIAL SECTOR REFORMS IN INDIA

Liberalisation of Indian economy has seen an increase in foreign capital inflow in India. Indian companies are allowed to tap foreign capital markets for their financial requirements. The Foreign Institutional Investors (FII) can invest upto 24% in the secondary market. Number of foreign companies have established their businesses in India. The norms for Foreign Direct Investments (FDI) have been eased and FDI is allowed even in non-priority areas. India's large market and high returns provide good opportunities for foreign companies to invest in India.

The number of Joint ventures have been increasing. Also, the foreign companies are increasingly establishing their subsidiaries in India. India is used as a low cost manufacturing base for sourcing exports to third world countries also without paying much taxes.

Critically examine what are the avenues open for Indian companies to raise capital in International Finance

BRIEF TIME TABLE FOR NOVEMBER 2005 C.A. FINAL EXAMINATION.
SUBJECT : DIRECT TAX

EXAMINATION	BRANCH	COMMENCING	ADMISSION STATUS
NOV 2005 (A.Y. 2005-2006)	ANDHERI	19-07-2005	In Progress
NOV 2005 (A.Y. 2005-2006)	CHARNI ROAD	24-05-2005	In Progress
NOV 2005 (A.Y. 2005-2006)	GHATKOPAR	17-07-2005	In Progress

Course Coverage for all the branches is the same.
All lectures are conducted by Professor Mr.Kalpesh Sanghavi Only.

V. INTERNATIONAL FINANCIAL INSTRUMENTS AND INDIAN COMPANIES

The various kinds of Financial Instruments to raise foreign currency funds are:

(i) Foreign currency Convertible Bonds (FCCBs).

- The FCCB is a bond issued in accordance with the relevant scheme and
- subscribed by a non – resident in a foreign currency and
- convertible into equity shares of issuing company, either in whole or part, on the basis of equity related warrants attached to the debt instrument.
- FCCBs are unsecured, carry fixed rate of interest and an option to convert into fixed number of equity shares of the issuer company. Interest rates are very low as compared to domestic market.
- FCCBs are denominated in freely convertible foreign currency.

FCCBs are popular with issues, as domestic market can be restricted with comparatively shorter maturities with high rates of interest. On the other hand low coupon security option and arbitrage opportunities available with the investors are also attractive feature.

Demerits

1. The major drawback is that issuing company cannot plan its capital structure, as it is not assured of conversion of FCCBs.
2. Moreover projection of cash out flow on maturities also cannot be made.
3. FCCBs are also subject to foreign exchange risk.
4. FCCBs result in creation of external debt, that requires foreign exchange outflow from the country, if conversion option is not exercised by the investors.

(ii) Global Depository Receipts (GDRs)

It is a dollar denominated instrument tradable on Stock exchange in Europe or the US or both. It represents a non-US company's publicly traded local currency (Indian rupee) equity shares. The modalities of issue of GDR can be put as follows:

(a) The GDR represents a certain number of equity shares. For instance, in case of Reliance Industries Ltd, one GDR represents two equity shares.

(b) The GDR is quoted and traded in dollar terms but the equity shares are denominated in rupees.

(c) The shares are issued by the issuing company to intermediary called "depository". The equity shares are registered in the name of depository and he is the person who subsequently issues the GDRs to the investors.

(d) The physical possession of the equity shares is with another intermediary called the "custodian", who is an agent of the depository.

(e) GDR has a distinct identity though it represents the issuing company's shares. In fact, GDR doesn't appear in the books of the issuing company.

(f) An investor has an option to convert GDR into a fixed number of equity shares of issuer company after a cooling period of 45 days. He can do so by advising the depository. The depository, in turn, will instruct the custodian about cancellation of GDR and release the corresponding shares in favour of the non-resident investor,

For being sold directly on behalf of the non – resident or

Being transferred in the books of account of the issuing company to the name of non – resident.

(g) The underlying shares are issued, the same cannot be recustodised.

(h) Until such conversion, GDRs are traded on Overseas Stock Exchange entitled for dividend but carry no voting rights. On conversion of GDRs into equity shares, the said shares get voting rights and yield rupee dividend and are tradable on Indian Stock Exchange like any other equity share.

Advantages of GDRs

(a) The issuer has the benefit of collecting the issue proceeds in foreign currency which may be utilised for meeting the foreign exchange component of the project cost, repayment of foreign currency/loan, etc.

(b) It has been perceived that a GDR issue has been able to fetch higher prices from international investors than that a domestic public issue would have been able to extract from Indian investors.

(c) GDR does not entitle the holder to any voting rights, so there is no fear of loss of management and control.

(d) The GDR holder can convert the GDR and become equity shareholder instead.

(e) GDR does not involve any foreign exchange risk to the issuing company, as the shares represented by GDR are expressed in rupees.

Implications of GDRs on Indian Capital Market

(i) Indian stock market to some extent is shifting from Bombay to Luxemberg.

(ii) There is arbitrage possibility in GDR issues.

(iii) Indian stock market is no longer independent from the rest of the world. This puts additional strain on the investors as they now need to be updated with world wide economic events.

(iv) Indian retail investors are completely sidelined. GDRs/Foreign Institutional Investor's placements + free pricing implies that retail investors can no longer expect to make easy money on heavily discounted rights/public issues.

Markets of GDRs

(a) GDRs are sold primarily to institutional investors.
(b) Demand is likely to be dominated by emerging market funds.
(c) Switching by foreign institutional investors from ordinary shares into GDRs is likely.
(d) Major demand is also in UK, USA (Qualified Institutional Buyers), South East Asia (Hong kong, Singapore), and to some extent in continental Europe (principally France and Switzerland).

Kinds of GDR investors:

The following parameters have been observed in regard to GDR investors.
(i) Dedicated convertible investors.
(ii) Equity investors who wish to add holdings on reduced risk or who require income enhancement.
(iii) Fixed income investors who wish to enhance returns.
(iv) **Retail investors**: Retail investment money normally managed by continental European banks which on an aggregate basis provide a significant base for Euro-convertible issues.

(iii) Euro – Convertible bonds

A convertible bond is a debt instrument which gives the bond holders an option to convert the bond into a predetermined number of equity shares of the company.

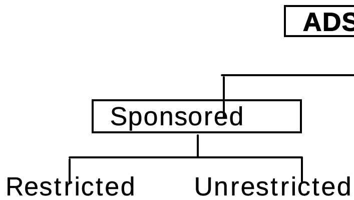
- Usually, the price of the equity shares at the time of conversion will have a premium element.
- The bonds carry a fixed rate of interest.
- The issue of such bonds may carry two options viz. call option and Put option. In case of call option, the issuer company has the option of calling (buying) the bonds for redemption before the date of maturity of the bonds. Put option gives the holder of the bonds rights to sell his bonds back to issuer company at a pre-determined price and date.
- In case of Euro-convertible bonds the payment of interest and the redemption of bonds will be made by the issuer company in **US dollars.**

(IV) American Depository Receipts (ADRs)

It is a Negotiable instrument denominated in US Dollars and issued by a depository bank (representing ownership in non – U.S. securities) representing the underlying ordinary shares. ADR enables **an American** investor to subscribe for the shares of a foreign company offered in his country or through the international market in the form of depository receipt. ADRs are considered as domestic securities and hence it makes possible for many U.S. Bonds and pension funds to invest in such securities, investment in which otherwise investment is prohibited.

The **advantages** of ADRs are almost similar to those of Global Depository Receipt as discussed earlier.

Types of ADRs



Unsponsored ADRs – These are issued without any formal agreement between the issuing company and the depository, although the issuing company must consent to the creation of the ADR facility. With unsponsored ADRs, certain costs, including those associated with disbursement of dividends, are borne by the investor. For the issuing company, it is inexpensive method of accessing the US capital markets. They are exempt from most of the reporting requirements of Securities and Exchange Commission (SEC).

Sponsored ADRs – These are created by a single depository which is appointed by the issuing company under rules provided in the deposit agreement. There are 2 types of sponsored ADRs –

(i) **Restricted ADRs –** These are restricted with respect to the type of buyer, and are privately placed.

(ii) **Unrestricted ADRs –** These are unrestricted with respect to the buyer and are publicly placed and traded. There are 3 classes of unrestricted ADRs, each increasingly demanding in terms of reporting requirements of SEC, but also increasingly attractive in terms of degree of visibility provided.

(V) Other Sources

(a) Euro-Convertible Zero Bonds – These bonds are structured as convertible bonds. No interest is payable on the bonds. But conversion of bonds take place on maturity at a predetermined price. Usually there is a 5 year maturity period and they are treated as a deferred equity issue.

(b) Euro bonds with Equity warrants – These bonds carry a coupon rate determined by the market rates. The warrants are detachable. Bonds are traded at a discount. Fixed income funds' management may like to invest for the purposes of regular income.

(c) Syndicated bank loans – One of the earlier ways of raising funds in the form of large loans from banks with good credit rating, can be arranged in reasonably short time and with few formalities. The maturity of the loan can be for a duration of 5 to 10 years. The Interest rate is generally set with reference to an index, say, LBOR plus a spread, which depends upon the credit rating of the borrower. Some covenants are laid down by the lending institution like maintenance of key financial ratios.

(d) Euro-bonds: These are basically debt instruments denominated in a currency issued outside the country of that currency. For example, Yen bond floated in France. Primary attraction of these bonds is the refuge from tax and regulations and provide scope for arbitraging yields. These are usually bearer bonds and can take the form of

(i) Traditional fixed rate bonds.
(ii) Floating rate Notes. (FRNs)
(iii) Convertible Bonds.

(e) Foreign Bonds: Foreign bonds are denominated in a currency which is foreign to the borrower and sold at the country of that currency. Such bonds are always subject to restrictions and are placed by that country on the foreigner funds,

(f) Euro Commercial Papers: These are short-term money market securities usually issued at a discount, for maturities less than one year.

(g) Credit Instruments: There are many types of credit instruments used in effecting foreign remittances. They differ in speed with which money can be received by the creditor at other end after it has been paid in by the debtor at his end. The price or the rate of each instrument, therefore, varies with the extent of the loss of interest and risk of loss involved. There are, therefore, different exchange rates applicable to different types of credit instruments. Some of the international credit instruments are –

(i) Telegraphic or cable transfer
(ii) Mail Transfer
(iii) Banker's draft or banker's cheques
(iv) Personal cheques
(v) Bills of exchange
(vi) Letter of credit
(vii) Other means of foreign payment, e.g. currency notes and coins, bullion, international money order, etc.

FOREIGN INSTITUTIONAL INVESTORS (FII)

Globalisation and liberalisation policies implemented by the Indian government has led to large inflow of foreign capital in different channels, which has led to increased capital formation and improved domestic investment in economy. The foreign investors – individuals and institutions have invested in India through different routes.

FIIs are permitted to make investments under the guidelines issued by Government of India, Ministry of finance. FIIs can invest in all the securities traded on the primary and secondary markets including the equity and other securities/instruments of companies which are listed or to be listed on the stock exchange in India. As a pre-condition, FIIs are required to obtain registration from the SEBI and approval from RBI.

There is no restriction on the value of investment for the purpose of entry of FIIs in the capital market.

FIIs have been playing significant role in share markets in India. They have been instrumental in influencing the share prices in India.

What do you understand by the term Euro issue? What are the eligibility norms? Also discuss advantage & disadvantage?

(VI). EURO ISSUES

Euro issue means an issue listed on a European stock exchange. However, subscription can come from any part of the world except India. Indian companies have recently started raising resources through Euro Issues by way of GDRs, Foreign currency convertible Bonds (FCCB) and pure debt bonds.

Eligibility of Companies for Euro-Issue

Companies with the following profile are the ones that may embark on Euro-issue –

(i) Good financial track record at least for a period of 3 years.

(ii) Market price stability

(iii) Market capitalisation

(iv) Good industry prospects

(v) Good company growth including EPS

(vi) Better quality management

(vii) Sound investment policies.

Advantages of Euro Issues

(a) For Company

i. **Pricing:** Euro-issues are priced around the market price of share. In fact, in the case of Euro- convertibles, the shares eventually get issued at a premium to the ruling market price.

ii. **No risk for foreign exchange rate fluctuation:** The foreign exchange fluctuations are to the account of investor and not to the company. Since, the investors in Euro-issues become shareholders, a depreciation in the value of the Indian rupee only affects investors' profits and does not lead to any extra outflow to the company.

iii. **Better image of company:** Euro-issues enhance the image of the company's products, services or financial instruments, in a market outside their home country.

(b) For Investors

i. It helps investors to diversify their portfolios internationally.
ii. GDRs are usually quoted in dollars, and interest and dividend payments are also in dollars.
iii. GDRs overcome obstacles that mutual funds, pension funds and other institutions may have in purchasing and holding securities outside their domestic markets. GDRs overcome foreign investment restrictions.
iv. GDRs are as liquid as the underlying securities because the two are interchangeable.
v. GDRs are negotiable.

Disadvantages of Euro Issues

i. As straight equity, a GDR issue would be immediately earnings dilutive.
ii. Pricing of GDRs are expected to be at a discount to the local market price.
iii. It is sometimes necessary to use warrants with GDRs to disguise discount, which can increase dilution.
iv. In India, GDR issues have an uneven track record for international investors.

Structuring of Euro-issues

The structuring of a Euro-issue is a tough task and involves the following issues –

(a) Whether the company has to go for private placement with FIIs or for GDR or Euro-convertible bonds.
(b) The dilution of promoters' holding as a result of private placement or GDR issue or by way of conversion of Euro-convertible bonds (ECB) issue is a matter of great concern for the management.
(c) Most companies avoid ECB issue with a convertible option to be exercised after lock-in-period at a price fixed at the time of closure of the issues.
(d) The companies with low equity base and high reserves built up over a long period would like to structure Euro-issues without much dilution of their equity holding strength.

(e) Some companies may like to structure Euro-bonds with warrants enabling investors to convert such warrants into limited equity shares without significantly diluting the existing holdings of the controlling interest.

(f) Some companies structure ECB issues with conversion price ruling at the time of conversion with a discount of 20% to 30%.

Pricing of the Issues

The price of the equity offered through GDR or Euro bonds is usually with reference to the market price which prevailed during the week and the day prior to the date of issue. If there is a demand for such securities abroad, the price may be at a premium over the market price.

Finalisation of equity price is done in consultation with the lead manager who knows the pulse of the European investment market.

What are the activities involved in Euro Issue? Discuss

Methodology for Euro-Issue

Generally the issuing company prepares its accounts for the last 3-5 years (which an already audited) in a revised format to confirm to the Generally Accepted Accounting Practices (GAAP) prevalent abroad. This is usually called **"Reformated Non-consolidated Financial Statements".** This statement indicates the financial soundness of the company.

The merchant banker occupies a pivotal role in organising a Euro-issue. As a head manager, he renders very valuable services to the company in a host of areas like :

(i) Formulation of marketing strategy

(ii) Designing issue structure

(iii) Arranging syndication

(iv) Finalising underwriting arrangements

(v) Looking after miscellaneous activities

(vi) Helping to select a team of intermediaries such as overseas underwriters, depositories and custodians, bankers etc. Each of these intermediaries has its own distinct role to play.

(vii) Organising due diligence meetings in which the lead manager, senior executives of the company, the auditors and legal advisors review the draft offer document, agreements, consent and comfort letters.

(viii) Organising team, arranging interviews and road shows. After having finalised the offer document, the lead manager helps in arranging interviews of Senior Executives of issuing company with the fund managers and potential investors to provide opportunity of interaction between them. Such meetings help in convincing and sustaining a conductive environment for the success of issue. Wide-spread distribution of pamphlets, brochures, impressive reports about the issuing company's activities and its global issue facilitates negotiations with the potential investors. Such meetings with the investors in common parlance, are known as Road Shows.

Check List of Activities for GDR Issue

Pre-Issue activities

1. The issuing company will be required to hold a meeting of Board of Directors to decide and pass a resolution to approve the Euro currency issue and approve the notice of the general meeting at which the special resolution for Euro-issue will be considered.
   - The Board of Directors of the company will have to take a decision on the quantum of funds to be mobilised, the sources from which these funds can be raised viz., domestic sources on Euro-issue route.
   - Having decided the quantum and sources, the Board will decide the types of securities to be issued and other modalities.
   - In respect of Euro-issue, various options may be considered like issue of Euro-Equity, Euro-bonds with interest and Zero Interest Convertible Bonds.
   - In order to enable the Board to take an appropriate decision a detailed note setting out various points involved and recommendations thereof may be prepared.
2. Hold a general meeting of shareholders to pass a special resolution under Section 81 (1A) of the Companies Act approving the Euro-issue and file the same with Registrar of Companies in Form No. 23.
3. Send an application to the Ministry of Finance seeking permission for the Euro-issue, giving the details of the quantum and terms of the issue, the price range, the track record of the company and the objects of the issue. It will also liaise with RBI.
4. The company needs to appoint overseas merchant bankers and underwriters for the issue.
5. Decide the depository for issue.
6. Appoint the custodians in consultation with the depository.
7. Decide on the solicitors and bankers to the issue.
8. Arrange for drafting the prospectus, by the solicitors and overseas merchant bankers, keeping in view the international disclosure standards.
9. Arrange for filing the prospectus with the appropriate authorities like Registrar of Companies (ROC) along with copies of all material contracts and documents.
10. Arrange for printing sufficient copies of prospectus and application forms.
11. Settle the draft of the depository agreement in accordance with international law in consultation with the solicitors and execute the same.
12. Settle the draft of the custodians' agreement in consultation with the solicitors and arrange the execution of the same.
13. Settle the draft of the subscription agreement between the investors and the depository with the solicitors.
14. Settle the format of the GDR to be issued to the depository in consultation with the solicitors and the merchant bankers.
15. Chalk out the marketing strategy for the issue in consultation with the merchant bankers and the underwriters.

16. Arrange to organise the road shows by the underwriters and merchant bankers to gauge investor response to the issue.
17. Decide on the timing of the issue and issue price after assessing the response to the road shows and keeping in view the prices of the securities on the Bombay Stock Exchange.
18. Announce opening of the issue.
19. Ascertain the response to the issue from the underwriters and decide on the quantum of subscription to be retained by the company.
20. The company will hold a meeting of Board of Directors and pass the following necessary resolutions:
    (a) Allotment of Equity Shares to the depository.
    (b) Execution of depository agreement.
    (c) Refund of subscription
21. Arrange for the dispatch of share certificates to the depository and lodging of the same with the local custodian.
22. Ensure that GDRs are issued to the underwriters who shall place the same with the investors.
23. Arrange for utilisation of the proceeds in foreign exchange by the depository.
24. Ensure the execution of the subscription agreement between the investors and the depository and the issue of GDR to the investors.
25. Ensure the execution of the custodian agreement between the depository and the custodian.
26. Comply with overseas listing requirements.

Post-Issue Activities

After the issue is closed, and GDRs issued the company will have to undertake the following tasks:-

Equity Issue

Allotment of shares:

(a) Particulars of the allottees (Depository Agent) as required to be entered into the Register of Members of the company in respect of the underlying shares allotted against the GDRs should be collected and the Register of Members should accordingly be updated.
(b) Return of allotment for these shares has to be filed with the Registrar of companies.
(c) Detailed Listing of Application in respect of these shares has to be prepared and filed with the Regional and other Stock Exchanges in India where the Company's shares are listed.
(d) The relevant share certificate should be deposited with the Domestic Custodian Bank.

Bond Issue

On conversion of Foreign Currency Convertible bonds, action in respect of the shares resulting on such conversion has to be taken in a manner similar to the Equity issue mentioned above.

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Relevant Acts/Rules/Circulars/Guidelines

1. Companies Act, 1956.
2. Securities Contract (Regulation) Act, 1956
3. Income tax Act, 1961.
4. Listing Agreements-Indian and all the foreign exchanges where GDRs are proposed to be listed.
5. Internal guidelines of Central Government finalised on April 20, 1993.
6. Central Government Guidelines dates 12.11.1993 vide S.R.No. 700(E)
7. Central Government Guidelines vide Press Note S-11 (25)/CCI-11/89/NRI dated 11.5.1994
8. Laws of the country in which the Depository Receipts are being issued.

Compare & Contrast GDRs & Euro-Bonds

VII GDRs Vs EURO-BONDS

1. GDR is an equity instrument whereas Euro-bonds are debt instrument.
2. GDR puts all the risks on the foreign investor, while Euro-bonds tend to add to the country's extend debt
3. The Government has preferred the equity route (i.e. the GDR) for foreign investment because it does not add to the country's burden and need not be redeemed if the company does not do well.
4. Volatility in Euro-bonds is far less than in the case of GDRs due to fairly high taxes on short-term capital gains.

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Chapter 16

16

FOREIGN EXCHANGE EXPOSURE AND RISK MANAGEMENT, FOREIGN EXCHANGE MARKETS AND DEALINGS THERIN

An Overview

Introduction

Reasons for Internationalisation of Business and Investments

Reduced Risk
Higher return
Tax Benefits
Seeking Political Stability

Basic Problems in International Financial Management

Foreign Exchange Fluctuations
Raising International Finance

Types of risks in International Transactions

Foreign Echange rate risk
Interest rate risk
Credit risk
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Foreign Currency Management

- *Foreign Exchange Market in India and its nature*
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Foreign Exchange risk

Spot Exchange Rates
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Exchange risk managements

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- *Spot contracts*
- *Forward Contracts*
- *Rupee roll-over contracts*
- *Cross-Currency forward contracts*
- *Cross currency roll over contracts'*
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- *Currency future contracts*
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Forward Cover vs. Options
Future Rate Agreements
Capital Account Convertibility

Derivative

I. INTRODUCTION

With the globalisation of the world economy, there is growing importance of international Financial Management owing to the emergence of international capital and money markets increase in the volume of international trade, increase in movement of capital and labour with lesser restrictions, increase in speed of communication and transportation, increase in concern with respect to exchange rate and interest rate fluctuations, etc. The complexity in international business is much more than the domestic business due to following reasons –

1. Operations across and within different, politic al, legal, taxation and cultural system.
2. Operations across and with a wider range of product and factor markets, each with differing levels of competition and efficiency.
3. Trading in wider range of currencies and frequently resorting to foreign exchange markets.
4. Unregulated international capital markets.

Due to above reasons, it has become very important for a finance manager to understand the environment of international financial management so that he can protect his organisation from the vagaries of international financial transactions.

Give the causes which led to Internationalisation of Business Investment.

II. REASONS FOR INTERNATIONALISATION OF BUSINESS AND INVESTMENT

1. Reducing Risk

A multinational company (MNC) has to operate in different environments. The degree of risk is different in different countries. It is observed that international diversification is often more effective than domestic diversification in reducing company's risk in relation to its expected return because economic cycle of different countries do not tend to be completely synchronized.

2. Higher Return

Another major reason for investing abroad is the expectation of higher returns for a given level of risk. There may be gaps (demand and supply gaps) in the international market within the scope of the firm's line of specialisation. Tapping of these gaps can yield higher returns to the firm. The other reason may be that the firm can efficiently produce that product in another country.

3. Tax Benefits

An MNC is exposed to various tax laws due to its operations in different countries. The type of tax and rates of tax vary from country to country. An MNC can get the best tax benefits by diversifying its investment in different countries.

4. Seeking Political Stability

The Government policy provides the biggest threat to the existence of an MNC. The very existence of an MNC can be endangered because of the whims and fancies of the Government. Political risk may range from regular interference to complete confiscation of company's assts. Some extra controls may be imposed any time. The political instability or an unfavourable attitude by the Government can seriously impair the functioning of these organisations. It is therefore important that political risk is assessed realistically. This can be done by assessing degree of stability of exist government, its attitude towards foreign investment, incentives and efficiency of government in processing the investment requests, etc., If the assessment reveals that political risk is high, the company may not invest even if very high returns are expected.

What are the difficulties one would face in International Financial Markets?

III. BASIC PROBLEMS IN INTERNATIONAL FINANCIAL MANAGEMENT

1. Foreign Exchange Fluctuations

It is the risk due to relative rise or fall of value of one currency with respect to another
The fall in value or devaluation of a currency may affect future sales, costs and remittances.

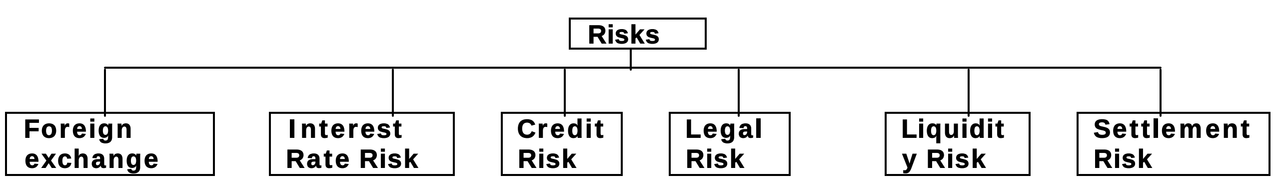
Thus, the international trade involves foreign exchange rate risk i.e., the risk relating to the uncertainty attached to the exchange rates between two countries.

2. Raising International Finance

Another major concern for the finance manager is to raise funds on most favorable terms. Funds can be raised from domestic or from international sources. Normally, both sources are tapped. There are a number of leading international agencies which provide finance at reasonable rates to MNCs. (For any inquiry or admission to kalpesh classes dial 2382 0676)

What are the types of risks which an Importer/Exporter would be subject to?

IV. TYPES OF RISKS IN INTERNATIONAL TRANSACTIONS



What are the types of risks which an Importer/Exporter would be subject to?

1. Foreign Exchange Rate Risk

It is the variance of the real domestic currency value of assets, liabilities or operating income attributed to unanticipated changes in exchange rates. The risk relates to uncertainty attached to the exchange rates between the two currencies.

Example – If an Indian businessman borrows some amount in dollars to repay loan in dollars a period of time, then he is exposed to foreign exchange rate risk during the currency of the loan. If the dollar becomes costlier vis-a-vis rupee during the currency of loan, he has to repay the loan in terms of more rupees than that which he obtained by way of loan.

Foreign exchange risk can be categorised into the following :-

(a) Transaction Exposure

A transaction exposure occurs when value of a future transaction, though known with certainty, is denominated in some currency other than the domestic currency. In such cases, the monetary value is fixed initially in terms of a foreign currency at the time of agreement. At the time of executions the exchange rate may differ & so the monetary value also differs.

All fixed value transactions such as receivables, payables, fixed price sale and purchase contracts etc., are subject to transaction exposure.

The transaction exposure looks at the effects of fluctuations in exchange rates on the transactions that have already been entered into and have been denominated in foreign currency.

(b) Translation Exposure

This is also called **accounting** exposure. The translation exposure occurs when the firm's foreign balances are expressed translated in terms of the domestic currency. Change in exchange rates can therefore, alter the values of assets, liabilities, expenses and profits of foreign subsidiaries.

It refers to and deals with the probability that the firm may suffer a decrease in asset value due to devaluation of a foreign currency even if no foreign exchange transaction has occurred during the year.

(c) Economic Exposure

It refers to the probability that the changes in foreign exchange rate will affect the value of the firm. Since the intrinsic value of the firm is equal to the sum of the present value of future cash flows discounted at an appropriate rate of return, the risk contained in economic exposure requires a determination of the effect of changes in exchange rates on each of the expected future cash flows. The measurement of economic exposure requires that a detailed analysis of the effects of rate changes on each of the future cash flows should be made.

It is useful for a firm to manage its economic exposures because it affects the value of the firm directly. The finance manager can adopt a number of policies to prevent the firm against such exposures.

2. Interest Rate Risk

Interest rate uncertainty exposes a firm to the following types of risks.

(a) Borrowing on floating rate entails uncertainty as to future payments because interest rates change at each reset date.

(b) As a result of floating rate, borrowing cost of capital is not known.

(c) Borrowings on fixed rate basis results in exposure to a situation wherein in future periods, interest rate may come down and the company is saddled with a heavy burden of debt-servicing.

(d) The reinvestment assumption cannot be realised, reducing the rate of return on investment.

3. Credit Risk

The credit risks are very important in foreign exchange and derivative transactions. This risk arises when a counter party, either a customer or a bank, fails to meet the obligations and theryo's the resulting open position needs to be covered at the going rate of exchange.

4. Legal Risk

This risk arises from legal enforceability of contract.

5. Liquidity Risk

This risk arises when, for whatever reason it may be, markets turn illiquid and positions cannot be liquidated except at a huge price concession.

6. Settlement Risk

This risk is the risk of counter party failing during settlement, because of time difference in the markets in which cash flows in the two currencies have to be paid and received.

Write a note on Foreign Market & Foreign Management for exchange?

V. FOREIGN CURRENCY MANAGEMENT

Foreign exchange market comprises of buyers and sellers of foreign currency. The operations in the out of market originate the requirements of customers to make remittances to and to receive foreign currency from other countries. The most important players in the foreign exchange market are the banks (Authorised Dealers) who undertake large and frequent deals in foreign exchange. (To know more about us visit KalpeshClasses.com)

All transactions of the foreign exchange market may be divided into following categories–
(a) Transactions between banks and their customers.
(b) Transaction between different banks in the same centre.
(c) Dealings between banks in a country and their correspondents and overseas branches.
(d) Transactions of the central bank of one country with central bank of other countries.

List do the features of Indian Foreign exchange Market?

FOREIGN EXCHANGE MARKET IN INDIA AND ITS NATURE

The important features of foreign exchange market **in India** are-
(a) The key participants in his market are the RBI, banks and business undertakings.
(b) The Indian foreign exchange market is a controlled market foreign exchange the RBI plays a key role in setting the day to day rates. FEDAI also takes part in regulation of Foreign Exchange Market.
(c) Business undertakings can participate in the market only to the extent to which they need to cover the exchange exposure arising from a merchant transaction or a foreign currency borrowing. This means they cannot resort to speculative transactions.
(d) The present exchange control regulations permit banks to have a net overbought to oversold position in a foreign currency subject to limits notified by the RBI from time to time.
(e) The Indian foreign exchange market is comparatively small.
(f) Dealings in foreign exchange take place in a manner in which foreign exchange dealers never meet each other; they transact business through a network of telephone lines linking the banks with exchange brokers (intermediaries).
(g) The major trading currency is US Dollar. Limited trading is also done in other foreign currencies such as pound, Yen, Euro etc.
(h) The organisations which have been granted licence by the RBI are called "Authorised Dealers". They may exercise powers within the parameters laid down by the "Exchange Control Manual" and circulars issued by RBI from time to time. They are also governed by rules of FEDAI.

(i) RBI has also granted licence to certain established firms hotels and other organisations, permitting them to deal in foreign currency notes, coins and traveller's cheques. They are called "Authorised Money Changers."

(j) All entities including importers, exporters and foreign currency borrowers who need to buy or sell foreign exchange, have to compulsorily deal with "Authorised Dealers" or "Authorised Money Changers" only.

How are Rupee-rates Determined?

1. Rupee – US Dollar Rate

Rupee – US Dollar rates are determined by demand/supply factors. RBI intervenes the market only to stabilise the exchange rate and prevent wide fluctuations.
US Dollar is actively traded in the inter – bank markets of Mumbai, Delhi, Kolkata and Chennai.

2. Rupee – Non Dollar Rates -

Exchange rate of any non-dollar currency against the rupee is a combination of dollar/rupee (Indian market rates) and dollar/other currency rates prevailing in the overseas market.

Examples :
Rupee-Dollar – Rs.42.00 (INR)
DM – Dollar – DM 1.5780 (overseas)

Rupee – DM (cross = Re/$ * $/DM) = $\frac{42}{1.5780}$ = Rs.26.62 (INR)

VI. (A) FOREIGN EXCHANGE RISK

Explain why & how Exporters & Importers are subject to Foreign Exchange Risks?

Globalisation of has made it necessary to undertake international transactions of purchasing/selling, import-export, settlement of balance of payments etc., The payment for such transactions could be in-

a. Seller's currency, or
b. Buyer's currency, or
c. a currency which is internationally accepted, e.g., US dollar.

If the seller is not interested in getting payment in the currency of the buyer, then the buyer has to purchase the seller's foreign exchange from the market. The rates of exchange between the buyer's currency and the foreign currency is not fixed and is determined by the market forces. Thus, the buyer is subject to exchange rate fluctuation risks.

The currency rates are determined by 2 types of transaction? What are they?

By the interactions of buyers and sellers and the application of various market forces, the currencies exchange rates are determined by two types of transactions-

a. Spot Transaction Rates

A spot exchange rate is a rate at which the currency is are being traded for delivery on the same day.

Example : An Indian importer may need US dollar to pay for the shipment that has just arrived. He will have to purchase the dollar in the market to make payment for the import. The rate at which he will buy the dollar in the market is known as the spot exchange rate.

The normal period required for final settlement of a spot transaction is **two working days.**

b. Forward Exchange Transactions - Forward Rates

A forward exchange rate is the rate at which buyers and sellers of currencies agree to deliver a specific amounts currency on a specified future date. The forward exchange rate is set and agreed by the parties and remains fixed for the contract period regardless of the fluctuations in the spot rates in future. The actual spot rate on that day may be lower or higher than the forward rate agreed today.

The Forward rate quoted normally includes the margin of profit/arbitrage of supplier.

Example : An Indian firm buys electronics from a British firm with payment of 10,00,000 pounds in 90 days. Suppose, the present price of pound is Rs. 68. Over the next 90 days, the pound may rise or decline against the Indian Rupee. The importer can undertake an agreement to buy 10,00,000 pounds at a rate, say Rs. 68.10, after 90 days. According to forward contract, the seller will give 10,00,000 pounds to the Indian importer, who in turn will pay Rs.68.10 X 10,00,000 = Rs. 68,00,000, to the supplier. In this way, the importer has made certain his payment obligation in terms of Rupee. Thus, the importer has covered his risk by buying pound in the forward market.

What are the Terms used in Foreign Exchange Markets

VII. EXCHANGE RISK MANAGEMENT:

1. Terms used in Foreign Exchange Markets

(a) **Direct Quote –** A direct quote denotes the number of units of the domestic currency required to buy one unit of foreign currency.

Example - \$1 = Rs. 49.00 means that one dollar can be exchanged for Rs. 49.00 The quote \$ 1 = Rs. 49.00 is a direct quote for an Indian.

(b) **Indirect Quote –** An indirect quote indicates the number of units of foreign currency that can be exchanged for one rupee of the domestic currency.

Example – The quote Re. 1 = \$ 0.0204 is an indirect quote for an Indian.

Direct and indirect quotes are reciprocals of each other.

$$\text{Direct Quote} = \frac{1}{\text{Indirect Quote}}$$

OR

$$\text{Indirect quote} = \frac{1}{\text{Direct quote}}$$

(c) **Bid Price –** It is the rate at which the dealer is ready to **buy** the foreign currency in exchange for the domestic currency. Therefore, it is the buying rate.

(d) **Offer Price (Ask Price) –** It is the rate at which the dealer 'asks' the customers to pay in local currency in exchange for the foreign currency. Therefore, it is the selling rate or offer rate at which foreign currency can be purchased from the dealer.

(e) **Spread –** The difference between the bid price and offer price is called spread. The offer price is always greater than the bid price as the dealers make money by buying at bid price and selling at offer price.
Example – A dealer quotes Indian rupees as Rs.43.80 – 43.90 vis-a-vis dollar. The bid price is Rs. 43.80, the offer price is Rs. 43.90 and the spread is Rs. 0.10 (i.e. 43.90 – 43.80). If an importer wants to purchase $s, he shall purchase at Dealers offer rate i.e., 43.90 peruse.

What are the various instruments used to headge exchange rate risks?

2. Instruments to Cover (Hedge) Exchange Rate Risks

Fluctuations in exchange rates cause gains/losses to the buyers and sellers depending upon market sentiments. There are, however, various hedging instruments through which a company may protect itself from possible fluctuations in exchange rates.

The objective of hedging is to transfer the risk from one individual or corporation to another individual or corporation.

The choice of hedging instrument will depend upon the type of company making the choice. Following are various hedging instruments available to cover exchange rate risks –

(a) Spot Contracts – Salient Features

(i) Covers the exposure on the date (or upto 2 days in advance) of payment/receipt.
(ii) The risk of currency appreciation or depreciation is borne by the company?
(iii) No cost is involved in the transaction except the premium/discount already included in exchange rate.

What do you mean forward contracts? Also state how to calculation Forward Premium & Forward Discount?

(b) Forward Contracts

A forward transaction (also outright forward) is a transaction requiring delivery at a future date of a specified amount of one currency for a specified amount of another currency. The exchange rate is determined at the time of entering into the contract, but the payment and delivery taken on maturity.

Forward Premium: When a currency is costlier in forward or say, on a future value date, it is said to be at a premium. In case of a direct quote, the premium is added to both the selling and buying rates.

Forward Discount: If the currency is cheaper in forward or on a future date, it is said to be at a discount. In case of direct quotation, the discount is deducted from both the selling and buying rates.

Formulae to calculate Premium / Discount:-

1. In case of Indirect Quotations:

$$\text{Premium/Discount} = \frac{F - S}{F} \times \frac{12}{n} \times 100$$

2. In case of Direct Quotations:

$$\text{Premium/Discount} = \frac{F - S}{S} \times \frac{12}{n} \times 100$$

Where, F = Forward Exchange Rate
S = Spot Exchange Rate
N = Number of months of forward contract.

Give the salient features of Forward RATES in India?

Forward Rates in India – Salient features:

(i) Forward rates in India are not determined by the interest rate differentials. They are determined by actual demand and supply conditions for respective currencies, mainly the US Dollars. These rates reflect to an extent the actual expected currency changes.

(ii) The cost of forward cover agreed forward rate (-) the ruling spot rate on the transaction day.

(iii) Now, the customers/corporates can cancel their forward contracts and keep their exposure open or book fresh contracts at a later date, if they so desire, without the prior approval of RBI. However, to ensure that corporates don't engage in speculation, the RBI requires Authorised Dealers to ensure that customers have an underlying exposure before they book forward contracts.

(iv) RBI has allowed corporations to split their non-dollar currency (e.g. Rupee yen exposure) into two parts viz., the rupee dollar part and the dollar and the foreign currency part (dollar against the yen). Corporations now have the following choices -

1. Leave the exposure open,
2. Cover the entire exposure i.e. both the parts,
3. Cover the dollar-rupee part, leaving the other part open, and
4. Cover the dollar-foreign currency part, leaving he rupee-dollar part open.

This measure will help the corporations to reduce their import costs or maximise export gains.

(v) The forward contracts can be booked only for a period of `180 days without the permission of RBI. In cases where the payment is to be made or received beyond a period of 180 days, the corporation will have to initially book the forward for 180 days and then roll over the contract for another 180 days and so on or obtain special approval from the RBI.

What are the various operations in regard to Forward Contracts?

(i) Extension of Forward Contracts

It becomes necessary when-

(i) the contract is booked for a shorter period as compared to the due date, or

(ii) the payment to be made is delayed beyond the period covered by the forward contract.

An extension of forward involves a swap i.e. simultaneous selling in the spot market and buying in the forward market or vice-versa, the cost of which is recovered or paid to the corporation.

The extension cost = Difference between the spot rate prevailing on the date of extension and the forward rate for the period upto which the contract is sought to be extended.

For example – Suppose an importer has a liability due five months from now say on 31.03.1999 amounting to $ 100,000, the spot rate is Rs. 31.32/31.42. The forward premium on the dollar for 5 months is 0.40/0.48, the importer has booked a forward contract on 31.10.1998 for delivery @ Rs. 31.45 and this contract is sought to be extended upto 31.03.1999.

In this case the swap charges will be calculated as follows:

		Rs.	Rs.
Spot on 31.10.1998		@31.32	
Sell spot	$100,000	@31.32	3132000
Buy Forward	$ 100,000	@ 31.82 (31.42 + 0.48)	3182000
Swap Charges			50,000

Thus by paying Rs. 50,000 as swap charges the importer retains his spot rate of Rs. 31.32 at which his liability of $ 1,00,000 will be crystallized.

(ii) Cancellation of Forward Contracts

In case of cancellation of a contract at the request of the customer, the bank shall recover/pay as the case may be, the difference between the contracted rate and the rate at which the cancellation is effected.

In case there is no instruction from the customer, contracts which have matured, shall on the 15th day from the date of maturity be automatically cancelled. The customer will not be entitled to exchange difference, if any, in his favour as the contract has been cancelled on account of his default.

Example – A customer had covered his $ 1,00,000 exposure, by booking a forward contract on 31.10.2002 for a period of five months at Rs. 31.45 for delivery on 31.3.2003. Suppose he can cancel his contract @ Rs. 31.55 on January 1, 2003.

In this case, the cancellation rate is in favour of the company. It will receive Rs. 0.10 per dollar (i.e. Rs. 31.55 – Rs. 31.45) and thereby make a profit of Rs. 10,000.

(iii) Early Delivery

It takes place when payment is received or made before the maturity of the forward contract covering the underlying transaction. Early delivery is opposite to extension of forward contracts and the same principles that apply to extension would also apply to early delivery.

c. Rupee Roll – over – Forward Contracts

(v) Maximum tenure of a forward contract is 6 months.
(ii) For longer term exposure, roll-over contracts are available.
(iii) Commercial banks quote a roll – over forward rate which is applicable at each transaction day.
(iv) A premium is paid (or received) by the company at each transaction day, depending upon the spot market rate and forward rate.

d. Cross – Currency forward contracts

For example, relating to DM-Dollar

- Covers the overseas leg of the exposure on any day before date of payment on receipt.
- There is no risk of currency appreciation or depreciation on the overseas leg after obtaining the cover.
- Cost/Benefit: forward premiums or discounts are available.
- No uncertainty in costing exercises on the overseas leg which is more volatile.

e. Cross Currency Roll-over Contracts

- This is an instrument to cover overseas leg of long term foreign exchange liabilities assets.

- The cover is initially obtained for 6 months and later extended for a further period of 6 months.
- Cost/Benefits : Roll over charge/Benefit depends on forward premiums/discounts, which in turn is a function of interest rates differentials between US dollar and the other currency.
- No risk of currency appreciation or depreciation on the overseas leg.
- Facilitates costing exercise to some extent.

What do you understand by currency options?

f. Currency options

Currency options are rights not obligations given to the buyers of foreign currency to buy or sell a specific amount of foreign currency at a specific exchange rate (the strike price) till a specific date when the contract expires. If not exercised, the option expires. For this protection, the buyer has to pay a premium.

Currency option may be entered either for a put or a call.

A put option gives the right to sell a foreign currency whereas a call option gives a right to buy foreign exchange. This depends upon the position that is required under a specific situation by the party entering into an option market.

A put option is required when the party requires foreign exchange. By buying a put option, the party sells the foreign exchange to procure the right amount of domestic currency. The reverse is done, when payment is needed to be done by the party.

A call option is entered so that foreign exchange can be bought by exchanging the domestic currency.

Currency option may be either **European option** or an **American option**. American option maybe exercised before the due date. However, it is not allowed under an European option.
Option contracts limit the maximum loss equal to the premium paid up-front and provides the opportunity to take advantage of favourable exchange rate movements.

Factors determining the Premium

- Strike price viz. the difference between the strike price and current rate for the same value date.
- Period viz. the length of the option period involved.
- Volatility viz. the amount of which the exchange rate of a currency is expected to fluctuate over a given period of time.
- Interest rates
- Supply and demand for options.

What do you mean by Currency Futures?

g. Currency future contracts

Currency future is just like any future deal, where an agreement is entered to buy or sell a standard object of value on a future day at a rate (price) agreed between parties, through a transaction in an organised market. The unique feature is that it is a future deal in a specific currency. Such currency future are transacted on the floor of an organised future exchange, and the clearing house of the exchange interacts itself between the purchaser and the seller. This means all transactions are with clearing house, not directly between the purchaser and the seller.
In practice, very few contracts involve actual delivery at the specified day. Rather, buyer and sellers of a contract independently take offering positions to settle down a contract. The seller cancels a contract by buying another contract, the buyer by selling another contract.

What is meant by a currency swap? How a currency swap contract is entered into? Explain

h. Currency Swaps

A currency swap is a contract in which two counter parties exchange specific amounts of two different currencies at the outset.

- Exchange interest payments in the two currencies over the term of the swap and
- re-exchange principal at maturity.

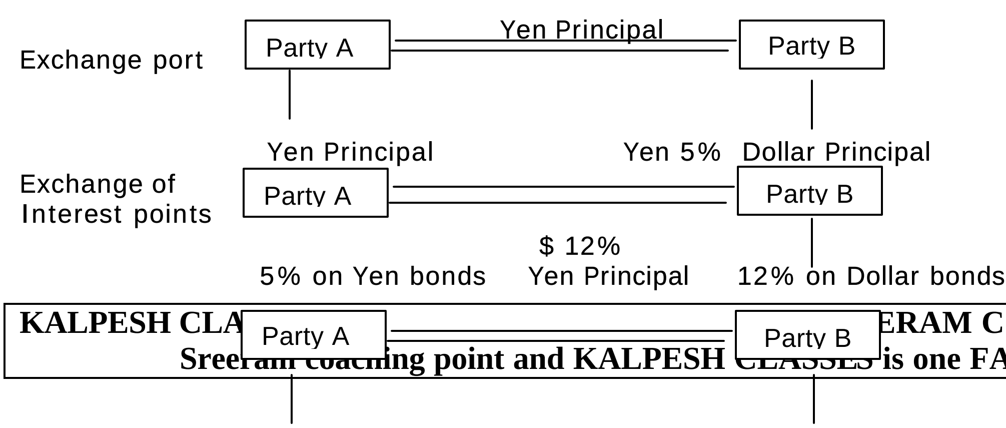
Steps involved in currency swap:

Step 1: Once equal but opposing needs for different currencies have been identified for two counter parties, the principal amounts are exchanged.

Step 2: Interest payments are exchanged periodically throughout the lifetime of the swap.

Step 3: Principal amounts are re-exchanged at the end of the swap.

Example:
If party A raises yen by issuing 5% year bonds in the Japanese market and party B raises dollars by issuing 12% dollar bonds in the US market, a currency swap between them may be represented diagrammatically as follows :



Re-exchange
of principal

Yen Principal Dollar Principal

Benefits of currency swaps:

(i) Cost cutting is the major motivation behind currency swap.

(ii) It enables access to a sector of international capital market otherwise not available.

(iii) Diversification of sources of funds.

TYPES OF CURRENCY SWAPS

Currency Swaps

- Fixed to Fixed Currency
- Fixed to Floating Currency

(i) **Fixed to Fixed currency swap**

It involves exchanging fixed interest payment on a loan in one currency for a fixed interest payment on an equivalent loan in another currency.

It is not necessary that actual principal be swapped.

Some times, an alternative currency can be exchanged at spot into desired currency, however the principal amounts are always re-exchanged at the maturity of the swap.

(ii) **Fixed to floating cross currency swap**

In this method, fixed rate obligations in one currency are swapped for floating rate obligations in another currency. For example, US dollars at fixed rates can be swapped against sterling with LIBOR + floating rate.

What do you understand by Interest Rate Swaps?

Interest Rate Swaps

Meaning:

An interest rate swap is a transaction involving an exchange of one stream of interest obligations for another.

Salient features of Interest rate swap

(i) Typically, it results in an exchange of fixed rate interest payments. Occasionally, it involves an exchange of one stream of floating rate interest payments for another.

(ii) It effectively translates a floating rate borrowing into a fixed rate borrowing and vice versa. The net interest differential is paid or received, as the case may be.

(iii) There is no exchange of principal repayment obligations.

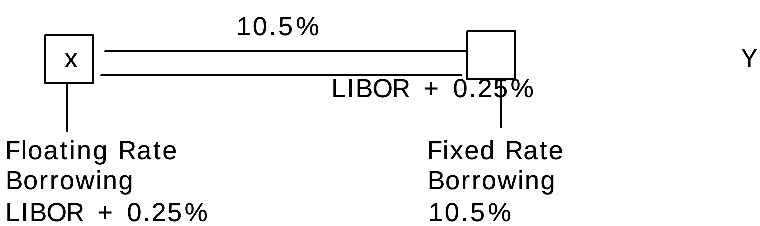
(iv) It is structured as a separate contract distinct from the underlying loan agreement.

(v) It is applicable to new as well as existing borrowings.

(vi) It is treated as an off – the balance sheet transaction.

Example – X has a borrowing of \$ 50 million on which a floating interest of LIBOR (London Inter Bank Offer Rate) plus 0.25 percent is payable and Y has a borrowing of \$ 50 million on which a fixed interest rate of 10.5 percent is payable. X and Y enter into an interest rate swap transaction under which X agrees to pay Y a fixed interest rate of 10.5% and y agrees to pay X a floating interest rate of LIBOR plus 0.25%.

This transaction can be grammatically represented as follows:



Types of Interest rate swaps

(i) **Liability Swap:** Where there is an exchange of interest obligation (i.e., interest to be paid), the swap is liability swap.

(ii) **Asset swap:** Where there is an exchange of interest receipts (i.e., interest to be received) from an investment.

What do you understand by the Term Arbitrage?

Arbitrage

Arbitrage is the buying and selling of same commodity in different markets. A number of pricing relationship exist in foreign exchange market, whose violation would imply the existence of arbitrage opportunities – the opportunity to make a profit without risk or investment.

These transactions refer to advantages derived in the transactions of foreign currency by taking the benefits of difference in rates between the two currencies at two different centers at the same time or of difference between cross rates and actual rates.

Example
A customer can gain by purchase of dollars in the local market at cheaper price prevailing at a point of time and sell the same for sterling in the London market. The sterling will then be used for meeting his commitment to pay the import obligation from London.

Types of Arbitrage
(i) Geographical/space Arbitrage – It occurs when one currency sells for two prices in two different markets.
(ii) Cross – rate Arbitrage
In a given market, exchange rates for currencies A and B and for currencies A and C imply an exchange rate called a cross – rate between currencies B and C. If the rate implied for B and C does not match the actual rate between B and C in some other market, an arbitrage opportunity exists.

(iii) Time Arbitrage
In time arbitrage, an investor may gain by executing a spot and forward deal to buy and sell a currency.

VIII. FORWARD COVER Vs OPTION

Forward cover: RBI allows cancellation and re-booking of forward contracts ad-libitum. Other advantages include-
(i) There is no front-end premium to be paid.
(ii) The buyer of the contract can make use of opportunity gain, besides hedging the underlying exposure.
(iii) A forward contract also improves the chances for additional profits which might arise out of large than anticipated movements in the currency. However, there are chances of downside risk also.

Option: A foreign currency option entitles the purchaser to buy or sell a fixed amount of some currency in exchange for another at a fixed price (the strike rate) on or before a fixed maturity date. In the case of options, the front-end fee is paid. This premium depends on the strike rate of the option, the duration of the option and the volatility in that particular currency.

Write a note on FRAs?

IX. FUTURE RATE AGREEMENTS

A Future Rate Agreement (FRA) is a contract which fixes the interest cost on a specified date in the future. The principal does not change hands, it is only notional. The contract is settled by means of a single payment representing the difference between the rate stated in the contract and the market interest rate specified in the contract. FRAs can be used to modify interest rate risk or as a trading instrument to create a position.

Write a brief note on CAC?

X. CAPITAL ACCOUNT CONVERTIBILITY (CAC)

CAC is the freedom to convert a country's domestic financial assets into foreign assets, and vice-versa at market determined exchange rates. Any person, company or legal entity can freely transfer funds from one country to another for trade, investment, remittances, financial services, buying stocks and shares, sending gifts or any other purpose whatsoever.

CAC has been allowed on current account of Balance of Payments (BOP). However, CAC on capital account of BOP is not complete and only partial convertibility has been allowed on capital account of BOP.

Foreign Exchange Management Act (FEMA), 1999 has replaced the Foreign Exchange Regulation Act (FERA) with the objective of liberalising capital account transactions.

An expert committee formed by RBI to chart out a road map towards CAC has made following recommendations-

1. Fiscal consolidation : fiscal deficit targeted to decline to 3.5% of GDP by 2000.
2. Full empowering of RBI for inflation management.
3. Strengthening of the financial system through reduction of non performing assets.
4. Reduction in cash reserve ratio to 3% by 2000.
5. The debt service ratio expressed as a percentage of current account receipts must be brought down to 20%.
6. Withdrawal of RBI from primary government borrowing programs.
7. Complete deregulation of interest rates.

Define the term "Derivatives"

XI. DERIVATIVE

Derivatives are those assets whose value is determined from the value of some underlying assets. The underlying asset may be equity, commodity or currency. Forwards, futures, options, swaps, caps and floor are some of more commonly used derivatives.

Role of Derivative

The derivatives are most modern financial instruments in hedging risk. The world over, the derivatives constitute a key part of the financial system.

The globalisation has made exchange risk an important part of the markets and institutions which operate in the economy. The well regulated forwards and futures markets are essential for efficient management of risk. Without such market, the firms and institution may lag behind their competitors across the world. Unhedged foreign exposure if widespread can lead to bankruptcies of many firms.

RBI has encouraged many risk management instruments in India by allowing forward contract, cross currency options etc., which have developed into a large market of more than US $ 1 billion a day. Today, derivative has become a part and parcel of the day to day life for ordinary people for sharing and transferring risk.

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Chapter 17

17 THE MONEY MARKET AND THEIR OPERATIONS

An Overview

Meaning of Money Market
Distinct features of money market
Pre – condition of an efficient money market
Rigidities in the Indian Money Market
Distinction between capital and money market
Vaghul group report
Organised and unorganized money market
Institutions operating in money market

- *RBI*
- *SCBs*
- *DFHI*
- *NMMF*

Money market instruments

Call/ Notice money
Inter – bank term money
Inter – bank participation certificate
Inter – corporate deposit
Treasury Bills
Commercial Biils
Certificate of Deposits
Commercial papers
MMMFs

Recent Developments in Money market

Debt securitisation

MMMFs
Repo Transactions
Liquidity Adjustment Facility

Suggestions for improvement of money market

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What do you mean by Money Markets? Also explain about call money market?

I. MEANING OF MONEY MARKET

A money market may be defined as the market for lending and borrowing of short-term funds. It is the place where the short term surplus ingestible funds at the disposal of banks and other financial institutions are lent to the borrowers comprising companies, individuals and the government. (To know more about us visit KalpeshClasses.com)

A well organised money market is the basis for an effective monetary policy. RBI plays a pivotal role in the Indian money market as it controls the flow of currency and credit into the market.

Call money market or interbank call money market is a segment of money market where scheduled commercial banks lend, borrow on call (i.e. overnight) or at short notice (i.e. for period upto 14 days) to manage the day-to-day surpluses and deficits in their cashflows. These day to day surplues and deficits arise due to the very nature of their operations and the peculiar nature of their assets and liabilities.

What are the features that make up a Money Market?

II. DISTINCT FEATURES OF MONEY MARKET

i) It is not one market but a collection of markets, such as call money, notice money, repose, term money, Treasury bills, commercial bills, CPDS, commercial papers, inter-bank participation certificates, ICDs, swaps, futures, options etc., and is concerned to deal in particular type of assets, the chief characteristic is its relative liquidity.
ii) All the sub-markets are inter-related & there is free movement of funds from one sub-market to another. There has to be a network of large number of participants which will add a greater depth to the market.
iii) The activities in the money market tend to concentrate in some centre that serves a region or an area; the width of such area may vary considerably in some markets like London and New York which have become world financial centres. Where more than one market exists in a country, with screen-based trading and revolutions in information technology, such

markets are rapidly becoming integrated into a national market. In India, Mumbai is emerging as a national market for money market instruments.

iv) The relationship that characterizes a money-market should be impersonal in character so that competition will be relatively pure.

(iv) In a true money market, price differentials for assets of similar type (counterparty, maturity and liquidity) will tend to be eliminated by the interplay of demand and supply. Even for similar types of assets, some differentials will no doubt continue to exist at any given point of time which give scope for arbitrage.

(v) Due to greater flexibility in the regulatory framework, there are constant endeavours for introducing new instruments/innovative dealing techniques; and

(vi) It is a wholesale market and the volume of funds or financial assets traded in the market is very large.

What are the requirement of an efficient Money Market?

III. PRE-CONDITION OF AN EFFICIENT MONEY MARKET

A well developed money market

1. Uses a broad range of financial instruments, e.g., treasury bills, bills of exchange, etc.
2. Channelises savings into productive investments.
3. Promotes financial mobility in the form of inter-sectoral flows of funds, and
4. Facilitates the implementation of monetary policy by way of open market operations.

Conditions for development of money market

(1) Institutional Development:- A reasonably well developed banking and financial system.
(2) Relative Political stability.
(3) Banks and other players in the money market should be licensed and effectively supervised by regulators.
(4) The market should be able to provide an investment outlet for any temporary surplus funds that may be.
(5) Efficient payment systems for clearing and settlement of transactions, e.g., Electronic Funds Transfer (EFT)

(6) Government/Central Bank intervention to moderate liquidity profile.
(7) Strong Central Bank to ensure credibility in the system and to supervise the players in the market.
(8) A large number of instruments with distinctive maturity and risk profiles to meet the varied appetite of the players in the market.
(9) Market should be integrated with the rest of the markets in the financial systems to ensure perfect equilibrium.

What are the regidities of Indian Money Market?

IV. RIGIDITIES IN THE INDIAN MONEY MARKET

Notwithstanding the deregulation process initiated by the RBI and several other innovations, the money market is not free from certain rigidities which are hampering its growth. The most important rigidities:

i. Markets are not integrated.
ii. High volatility.
iii. Interest rates not properly aligned,
iv. Players are restricted
v. Supply based-sources influence uses.
vi. Not many instruments.
vii. Players do not alternate between borrowing and lending.
viii. Reserve requirements.
ix. Lack of transparency, and
x. Inefficient Payment Systems.

Distinguish between Money Market & Capital Market

V. DISTINCTION BETWEEN CAPITAL AND MONEY MARKET

Sr.No.	Money Market	Capital Market
1.	It is a market for lending and borrowing of short-fund funds, upto one year.	Capital markets deal in long-term securities, for a period beyond one year.
2.	It is not a well-defined market where business is done.	It is a well defined market where business is done, e.g. stock exchanges.
3.	It deals in short-term financial assets, e.g., Interbank call money, treasury bills, commercial paper, etc.	It deals in medium and long-term financial assets, e.g., equity shares, debentures, etc.
4.	There is no sub-division in money market.	There is a classification between Primary Market and secondary market.
5.	The total value of transactions in money market far exceeds the capital market.	Capital market lags behind the money market, in total value of transaction.

6.	The instruments dealt in money market are very many, e.g. (a) Inter bank call money (b) Notice money upto 14 days (c) Short-term deposits upto 3 months (d) 91-days treasury bill (e) 182-days treasury bill (f) commercial paper, etc.,	The instruments in capital market are shares and debentures.
7.	The participants are Bankers, RBI and Government	The participants are general investors, brokers, merchant bankers, registrars to issue, underwriters, corporate investors, FIIs and Bankers.

Give a note on Vaghul Group recommendation towards development of an efficient Money Market

VI. VAGHUL GROUP REPORT

The students are advised to refer the Institute's study material for terms of reference and recommendations suggested by vaghul group for the development of a healthy and active money market. However, important suggestions are outlined below :

1. The money market should provide an equilibriating mechanism for evening out short-term surpluses and deficits
2. It should provide a focal point for central bank intervention for influencing liquidity in the market.
3. It should provide reasonable access to the users of short-term money to meet their requirements at a realistic price.

To achieve the above objectives, the Vaghul group suggested the following strategy-

(a) Selective increase in the number of participants to broaden the base of the money market;
(b) Activating the existing instruments and developing new ones so as to have a diversified mix of portfolios.
(c) Movement from administered interest rates to market determined interest rates, and
(d) Creating an active secondary market by establishing new instruments.

Briefly list down the features of organised & unorganised Money Market

VII. ORGANISED AND UNORGANISED MONEY MARKET

Organised Money Market:

Salient Features

1. A significant part of organized money market is dominated by commercial banks. Which are subject to tight control by RBI. RBI regulates interest rate structure, provides support to the banks by lending them on a short-term basis, insures the deposits made by the public.
2. It is characterised by fairly rigid and complex rules which may prevent it from meeting the needs of some borrowers even though funds may be available.
3. There is a shortage of loanable funds because of the low rate of interest paid on deposits.
4. The principal intermediaries in the organised segment are the commercial banks, NBFCs and co-operative societies. These intermediaries accept deposits from the public and had them on a short-term basis to industrial and trading organisations.
5. There is an active inter-bank loan market as part of the organised money market.

Unorganised Money Market:

Salient Features –

1. The Principal participants in the unorganized segment are money lenders, indigeneous bankers, nidhis (mutual loan associations) and chit-funds.
2. It lends primarily to borrowers who are not able to get credit from organised money market.
3. The characteristics of the unorganised money market are –
   (a) Informal procedures
   (b) Flexible terms
   (c) Attractive rate of interest to depositors.
   (d) High rates of interest to borrowers.
4. The unorganised money market is generally outside the control and supervision of RBI.
5. The size of unorganized money market is difficult to estimate. However, its relative importance to that of organised money market is declining.

Write a note on the various Institutions in Money Market & Their respective roles.

VIII. INSTITUTIONS OPERATING IN MONEY MARKET

1. Reserve Bank of India (RBI)

It is the most important participant of money market. It takes requisite measures to implement monetary policy of the country. RBI has been able to remove the differences which existed between different sections of money market. It has also reduced considerably the differences in rates of interest which existed between different segments of money market at different times.

2. Scheduled commercial Banks (SCBs)

They form the nucleus of money market. They are the most important borrowers/suppliers of short-term funds.

3. Discount and Finance House of India (DFHI)

It has been set up as a part of the package of reform to the money market. It fills the longstanding need of a discount house which will buy bills and other short term papers from banks and financial institutions. In this way, DFHI enables banks and other financial institutions to invest their idle funds for short periods in bills and short-dated paper. Banks can sell their short-term securities to DFHI and get funds, in case they need them, without disturbing their investments.

The DFHI has been very active in the short-term money market and effectively contributed to the overall stability of the money market. It has carried out following functions very efficiently –

(a) Selling short-term securities in its possession to banks and financial institutions which have surplus short-term funds at their disposal.
(b) Buying other short-term securities from banks and financial institutions and supply them with cash, in times of monetary shortages.
(c) Lending banks whenever they need cash to satisfy their CRR (Cash Reserve Ratio) requirements.
(d) Recently, it has started buying and selling government securities to develop a secondary market in government securities.

4. Money Market Mutual Fund (MMMF)

This has been discussed in detail later in this chapter.

What are the instruments dealt with in MM? Briefly explain. What do you understand by term call money give its features?

IX. MONEY MARKET INSTRUMENTS

1. Call / Notice Money
Call money or inter-bank call money is the medium through which the scheduled commercial banks lend, borrow or call (i.e. overright)
or at short notice (i.e. for periods upto 14 days) to manage the day-to-day surpluses and deficits in the cash flow. (For any inquiry or admission to kalpesh classes dial 2382 0676)

Salient Features

Who are the participants?

(a) The participants in call/notice money markets are commercial banks, co-operative banks and primarly dealers.

Who can belenders?

(b) Large mutual funds promoted by nationalised banks, private sector mutual funds and all-India financial institutions (AIFI) can participate in market as lenders only.

Whether corporate ending allowed?

(c) Corporate entities having bulk lendable resources of minimum of Rs. 5 crores per transactions have been permitted to lend in call money through all Primary Dealers provided they do not have any short-term borrowings from banks.

(d) Brokers are not permitted in call money market.

How intratics determined?

(e) Interest rate in the market is market driven and is highly sensitive to the forces of demand and supply.

(f) This market is exposed to a high degree of volatity in the interest-rate.

Whether liquid?

(g) It is a highly liquid market.

(h) The activities in the call money market is subject to fluctuations due to seasonal factors i.e. busy (November to April) and slack (May to October) seasons.

2. Inter-bank Term money

Give the basic features toward in Inter Bank term money?

Salient features

What are the participants?

(a) This market was exclusively for commercial banks and co-operative banks. From October, 1993, it has been opened for select All-India Development Financial Institutions. (AIFIs).

Who can borrow?

(b) The Development Financial Institutions (DFIs) are permitted to borrow from the market for a maturity period of 3 to 6 months within the limits stipulated by RBI for each institution.

How interest rates are determined?

(c) Interest rates in the market are market-driven.

Whether liquid?

(d) The lenders cannot prematurely recall these funds. Hence, this instrument is not liquid.

(e) The market is pre-dominently 90-days market.

3. Inter-Bank Participation Certificate (IBPC):-

What is an Inter-Bank participation certificate? Explain its mechanism

A participation Certificate (PC) is a deed of transfer through which a bank sells or transfers to a third party (transferee), a part or all of a loan made by it to its clients (borrowers). It is called a participation certificate because through it, the PC holder participates in a bank loan, and so also in the interest, the security of the loan, and risk of default on a proportionate basis.

Salient Features

(a) IBPC leads to fuller utilisation of loanable funds of banking system as a whole, as they make possible the use of surplus funds of some banks to finance partly the loan portfolios of other banks. This evens out liquidity within the banking system.

(b) The IBPCs are about-turn instruments to even out the short term liquidity within the banking system.

(c) It can be issued by scheduled commercial banks and can be subscribed by scheduled commercial banks.

(d) It is issued against an underlying advance classified as standard. During the currency of participation, the aggregate amount of participation should be covered by the outstanding balance in account.

(e) The interest rate on IBPC is market-driven.

(f) The certificates are neither transferable nor prematurely redeemable by the lending bank.

(g) The participation can be issued in two forms, viz., with and without risk to the lender, participation without risk can be for a period not exceeding 90 days, participation with risk can be for a period between 91 days to 180 days.

(h) IBPC scheme is supervised by RBI.

(i) IBPC arrangement is variant of “consortium banking” under which a few banks get together (form consortium) to finance big loan on participation basis.

(j) IBPC with risk can also be used for capital adequacy management. A bank with capital shortfall can temporarily park its advances with other banks which have surplus capital.

What is an ICD?

4. Inter-Corporate Deposit (ICD)

ICDs operate outside the purview of regulatory framework. It provides an opportunity for the corporates to park their short-term surplus funds at market determined rates. This market is pre-dominantly a 90 days market. (Also refer chapter “Types of Financing”)

Write a note on T-Bills along with the classification of T-Bills?

5. Treasury Bills (TBs)

TBs are short-term instruments issued by the government to tide over. They are highly liquid instruments because there cannot be a better guarantee of repayment than the one given by the government and RBI is always willing to discount them. RBI is the agent for issuing TBs. These bills enable the government to manage their cash position in a better way, as the government revenue collections are bunched and expenses are dispersed.

Types of Treasury Bills (TBs)

- Based on Nature of Issue
  - On-Tap TBs
  - Adhoc TBs
  - Auctioned TBs
- Based on Maturity Dates
  - 14 Days TBs
  - 182 Days TBs
  - 364Days TBs

(a) On Tap Treasury Bills

These are issued by RBI on tap to investors on any working day at a discount of 4.6%. The amount that can be invested in these securities is unlimited.

(b) Adhoc Treasury Bills

These bills were specially created, RBI's to replenish government's cash balances with RBI. Thus, they essentially are just an accounting measure in RBI's books. They have a maturity period of 91 days, but can be redeemed earlier.

(c) Auctioned T-Bills

These are issued through auctions conducted by RBI. The yield is determined by the market on the basis of bids tendered and accepted at the action. There is no notified amount at these auctions and the RBI absorbs as much as the government needs based on the bids received.

(d) 14 Days Treasury Bills

Salient features –

(i) Sold for a minimum amount of Rs.1,00,000 and in multiples of Rs.1,00,000.

(ii) Issued only in book-entry form.

(iii) Not transferable.

(iv) Discount rates are set at quarterly intervals. The effective yield is equivalent to the discount rate on ways and Means Advances Chargeable to Central Government.

(v) Re-discounted at 50 basis points higher than the discount rate. On rediscounting, the TBs are extinguished.

(e) 182 Days Treasury Bills

1. In response to chakravarty Committee recommendations, 182 days TBs were introduced in order to develop the short-term money market, which also provide an additional avenue for the government to raise financial resources for its budgetary expenditure.
2. These TBs are sold in the market by RBIs in auctions. The market participants bid for the amounts of bills at a discount rate of their choice.

3. The authorities would determine the cut-off discount rate and the amount of T-Bills sold in an action.
4. These are issued in multiples of Rs. 1,00,000 with a minimum amount of Rs. 1,00,000.
5. The auctions are made fortnightly.
6. These are eligible securities for statutory Liquidity Ratio (SLR) purpose.
7. The interest rate on is flexible.

(f) 364 Days Treasury Bills

These bills have been floated by the G.O.I to stabilise the money market in the country. These bills are auctioned fortnightly, but the amounts not specified in advance. These bills have become popular due to their higher yield coupled with liquidity and safety and are being used as a bench-mark by financial institutions such as IDBI, ICICI, etc. for determining the rates of interest on floating bonds/notes.

What do you mean by commercial bills? List down the RBI

6. COMMERCIAL BILLS

1. Meaning

It is a written instrument containing unconditional order signed by the maker, directing to pay a certain amount of money only to a particular person, or to the bearer of the instrument. It is a negotiable self-liquidating instrument with low degree of risk.

2. Utility

Purchase and discounting of commercial bills is a way by which banks provide funds for working capital required by commerce, trade and industry.

3. Disclosing

The spread between the face value of bill and ready money paid is the discount rate. Till the bill matures, the banks can use the same process of discounting to get ready cash. The eligibility criterion is that the bill should arise out of a genuine trade transaction and the maturity period should fall within 90 days from the date of discounting.

In order to popularize and regulate the bill operations in India, the RBI announced the New Bill Marker scheme in 1970. The scheme envisaged the bill discounting as a means of providing short-term finance against cash credit system.

4. New Bill Market scheme

RBI has issued certain directions to prevent irregularities in Bills re-discounting. These are –

(i) The bill finance should be the part of the MBF/working capital limits.

(ii) Only bills covering purchases of raw materials/inventory for production purpose and sale of goods should be discounted by banks. Bills covering payment in respect of electricity charges, customs duty, sale of securities and other types of financial accommodations should not be discounted by banks.

(iii) Accommodation bills should never be discounted by banks. The underlining trade transaction should be clearly identified.

(iv) Bank should circumspect while discounting bills drawn by front companies set up by large industrial groups or other group companies.

(v) Funds accepted by banks from their constituents under Portfolio Management Scheme (PMS) should not be deployed for discounting bills.

(vi) Banks should not re-discount the bills earlier discounted by non-banking financial companies.

(vii) Banks should seek re-discounting facility only to the extent of eligible usance bills held by them. Any excess amount obtained by any bank either due to inadequate cover or by obtaining re-discounting facilities against ineligible bills will be treated as borrowing and the bank will have to maintain RR/SLR on such borrowings.

Wrtie a note on certificate of Deposits?

7. Certificate of Deposits (CDs)

CDs are time deposits of specific maturity similar to commonly available fixed deposits (FDs) of the banks with the major difference between the two being CDs are easily transferable from one party to another, whereas FDs are not transferable.

1. Issuer

They are unsecured negotiable promissory notes issued by commercial banks and Development Financial Institution (DFIs).

2. Discount to Face Value

While the commercial bank CDs are issued on discount to face value basis, the CDs issued by DFIs can be comper bearing.

3. Discount rates

The discount rates of CDs are market determined.

4. Maturity

The maturity period ranges from 91 days for the CDs issued by banks to 1-3 years for those issued by DFIs.

5. Minimum Amount

The CDs can be issued for a minimum amount of Rs.5 lakhs to a single investor. CDs above Rs.5 lakhs should be in multiples of Rs. 1 lakh. There is no limit on total quantum of funds raised through CDs.

Banks are prohibited from granting loans against CDs as buyback of their own CDs.

8. Commercial Papers (CPs)

Discussed elsewhere in the book.

Give the salient features of MMMFs?

X. MONEY MARKET MUTUAL FUNDS (MMMFs) : Salient features

	Earlier	Now
Eligibility	Scheduled commercial bank & FIs, their existing MFs, and subsidiaries.	MFs in the private sector included
... on raising resources	2 per cent of average deposits in 1991-92	Withdrawn
Minimum size of MMMF	Rs.50 crores	Withdrawn
Investment in GOI paper (T-bills and dated securities)	Minimum 25 per cent	Limit Withdrawn
Investment in call/notice money	Minimum 30 per cent	Limit Withdrawn
Investment in commercial paper	Maximum 15 per cent	Limit Withdrawn
Investment in commercial bills	Maximum 20 per cent	Limit Withdrawn
Eligibility of investors	Units/shares of MMMFs to be issued only to individuals	NRIs can also invest, but they can only repatriate dividend/income, but not the principal amount of subscription
Minimum size of investment by single investor rate	--	MMFs are free to determine but can't offer a guaranteed rate of return
Minimum lock-in period	56 days. Investors can't exit the fund within 46 days of making their investment.	Retained

Explain how Banks use call money market

XI. INTERLINKAGES OF CALL MONEY MARKET WITH THE FOREX MARKET

The interlinkages of call money market and forex market provide arbitrage opportunities. This works as follows-

When call rates are low and rupee is depreciating continuously, banks start buying dollars by borrowing rupees on call.

These dollars are sold a day or two later, thus, earning the spread.

Similarly, when call rates are high and the rupee is relatively stable, the banks sell dollars to lend in the call money market.
They would earn the spread between the call money rate and premium on spot dollar over cash dollar and buy back the dollars after a couple of days.

Write a short note on Debt securitisation.

XII. RECENT DEVELOPMENTS IN MONEY MARKET

1. Debt Securitisation:
It refers to converting retail loans into wholesale loan and their reconverting into retail loans. For example, a bank lends Rs. 10 lakhs each to 300 borrowers as part of its loan portfolio. The total debts thus on the bank's books will be Rs.30 crores. By way of securitisation, the bank can break the entire portfolio of loan/debt of Rs.30 crores into a paper of Rs.300 each for instance, and market it in secondary market to investors. The philosophy behind the arrangement is that an individual body cannot go on lending sizeable amount for about a longer period continuously but if the loan amount is divided into small pieces and made transferable like negotiable instruments in the secondary market, it becomes easy to finance large projects having long gestation period.

Given the scarcity of resources and to provide flexibility to investors, innovative financing techniques such as debt securitisation which will mobilise additional resources through a wider investor base, is a step in the right direction.

In India, HDFC has securitised its debt by selling a part of its loan to infrastructure leasing and Financial services Ltd. (ILFS).

2. Money Market Mutual Funds (MMMFs) : Refer section X.

Write notes on Repo & Ready forward contracts?

3. Repurchase Options (Repo.) and Ready Forward (RF) contracts

REPO Meaning:

In a Repo transaction, one party sells a security to another party with an agreement to buy it back at a specified time and price at agreed interest cost.

No fixed period has been prescribed for the transactions.

Who can deal?
The transactions can be undertaken by commercial banks, financial institutions, brokers, DFHI.

Interest Rates
However, generally repo transaction are for a minimum period of 14 days and maximum period of one year.

Period
The interest is market determined and built in the structure of the Repo.

At present, Repo transactions have been prohibited in all securities except treasury bills.

Ready Forward (RF) transactions

Meaning:

These are structured to suit the requirements of both the borrower and the lender. The borrower has advantage of raising funds against securities without altering its assets mix while lender finds a safe avenue giving attractive returns. Moreover, the funds management of both borrower and lender is improved as the date of reversal of transaction is known in advance.

RBI intervenes in the market as and when required by conducting repos (ready forward purchases) through its two subsidiaries –

- Securities Trading Corporation of India (STCI)
- Discount and Finance House of India (DFHI)

Repo or Ready-forward deal in a sale of RBI approved securities (or Repo securities) by a bank to another bank, or STCI or DFHI, with a commitment to repurchase the same at an agreed future date. For example, Bank A can sell its Repo securities to Bank B at Rs. 96.25 with a commitment to repurchase them at Rs.96.75 after 14 days. The difference between the sale price and repurchase price represents the interest or repo rate on borrowed money. The repo rate (interest rate) is negotiated by the counterparties and are influenced by the overall money market conditions. In India, the repo rates are determined on the basis of expected call money rates during a reserve mark-up period.

The Amount of interest earned on funds invested in a Repo is determined as follows:-

Interest earned = Fund Invested x Repo rate x Number of days/365

Conditions Imposed by RBI in regard to Repo transactions:-

(i) The banks should enter into Repo transactions only in respect of TBs of all maturities, notified G.O.I. dated securities, and private corporate bonds/PSU bonds which are in demateralised form and the transactions shall be done in recognised Stock Exchanges.
(ii) Repo transactions should be entered only with commercial and co-operative banks and Primary Dealers. However, non-bank entities who are holders of SGL Account with RBI can enter into Reverse Repo transactions with banks/Primary Dealers in TBs, notified G.O.I. stocks, debentures/PSU bonds;
(iii) The purchase/sale price should be in alignment with the ongoing market rates;
(iv) No sale of securities can be effected unless such securities are actually held by them in their own investment portfolio;
(v) Immediately on sale, the corresponding amount should invariably be deducted from the investment account of the banks;
(vi) The minimum period of the Repo should be 3 days; and
(vii) The securities under Repo should be marked to market on the balance sheet date.

What is mean as LAF?

4. Liquidity Adjustment Facility (LAF)

On the recommendations of the committee on Banking sector Reforms, Liquidity Adjustment Facility (LAF) has been introduced to develop the short-term money market through provision of adequate liquidity. LAF will enhance the efficiency of the money market.

LAF involves injection and absorption of liquidity via variable rate reverse repo auctions and variable rate repo auctions respectively. LAF also provides a mechanism of liquidity management through export credit refinance and collateralised lending facilities supported by open market operations (OMO) at set rates of interest.

The quantum of adjustment as well as rates under LAF are flexible in response to the changing/emerging needs of the system. Also, the funds made available by RBI through LAF meet primarily the day to day liquidity mismatches in the system and not the normal financing requirements of eligible institutions.

Give few suggestions to improvement of money market

XIII. SUGGESTIONS FOR IMPROVEMENT OF MONEY MARKET

1. RBI should use its rediscounting business in an increasing manner as a method of refinance to popularise the bill as an instrument of finance. This step will help to expand the bill market.
2. More participants should be inducted into the money market.
3. More credit instruments should be evolved and introduced in the Indian money market. This will help in developing and activising the secondary market. The setting up of DFHI is an important step in this direction.
4. Well-managed NBFCs like the hire-purchase and leasing companies as well as merchant bankers should be allowed to operate in the money market. Even venture capital companies should be allowed to place their short-term capital funds in the money market.
5. The stamp duty shall be exempted on certificate of Deposits (CDs) and lock in period be reduced from 45 days to, say 21 days. These steps will make CD more attractive.
6. In addition to above, the minimum size of CD issue should be reduced from Rs.25 lakhs to around Rs.5 lakhs. This will motivate the organized groups to pool their resources and earn more through CDs. This will also increase the saving rate.
7. The interest rates on bank credit should be deregulated. It will align bank interest rates with the market rates and make borrowings from bank costlier. This will lead to more companies issuing commercial papers (CPs) and expand the CP market.
8. Securitisation of receivables like loan, export credit, working capital finance, etc. will enable the banks to improve their liquidity in times of need.

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Chapter 18

18 SPECIAL FEATURES OF FINANCIAL MANAGEMENT IN PUBLIC SECTOR UNDERTAKING

An Overview

Meaning of PSUs

Special features in the financial management

Budget
Revised Budget
Sources of funds
Role of Financial Advisor
Capital Budgeting
Working Capital Management
Accounts and Audit
Financial Delegation
Financial Reporting

Reforming

By signing MOUs
Greenfield Privatisation

Privatisation

Meaning
Ownership measures
Organisation measures
Operational measures

Reforming through Disinvestment

- *Objectives*
- *Disinvestment strategies*
- *Modalities*
- *Merits and Demerits*

Disinvestment commission

Issues in Indian Disinvestment

Government's role in Industrial Development
Privatisation vs. Disinvestment
Classification of Industries and extent of disinvestments
Employee interests
Use of disinvestments proceeds

Critical analysis of Disinvestment programme in India

I. MEANING OF PUBLIC SECTOR UNDERTAKING (PSU)

A public undertaking may be defined as a business undertaking which is owned, managed and controlled by the state on behalf of public at large. These enterprises enjoy a unique position in Indian economy. They have been responsible for forming a strong industrial base and providing the basic infrastructure for the development in the country. These enterprises produce diverse products such as steel, coal, aluminium, fertilizers, basic chemicals, minerals, locomotives, aircrafts, ships etc.,

The significant growth of PSUs has been due to several factors, e.g., our philosophy of socialistic pattern of society, the strategy of heavy industrialization, the need for prevention and concentration of economic power in few hands, the development of backward area, etc.,

In respect of area and nature of job contained in Financial Management, there is primarily no significant difference in a private sector or a public sector organization. But as the public sector deals with the taxpayer’s money, the rules, procedures and checks for accountability of this money are comparatively more rigid than in the private sector.

Briefly explain the distinct features found in the case of PSUs in regard to Financial Management.

II. SPECIAL FEATURES OF FINANCIAL MANAGEMENT IN PSUs

1. Budget

The revenue and expenditure (including capital expenditure) sources and application of funds are budgeted prior to the commencement of financial year. The Budget section of the Accounts and Finance Department is generally responsible

- for co-ordinating the budget exercise,
- collecting data from all departments/divisions concerned and
- finalizing the budget for presentation to the Board of Directors.

Though “zero based budget” has been introduced in the government sector, yet there are several public sector units, which are following the traditional budgeting process. The Budget approved by the Board of Directors forms the basis for all expenditure and yardstick for revenue earning. No expenditure can be incurred unless it is included in the budget. It is generally observed that expenditure follows the budgeted pattern whereas revenue declines from the budgeted target. Thus, mis-matching of inflow and outflow is a paramount issue for the manager of public sector finance.

2. Revised Budget

In PSUs, there is a convention of preparing a revised budget, if required, after the expiry of the first two or three quarters of the financial year depending upon exigencies. Revised budget is prepared when any material change takes place, which could not be envisaged at the time of preparation of original budget. Examples of material changes could be changes in exchange rate; new levy of substantial direct and indirect taxes, etc. Revised budget is prepared in a similar manner as the original budget.

The practice of preparing revised budget should be strictly followed only when the situation would compel such exercise and it should **not be liberally pursued when original targets become unachievable.**

3. Sources of Funds

Funds can be obtained by a PSU through internal as well as external sources such as shares, debentures, loans from financial institutions, cash credit from commercial banks, deposits from public, intercoporate loans/deposits, and by raising funds from international financial market, besides internal generations like retained earnings, depreciation etc.

PSU projects are financed on the basis of debt-equity ratio of 1:1. However, following factors are considered while designing capital structure-
(a) Gestation period
(b) Level of business risk
(c) Capital intensity of project, and
(d) Freedom of pricing.
Many PSUs suffer from over-capitalisation resulting into low capital-output ratios, surplus capacity etc. A large amount of funds has been tied in non productive uses. The government, recently has started a programme of capital re-structuring and extension of loan repayment period in some cases.

4. Role of Financial Advisor
1. Determination of financial needs of the firm and the ways these needs are to be met.
2. Formulation of a programme to provide most effective cost-profit volume relationship.
3. Analysis of financial results of all operations and recommendations concerning future operations.
4. Examination of feasibility studies and detailed project reports from the point of view of overall economic viability of the project.
5. Conduct of special studies with a view to reduce costs and improve efficiency and profitability.

5. Capital Budgeting

In order to ensure proper evaluation and implementation of capital budgeting decision in a PSU, the following points are given due consideration :-

(a) Guidelines provided by the Government

I. Previously, no guidelines were provided by central government or planning commission to the PSUs or their administrative ministries for preparing both feasibility report and detailed project report. Later planning commission issued a manual on feasibility studies. The manual-

(i) suggested the use of various criteria like return on investment, payback period, net present value (NPV), and internal rate of return for measuring profitability;

(ii) Laid stress on the use of NPV to be calculated at a discount rate of 12%, with a mention that different accounting rates may have to be used for different projects;

(iii) emphasized the need for analysis of risk, though it did not suggest any particular method for doing so; and

(iv) underscored the need for assessing the 'national economic' from the project.

II. A more comprehensive manual called "Guidelines for the preparation of feasibility Reports for Industrial Projects" was issued in 1975 by the Project Appraisal Division of the Planning commission. There guidelines suggest that project should be appraised from the technical, commercial, financial and economic angles without specifying the modes of such analysis. In these guidelines, emphasis was placed on the IRR method as against the NPV method recommended in earlier manual.

(b) Delegation of Investment Decision-making Power

A distinctive feature of capital budgeting in PSUs is that the Boards of these enterprises are empowered to sanction capital expenditure within certain limits, which are reviewed from time to time. However, projects beyond specified limits come under the purview of Central Government and the same is decided by Public Investment Board (PIB)

(c) Approval of Public Investment Proposals

The government has set up a high powered Public Investment Board (PIB) to approve public sector projects speedily which are beyond the authority of the Boards of the PSUs. PIB appraises and approves the project under its purview other than those relating to departmental undertakings viz. Railways, Ordnance factories, etc., where the projects the appraised by the concerned ministry and planning commission.

The PIB, has also formulated certain guidelines for project appraisal, which inter-alia include that –

(i) The project should be in consonance with plan priorities.

(ii) There must be feasibility of undertaking the project in public or joint sector.

(iii) The internal rate of return shall be adequate.

(iv) The analysis of social cost benefits undertaken.

(v) The project has to contribute to export needs to be foreign exchange earnings etc.,

(vi) There a provision of funds in budgetary allocations.

(vii) Logical sequencing of project schedule has to be arranged.

(viii) Adequacy of safety and anti-pollution measures to be ensured.

(ix) Marketing feasibility of project to be brighter.

In case the project is recommended by the public investment Board, it goes to the cabinet through ministry of finance for its approval. In case the project is approved, a detailed project report is prepared providing sufficient details.

6. Working capital Management

The salient features of working capital management in PSUs are as follows:

(a) There is often no provision for working capital margin when the project is estimated. Hence, long-term funds are not made available for working capital margin. This means that PSUs are required to raise finance for current assets from short-term sources.

(b) Most of the PSUs are capital intensive, e.g., steel, oil refining, etc. Hence, the ration of current assets to fixed assets is generally very low.

(c) Apparently, PSUs don't have much difficulty in obtaining bank credit. PSUs can obtain short-term financing from all nationalized banks. Since the risk involves in lending to PSUs appears minimal, commercial banks are quite liberal in extending credit to PSUs.

(d) Management of inventories in PSUs is rather laz. This is evident from the high inventory to sales ratio found in most of the PSUs.

(e) Most of the PSUs have very little freedom to manipulate credit policy variables like discount rate, credit period etc. This may be cause by selling the bulk of their output to government or their output may be chronically in short supply

7. Accounts and Audit

PSUs have their own system of maintaining books of accounts based on the principles of Government accounting. Most of the PSUs do not have systematic monitoring of the activities. Accounting infrastructure is not strong. Also the internal audit is weak.

There are 2 types of audit conducted in case of PSUs-
(a) Statutory audit conducted by professional accountants.
(b) Efficiency-cum-propriety audit conducted by (C&AG) who submits his report to parliament for discussion.

From time to time, the C&AG has been highlighting the shortcomings of different PSUs on different aspects of failure causing losses of several lakhs of rupees. Most of these losses are due to inefficient management fails to take timely decisions and follow government guidelines.

8. Financial delegation

Every PSU has laid down procedures for approval of expenditure by competent officials. For more peculiar or complicated nature of expenditure of higher amount, the authority to approve the expenditure vests with senior officials.
While approving the expenditure, the following factors are considered-

(a) Whether the expenditure is necessary?
(b) Alternative ways to carry out the desired. Work to minimize cost.
(c) Overall effect of the expenditure on business.
(d) Whether the expenditure is permissible as per the internal rules of the company, and if not, the procedure that needs to be followed has been complied or not?
(e) Whether the official is authorized to incur the expenditure?

9. Financial Reporting

In addition to regular internal finance reporting, each PSU is required to submit monthly report in prescribed format to its administrative ministry. The monthly report contains –

(a) Profit and Loss Account
(b) Plan Expenditure Approved and sent
(c) Cost of Production
(d) Inventory Holding and Debtors Credit Period
(e) Variance between budget and actual

The monthly reports re submitted within 15th of the following month.

How to revive the PSUPs in India?

III. REFORMING THE PUBLIC SECTOR UNDERTAKINGS (PSUs)

There has been considerable criticism about the poor performances and in some cases utter failures of PSUs. For example, out of 242 central PSUs, over 100 are loss making units and many of them are terminally sick. There is much scope for improving the efficiency and working of PSUs.

The government has realized the need for reforming the PSUs. The measures for reforming the PSUs are broadly divided into following-

1. Reforming PSUs by signing Memorandum of Understanding (MOUs) and Greenfield Privatisation.
2. Reforming PSUs by selling their assets either partially or wholly to the private sector or to the general public.
3. Close down PSUs which can not be revived.

1. Reforming PSUs by signing MOUs

The government has entered into MOUs with number of PSUs. The main aim of MOU is to bring about a balance between autonomy and accountability. The industrial policy, 1991, extended the scope of MOUs to all the public sector enterprises. The main goal of MOU policy is to reduce the "quantity" of control and to increase the "quantity" of accountability. The real purpose of MOU is to manage PSUs by "management by objectives" rather than "Management by control". This is sought to be done by a "freely" negotiated performance between a public enterprise and Government acting as an owner in which both parties clearly specify their commitment and responsibilities.

2. Greenfield Privatisation

It refers to the process that aims to reduce involvement of the government or the public sector in the nation's economic activities and increase the role of private sector. The New Economic Policy (NEP), 1991 aims to achieve this through the following measures –

(a) **De-licensing –** Industrial licensing has been abolished for all projects except for a short list of industries reserved related by to strategic and security concerns. Thus, private sector has been allowed entry in sectors which were reserved for public sector before 1991 policy.

(b) **Reduction in budget allocation –** There will be reduction in budget allocation to PSUs and henceforth PSUs will be required to raise funds either from their own sources or through markets.

(c) **External aid/ grant:** Many infrastructure industries in absence of the budget allocations resort to external funding from multilateral and bi-lateral agencies. This, in turn, affects markets for domestic products.

(d) **Dis-Investment:** In order to raise resources and encourage wider public participation, a part of the government's shareholding in the PSUs would be offered to mutual funds, financial institutions, general public and workers.

IV. PRIVATISATION OF PUBLIC ENTERPRISES

Explain the term "Privatisation" What are the measures to be formulat?

1. Meaning of Privatisation

In a narrow sense, privatization implies the introduction of private ownership in publicly traded enterprises. But in a broader sense, it connotes besides private ownership (or even without change of ownership), the induction of private management and control in the public sector enterprises. Thus, privatization covers three sets of measures :-

(a) Ownership Measures

The sets of measures which transfer ownership of public enterprises, fully or partially, lead to privatization. The higher the proportion of transfer of ownership to the individual, co-operative or corporate sector, the greater is the degree of privatization. It can take four forms :

(i) **Total denationalization:** It implies a complete transfer of ownership of a public enterprise to private hands.

(ii) **Joint Venture:** It implies partial introduction of private ownership. The range of private ownership can vary from 25 to 50 percent or even more, depending upon the nature of the enterprise and state policy in this regard.

(iii) **Liquidation:** It implies a sale of assets to someone who may use them for the same purpose or some other purpose depending upon the preference of the buyer.

(iv) **Management Buy out:** It is a special version of denationalization. It implies sale of assets to the employees. For this purpose appropriate provision of loans from banks is also made to enable employees to take over ownership. In this case, the employees become entitled to ownership dividend, apart from wages.

(b) Organisation Measures

A number of organizational measures are conceived to limit state control. These are -

(i) **A Holding company structure –** It is so designed that the government limits its control interventions to apex level decisions and leaves the operating companies within a sufficient degree of autonomy in decision-making within the framework of market forces. For e.g., a very large enterprise is split into smaller units without loss of economies of scale. Although the smaller units comprise of a family, but they become independent in certain product lines or regional operations.

(ii) **Leasing –** A public enterprise while retaining ownership may lease out a private bidder for a specific period of use. But before the appointment of the bidder is finalized, the tenderers have to give an undertaking that the profits would pass over to the state and also give a convincing set of measures to undertake in this regard. The government enjoys the right of obtaining profits as per agreement, on the other hand, the private bidder brings improved efficiency or lower cost of operation.

(iii) **Restructuring –** To bring public sector enterprises under market discipline, it would be desirable to go in for two forms of restructuring :-

Financial restructuring can be effected in the sense that the accumulated losses are written off and capital composition is rationalized in respect of debt-equity ratio.

Basic restructuring may be effected by redefining the set of commercial activities which the enterprise will undertake henceforth. It may shed some activities to be taken up by ancillaries or small scale units.

(c) Operational Measures

These measures are intend to improve the efficiency of the organization, even when full denationalization has not been undertaken. They infact inject the spirit of commercialization in public enterprises (PE). The measures include grant of autonomy to P Es in decision making.

- Provision of incentives to employees consistent with increase in efficiency and productivity,
- Freedom to acquire certain inputs from the market by a system of “contracting” instead of producing them within,
- Development of proper investment criteria,
- Permitting PEs to go to capital market to raise funds, etc.,
- The basic purpose of these measures is to bring about a drastic reform to reduce government control over public enterprises.

Write short notes on Disinvestment?

V. REFORMING PUBLIC SECTOR ENTERPRISES THROUGH DISINVESTMENT

In India, with the onset of the era of liberalisation and globalization, the government came to realize that the PSUs were plagued by financial crisis and mismanagement and were no longer in a position to take the economy to commanding heights. Disinvestment offered a viable solution to provide strength to these sick PSEs. Today, profit making PSEs are also being targeted for disinvestment. There is no going back as far as government is concerned because it believes that disinvestment has led to benefits for the economy, the tax payer, the stock market and the employees. (To know more about us visit KalpeshClasses.com)

OBJECTIVES/GOALS OF DISINVESTMENT

1. To release large amount of public resources locked up in non-strategic PSEs for redeployment in areas that are much higher on the social priority scale, e.g., health, family welfare, etc.
2. To reduce the public debt that is assuming threatening proportions.
3. To facilitate transferring the commercial risk to which the taxpayers' money locked up in PSEs is exposed, to the private section wherever the private sector is willing to step in.
4. To release tangible and intangible resources such as large manpower locked up in managing PSEs and for redeployment in high priority social sectors.
5. Disinvestment would expose privatized PSEs to market discipline and help them become self-reliant.
6. Disinvestment would have a beneficial effect on capital market. The increase in floating stock will give the market more depth and liquidity give investors early exit options, help establish more accurate benchmarks for valuation and raising of funds by privatized companies for their projects and expansion.
7. Disinvestment would result in wider distribution of wealth by offering shares of privatised companies to small investors and employees.
8. Opening up of the public sector to appropriate private investment would increase economic activity and shall have an overall beneficial effect on the economy, employment and tax revenue in the medium to long-term.
9. It would provide consumers with more choices and better quality of products and services, e.g., telecom sector.

DISINVESTMENT STRATEGIES

1. How to disinvest?

An important issue that arises with respect to disinvestment relates to the process to be adopted for disinvestment. This in turns revolves around appropriate valuation of the shares and the modalities to be adopted for sale. In general, three methods for valuation of shares are adopted -

(a) Net-Asset value method (NAV method)
(b) Profit earning capacity value method
(c) Discounted cash flow method (DCF method)

While the NAV would indicate the value of the asset, it would not be in a position to indicate the profitability or the income to the investors. The profit earning capacity is generally based on the profit actually earned or anticipated. DCF method is a far more comprehensive method of reflecting the expected income flows to the investors.

Of these three methods, the DCF method has the greatest relevance though it is the most difficult. It is to be noted that while the different valuation methods can provide a bench-mark for the price, but the price at which a share can be sold is determined more by investor perception rather than any mechanical measure of intrinsic worth. There is, therefore, a need for full disclosure of the method adopted for valuation of PSEs to generate credibility and investor interest. Rise and fall in the share price soon after disinvestment does not by itself indicate that shares were underpriced or overpriced at the time of disinvestment.

Modalities of disinvestment

There are two acceptable and transparent processes available
(a) offering shares of PSEs at a fixed price through a general prospectus. This offer is made to the general public through the medium of recognized market intermediaries.
(b) Sale of equity through auction of shares amongst predetermined clientele whose numbers can be as large as necessary or practicable. The reserve price for the PSE equity can be determined with the assistance of merchant bankers.

Merits and Demerits of the above methods

In the first alternative of “offer for sale,” difficulties may be encountered in estimating and determining the fixed price if it is offered for the first time and the shares are not actually traded in the stock exchange. On the other hand, this method has the advantage of spreading the ownership widely amongst the general public and in a transparent manner.

In the case of those PSEs for which the first sale of equity is yet to be made, or those where the track record of trading in shares is yet to be established, the tender system would be advantageous. Once a reasonable period of time express and a public enterprise completes the preparatory work, the fixed price method would be appropriate.

2. Restructuring of PSEs

Another issue relates to restructuring of PSEs. In some cases, more restructuring can result in increasing the proceeds of disinvestment. Whether some restructuring should be undertaken before sale of PSEs or not, should depend upon the time, energy and resources to be devoted for such restructuring. There has to be a balance of costs and benefits.

3. Conditions in the capital Market

The process of disinvestment should take into account the conditions in the capital market. Disinvestment should not result in “crowding-out” resources available for the private sector.

4. Extent of Disinvestment

The extent of disinvestment should depend upon whether the PSEs belong to strategic, core and non-core non-strategic sector.

Sector	**Extent of Disinvestment**
Strategic	Nil
Core	49%
Non-core non-strategic	74% or more

5. Disinvestment of Loss-making PSUs

The question of eventual disinvestment in loss making PSUs raises the issue of funds required for revival and restructuring.

- Where it is possible to disinvest a PSE without restructuring, it should sell those PSEs as a going concern on as-is-where-is basis.
- Wherever possible, the PSEs should be restructured and turned around before disinvestment. Where it is neither possible to restructure nor disinvest as a going concern, the PSE should be closed down. However, in all cases, the interest of affected workers should be protected by devising suitable schemes for retraining, redeployment or voluntary retirement with adequate compensation.

Write a brief note on Disinvestment Commission

VI. DISINVESTMENT COMMISSION

The Government of India has set up the Disinvestment Commission in August 1996 to advise it on the extent, strategy, methodology, time, size and price for investment in each PSU. The commission is an advisory body. However, it is felt that the commission should be given a statutory status in order to enable timely restructuring of PSUs and timely completion of disinvestment process.

The major highlights of the commission are as follows:-

(a) Long-term disinvestment programme to be prepared.
(b) Extent of disinvestment in each PSU to be determined.
(c) Sales process to be supervised and decisions to be taken on instruments, pricing and timing.
(d) Financial advisors for specified PSUs to be selected.
(e) Progress of dis-investment process to be monitored.
(f) Substantial number of shares to be offered to workers.
(g) Claw back mechanism and instalment purchase of shares to be introduced.
(h) A chain of share shops to be encouraged.

The Government has laid down the terms of reference for the commission with the intention of making the disinvestment exercise more transparent and responsive.

The commission generally draws a comprehensive overall long-term disinvestment programme within 5 to 10 years for the PSUs referred to it. It also determines the extent of disinvestment in each PSU. The commission prioritises the PSUs referred to it by the core group in terms of the overall disinvestment programme

The commission monitors progress of disinvestment process and takes necessary measures and reports periodically to the government on such progress, ensures that appropriate measures are taken to protect the interests of affected employees, encouraging employees participation in the sale process.

The disinvestment commission has recommended to offload 74% government equity in PSUs in the non-core non-strategic areas.

Discuss the various issues arising in case of Disinvestment

VII. ISSUES IN INDIAN DISINVESTMENT

Government's role in Industrial Development

Since the Industrial policy was announced in 1991, the Government Controls on entry in a number of industries have been either abolished or simplified. It has been accepted now that there is ample room for public as well as private investment. With-increasing role assigned to private sector in national development, the role of government as a regulator and as an investor needs to be redefined.

Privatisation Vs. Disinvestment

Privatisation means opening up certain sectors for private sectors participation. Disinvestment has raised wider questions such as the need for restructuring PSUs, the extent of disinvestment of Government shareholding in operating sectors and partial/total withdrawal of Government from certain industries. The common Minimum Programme has acknowledged that the public sector should be strong and competitive and hence requires reforms and restructuring.

Classification of Industries and Extent of Disinvestment

It has been felt that the government should limit its role to strategic and core sectors but the definition of industries included in these sectors have varied. The extent of disinvestment in strategic, core and non-core and non-strategic sectors has been indicated by the Government as nil, 49% and 74% or more respectively. In case where the disinvestment can go up to 74% or more, the need for residency government control has to be addressed.

Employee Interests

The disinvestment commission has recommended protecting employee interest in the light of restructuring of PSUs. The modalities will depend upon the extent of restructuring and will be specific to each PSU. There should be suitable schemes for retraining, redeployment or for voluntary retirement with adequate compensation.

Use of Disinvestment Proceeds

The proceeds of disinvestment goes to Government. In order to sustain the interests of the enterprise in the process of disinvestment, it may be useful to set aside a certain percentage of profits, say 10%, to be given to the enterprises for their own expansion. Also, the proceeds of disinvestment should be utilized for creation of physical and social infrastructure (e.g. health and education). A part of such proceeds should be earmarked for creation of an investment fund, which will be used to strengthen other public sector enterprises. A view have also been expressed that the proceeds should be utilized for retiring government debt and thus reduce the interest burden.

However, it is feared that the disinvestment proceeds will be used for meeting the recurring expenses of the government. (To know more about us visit KalpeshClasses.com)

Critically analysis the disinvestment programme in India

VIII. CRITICAL ANALYSIS OF DISINVESTMENT PROGRAMME IN INDIA

1. There is a lack of clarity about the goals of disinvestment.
2. The policy makers have exhibited their ignorance about the merits of partial versus full disinvestment. There have been cases of full disinvestment in the case of some state PSUs, but the success has been partial. The success of partial privatization in India is plagued by the presence of Article 12 of the Indian constitution, C&AG Audit and the fear of vigilance.

3. The disinvestment programme suffers from lack of involvement of PSU executives and excessive domination by the bureaucrats. The speed and control are the other two aspects hampering the forward movement of disinvestment programme.
4. The policy-makers have given no regard to the capital market dimension of the disinvestments. There has been no serious efforts towards dematerialization of shareholdings, removal of restrictions on the repatriation of dividend and interest, listing on stock exchanges and foreign bourses, etc. Some of the disinvested PSUs have even applied to SEBI to exempt them from submitting the quarterly returns.
5. A well devised disinvestment programme would show a high concern to the welfare of the workers, consumers, government and buyers. In India, a small advance in this direction has been made by setting Telecom Regulatory Authority of India (TRAI) and Insurance Regulatory Authority. However, they have not made the desired mark and there have been continuous interference by the government.
6. In India, the efforts regarding internal and external restructuring has been dismal. Interests of workers have not been protected. The National Renewal Fund has been put forward only to pay lip service.
7. The amount raised through disinvestment from 1991-2001 is too small as compared to the budgeted estimates. Further, the money raised by disinvestment is being used for meeting recurring expenditure of the government rather than creating private and social infrastructure, etc.,
8. There is a lack of political consensus on the issue of disinvestment.

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19 DIVIDEND POLICY

An Overview

Introduction

Concept and Significance

Models

Walter's Model
Gordon's Model
Modigliani and Miller's Model

Factors affecting dividends policy

External Factors

General State of economy
State of capital market
Legal requirements
Contractual restrictions
Tax policy

Internal Factors

Desire of the shareholders
Financial needs of the company
Nature of Earnings
Desire of control
Liquidity Position

Introduction

The term dividend refers to that portion of profit (after tax) which is distributed among the owners/shareholders of the firm and the balance profit which is not distributed is known as retained earning. The dividend policy of the company should aim at achieving the objective of the companies to maximize shareholders wealth.

I. CONCEPT AND SIGNIFICANCE

The Concept of "Dividend Policy" implies that companies through their Board of Directors evolve a defined pattern of dividend payments which has a bearing on future action. While deciding the dividend payout ratio the firm should consider the effect of such policy on the objective of maximization of share holder's wealth. If payment of dividend is expected to increase the market value of the share, the dividend must be paid, otherwise retained and used as an internal source of finance. So, the firm must find out and establish a relationship between the dividend policy and the market value of the share.

Thus in dividend decision, a financial manager is concerned to decide one or more of the following:

Should the profits be ploughed back to finance the investment decisions?
Whether any dividend be paid?
How much? When? In what form?

All these decisions are inter-related and have bearing on the future growth plans of the firm. Hence the establishment and determination of an effective dividend policy is therefore, of significant importance to the firm's overall objective.

II. MODELS

There are conflicting theories regarding impact of dividend decision on the valuation of a firm. According to one school of thought, dividend decision does not affect the shareholders' wealth and so also the valuation of the firm. While according to another school of thought, dividend decision materially affects the shareholders' wealth and also the valuation of the firm.

1. WALTER'S APPROACH

According to this approach dividend policy always affects the value of the enterprise. A Mathematical formula is suggested to evolve dividend policy with a view to maximize the wealth position of equity shareholders.

This is based on the relationship between the firm's –
i. Return on investment or IRR (i.e. R) and
ii. Cost of capital or required rate of return (i.e. K)

R > K A firm can maximize the market value of its share and the value of the firm by adopting a dividend policy as follows:

if R > K the firm can have higher return on their investment and the firm should retain the earnings.

R < K In case of firm which does not have profitable investment opportunities i.e. **R < K** the optimum dividend policy would be to distribute the entire earnings as dividend. The shareholders will stand to gain because they can utilize the dividends so received in channels which can give them higher return.

R = K

- In case of firms where **R = K**, it does not matter whether the firm retains or distributes its earnings. In this case the value of the firm's share would not fluctuate with change in the dividend rates.

Mathematical Formula

$$VC = \frac{D + RA\,\frac{(E - D)}{RC}}{RC}$$

VC = Theoretical market price of an equity share
D = Dividend per share
E = Earnings per share
RC = Cost of equity capital or market capitalisation rate
RA = Internal Rate of return or Internal Productivity rate

Assumptions of Walter's Model

i. The firm does the entire financing through retained earnings. It does not use external sources of funds such as new debt or new equity capital.
ii. The firm's business risk does not change with additional investment. It implies that the firm' IRR and cost of capital remain constant.
iii. The firm has a very long life.

Criticisms on Walter's Model:

i. The assumption that financial requirements of a firm are met only by retained earnings and not by external financing, is seldom true in practice. Firms do raise funds by issuing new debentures or equity shares whenever they are in need of additional funds.
ii. The assumption that firm's IRR will remain constant does not hold good. As a matter of fact, with increased investments, IRR also changes.

iii. The assumption that cost of capital will remain constant does not also hold good. A firm's risk pattern does not always remain constant.

2. **GORDON'S MODEL**

This model is also based on the assumptions similar to those made on Walter's model. However two additional assumptions made in this model are as follows:

i. The growth rate of the firm 'g" is the product of its retention ratio "b" and its rate of return, "r" (i.e., g = br) and
ii. The cost of capital besides being constant is more than the growth rate, i.e., $K_e > g$.

Under this model, the market price of a share can be calculated as follows:

$$P = \frac{E(1-b)}{K_e - br}$$

Where
P = Market price of equity share
E = Earnings per share of the firm
b = Retention Ratio i.e., (1- payout ratio)
r = Rate of return on investment of the firm
K_e = Cost of Equity share capital, and
br = g

BRIEF TIME TABLE FOR NOVEMBER 2005 C.A. FINAL EXAMINATION.
SUBJECT : DIRECT TAX

EXAMINATION	BRANCH	COMMENCING	ADMISSION STATUS
NOV 2005 (A.Y. 2005-2006)	ANDHERI	19-07-2005	In Progress
NOV 2005 (A.Y. 2005-2006)	CHARNI ROAD	24-05-2005	In Progress
NOV 2005 (A.Y. 2005-2006)	GHATKOPAR	17-07-2005	In Progress

Course Coverage for all the branches is the same.

3. MODIGLIANI AND MILLER'S APPROACH (M M HYPOTHESIS)

The fundamental premise of this theory is that the price of the shares of a firm is determined by its earning potentiality and investment policy and never by the pattern of income distribution. The logic put forward in support of this theory is that only increase in shareholders' wealth resulting from dividend payments will exactly offset the effect of raising additional capital.

Assumptions of M. M. Hypothesis

i. Capital markets are perfect
ii. Investors behave rationally. Information is freely available to all of them and there are no floatation or transactions costs.
iii. There are either no taxes or there are no differences in the rates applicable to capital gains and dividends
iv. The firm has a fixed investment policy
v. Risk of uncertainty does not exist.

Proof for M. M. Hypothesis:

According to M. M. Hypothesis, the market value of a share at the beginning of the period is equal to the present value of dividends paid at the end of the period plus the market price of the share at the end of the period.

$$P0 = \frac{D1 + P1}{(1 + Ke)} \qquad \text{OR} \qquad P1 = P0\ (1+Ke) - D1$$

P0 = Prevailing market price of a share
D1 = Dividend to be received at the end of period
P1 = Market price of share at the end of period one
Ke = Cost of equity capital

Computation of the number of new shares to be issued:

$$M \times P1 = I - (X - ND1) \qquad \text{OR} \qquad M = \frac{I - (X - ND1)}{P1}$$

M = Number of shares to be issued
P1 = Price at which new issue is to be made
I = Amount of investments required
X = Total net profit of the firm during the period
ND1 = Total dividend paid during the year.

Criticisms of M.M. Hypothesis

i. Tax differential

M.M. Hypothesis assumption that taxes do not exist is far from reality. In practical life not only the shareholders have to pay tax but there are different rates of tax for capital gains and dividends. Capital gains are subject to lower rate of tax as compared to dividends. The cost of internal financing will therefore be cheaper as compared to cost of external financing.

ii. Cost of Floating

A firm always has to pay floating costs in terms of underwriting commission and other incidental costs, whenever it wants to raise funds from outside, as a result, the external financing is costlier than internal financing.

iii. Transaction costs

The shareholders have also to pay brokerage, fee etc. when they sell the shares. Moreover, it is inconvenient to sell the shares. On account of these reasons a shareholder would prefer to have dividends rather than capital gains on sale of shares?

iv. Discount rate

Under this Hypothesis, application of single discounting rate for discounting cash inflows arising in different time periods is not correct. Uncertainty increases with the length of the time period. Investors prefer immediate dividends to future dividends. It means in M.M. Hypothesis the value of shares of that company which is paying higher dividends will have a higher value as compared to a company which is following the policy of retention of earnings, which is not company.

III. FACTORS AFFECTING DIVIDEND POLICY

The factors affecting the dividend policy are both external and internal.

1. EXTERNAL FACTORS

i. **General state of economy**

- In case of uncertain economic and business conditions, the management may like to retain the whole or part of the firm's earnings to build up reserves to absorb shocks in future.
- Similarly in the period of depression, the management may also withhold dividend payment to retain large part of earnings to preserve the firm's liquidity position.
- In the periods of prosperity the management may not be liberal in dividend payments because of availability of large profitable opportunities.

ii. **State of Capital Market**

In case a firm has an easy access to the capital market to raise funds, it can follow a liberal dividend policy. Otherwise it is better to adopt more conservative dividend policy

iii. **Legal Restrictions**

The management has to take into account all the legal restrictions before taking the dividend decision, otherwise, it may be declared as ultravires.

iv. **Contractual Restrictions**

Lending financial institutions generally put restrictions on dividend payments to protect their interests in periods where the firms are experiencing liquidity or profitability problems.

v. **Tax Policy**
Prevailing Corporate Income Tax and Tax on Dividend also affects the dividend policy.

2. INTERNAL FACTORS

i. Desire of the shareholders
Shareholders are technically the owners of the company and therefore their desire cannot be overlooked while deciding the dividend policy. Shareholders expect two forms of return on their investment viz. dividend and capital gain. In most cases, shareholders desire to get dividend gets priority over the desire to earn capital gain because of the following reasons

- Indication of Strength
- Reduction of uncertainty
- Need for current income

ii. Financial Needs of the Company
The financial needs of the company may be in direct conflict with the desire of the shareholders to receive large dividends. However a prudent management should give more weightage to the financial needs of the company, rather than the desire of the shareholders.

iii. Nature of Earnings
A firm having stable income can afford to have higher pay-out ratio as compared to a firm which does not have such stability in its earnings conditions

iv. Desire of Control
Dividend policy is not only influenced by the desire of Shareholders, but the management's desire to keep control over the company. Additional equity issue dilutes the control. In case of strong desire for control, the management may pay substantial dividends and prefer a higher dividend pay-out ratio. However where the management is strongly in control either because of substantial share holding or because of the shares being widely held, the firm may offer a low dividend payout ratio.

v. Liquidity Position

The management always takes into account the cash position and overall liquidity position of the firm before and after payment of dividends while taking the dividend decision.

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20 *Glossary*

Glossary of Mutual fund and Investment terms:

Advisor

1. Person or organisation responsible for making mutual fund investments.
2. Organisation employed by a mutual fund to give professional advice on the funds investments and asset management practices. Also known as investment advisor.

Aggressive growth funds

Mutual funds that spine for maximum growth as the primary objective. The fund usually remains fully invested in stocks at all times, it buys small, speculative companies and depressed stocks and may use techniques like short selling and leverage.

Agreement

This is a culmiuation of various steps of negotiations. When an agreement has been signed and delivered the parties are bound by the terms of the agreement. This is the final stage of commitments specified and acceptual by various counterparts.

Americans Depository Receipt

A security created by U.S. bank that shows ownership of a certain number of shares of a foreign stock.

Annual report

Updates that detail performance and provide financial statements of an entity for the year.

Annual return

The percentage of change in a mutual fund's net asset value over a year's time, factoring in dividend payments, capital gains and reinvestment of these distributions.

Annuity

A type of investment marketed for individuals who want future income, particularly at retirement. An annuity is a contract between an insurance company and an individual investor. The insurance company agrees to pay a stipulated amount to the investor (the annuitant), for life or for some specific period in return for a single payment or series of payments. Benefits may begin immediately or at some later date. The major types are fixed and variable annuities, which resemble mutual funds. The major difference between annuities and mutual funds is that earnings on variable annuities are tax deffered while mutual funds an taxed on distributions and gains each year. As with mutual funds, the maximum sales charge is 8.5 per cent. In addition, these are other expenses described in the prospectus that are not part of the sales charge. Most have front end loads. (To know more about us visit KalpeshClasses.com)

Arbitrage

An investment technique used by big companies and high-rolling investors to cash in on seemingly insignificant differences between stock indices and future contracts on those indices.

Ask (or offer)

Price of mutual fund, stock bond, option etc to investor.

Asset allocation fund

Balance fund in which changes are made in the stock and bond percentage mix, based on the outlook for each market. As asset allocation fund either keeps a fixed percentage of its assets in various investments, bonds, stocks, precious metals, real-estate or varies the percentages, depending on where the find managers think that investment markets are pending. A true asset allocation funds has some investments in inflation, resistant hard assets (such as precious metals or real estate)

Automatic investment man

Program that allows an investor to hare a little as $50 a month electronically deducted from a checking account and invested in the selected mutual fund.

Automatic Reinvestment

Choice a shareholder can make to have distribution or dividends reinvested in more fund shares.

Average Price per share

Most popular method of paying taxes on mutual fund sales in which in investor calculates gains or losses by figuring an average cost per share. This is done by calculating the total cost of all the fund shares owned and then dividing by the number of shares owned.

Back-end load

A sales fee or commission charged by the management of a mutual fund at the time of the fund shares are sold. Also called a deffered sales charge.

Commercial Production

When the plant starts at rated capacity of production on commercial basis.

Counter guarantee

This guarantee provided by guarantor is subservient to a main contract involving various parties. Such guarantee is provided to cover uncertain eventualities in high stake projects like big power plants or Irrigation projects. Such guarantees have legal binding and are better defined and more specific than letter of comfort.

Credit Rating

When the rating of a company and its various debt instruments is done by a professional outside agency like CRISIL.

CRISIL

Credit **R**ating **I**nformation **S**ervices **I**ndia **L**td.

Deep discount bond

These are bonds which are issued for long term maturity like 10-15 years. In such instruments the interest payable is accumulated every year and the compounded interest alongwith principal is paid at the time of maturity. The instrinsic value of the bond increases with the passage of time due to loading of interest.

Escrow Payment Mechanism

This is a payment mechanism to provide for embarking a stream of cash/funds inflows towards specific payments. Such mechanism has evolved to provide comfort to shareholders in raising projects. (For any inquiry or admission to kalpesh classes dial 2382 0676)

Expansion Plans

The plans for increasing the production capacity to match its business plan for enhancing the market share.

Financial Closure

When the project has fixed up the complete means of Finance

Floating rate notes

Borrowings by was of promissory note with interest coupon which are Floating i.e. they are linked to a certain variable such as prime lending rate, bank rate, index of call money rates, or Central Government P. F. rates and so on.

Green shoe option

An announced option in the prospectus or Information Memorandom of private placement to retain over-subscription to a certain extent.

Hybrid Instruments

They consist of portion of equity as well as debt. Fully and partly convertible debentures are examples of Hybrid instruments. (To know more about us visit KalpeshClasses.com)

Infrastructure bonds

Companies engaged in infrastructure projects to raise funds by issue of debentures/bonds after obtaining cover under section 10(23) G of the Income Tax Act, 1961. The advantage to investors in such infrastructure bonds is that the interest income netted out by cost of funds is tax free.

Initial Public offering

First public issue of equity shares by a company.

Issue at discount

Instruments issued at discount to their face value. For example, Deep discount bond or Zero coupon debentures.

Issue at premium

Instruments issued at premium to their face value. Debentures may also be issued at premium.

Letter of Comfort

Credit enhancement mechanism employed by well known financial and corporate entities. Only well reputed companies and institutions can offer letters of comfort which are accepted in the market.

Letter of intent
The first steps of approval & commitments which signals a process to undergo towards a final approval. This indicates an interest and intention to go through a certain process of satisfying terms and conditions towards final approval.
LIBOR/MIBOR
London Interbank Offer Rate and Mumbai Interbank Offer Rate are the closing rates on a particular date with regard to interbank borrowings.

Terms Used in Connection with Leases

Lessor
A person, who under an agreement, conveys to another person (the lessee) the right to use, in return for rent, an asset for an agreed period of time.

Lessee
A person, who under an agreement, obtains from another person (the lessor) the right to use, in return for rent, an asset for an agreed period of time.

Lease
An agreement whereby the lessor conveys to the lessee, in return for rent, the right to use an asset for an agreed period of time.

Non-Cancellable Lease
A lease that is cancelable only:
(a) upon the occurrence of some remote contingency,
(b) with the permission of the lessor,
(c) if the lessee enters into a new lease for the same or any equivalent asset with the same lessor, or
(d) upon payment by the lessee of an additional amount such that, at inception, continuation of the lease is reasonably certain.

Inception of the Lease

The earlier of the date of the lease agreement or of a commitment by the parties to the principal provisions of the lease.

Lease Term

The non-cancellable period for which the lessee has contracted to take on lease the asset together with any further periods for which the lessee has the option to continue the lease of the asset, with or without further payment, which option at the inception of the lease it is reasonably certain that the lessee will exercise.

Minimum Lease Payments

The payments over the lease term that the lessee is or can be required to make (excluding costs for services and taxes to be paid by and be reimbursable to the lessor) together with the residual value.

Fair Value

The amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction.

Useful Life

In the case of an operating lease either

(a) the period over with a fixed asset is expected to be used by the enterprise; or
(b) the number of production (or similar) units expected to be obtained from the asset by the enterprise. In the case of a finance lease, the useful life of the asset is the lease term.

Residual Value

Value estimated at the inception of lease, of the lease asset, at the expiry of the lease term.

Interest Rate Implicit in the Lease

The discount rate that, at the inception of the lease, causes the aggregate present value of the minimum lease payments, from the standpoint of the lessor, to be equal to the fair value of the leased asset, net of any grants and tax credits receivable by the lessor.

Gross Investment in the Lease

The aggregate of the minimum lease payments under finance lease from the standpoint of the lessor.

Unearned Finance Income

The difference between the lessor's gross investment in the lease and its present value.

Net Investment in the Lease

The gross investment in the lease less uncearned finance income.

Classification of Leases

Finance Lease

A lease under which the present value of the minimum lease payments at the inception of the lease exceeds or is equal to substantially the whole of the fair value of the leased asset. A lease is classified as a finance lease if it secures for the lessor the recovery of his capital outlay plus a return on the funds invested during the lease term. Such a lease is normally non-cancellable and the present value of the minimum lease payments at the inception of the lease exceeds or is equal to substantially the whole of the fair value of the leased asset.

Operating Lease

A lease other than a finance lease. A lease is classified as an operating lease if it does not secure for the lessor the recovery of his capital outplay plus a return on the funds invested during the lease term.

Memorandum of understanding

Understanding arriving between various parties in the project. A MOU is an understanding on broad issues and indicates some degrees of commitments.

Modernisation

Changes/upgradation effected to existing plants to meet the new technologies and new machineries.

Pilot Plant

The initial testing of the plant and the technology.

Private Placement

When subscription to equities or debentures or other instruments is sought by placement of these instruments on a private invitation basis.

Prospectus

This is a document detailing the objectives of the issue, company profile, financial projections terms of issue etc.

Public Issue

Invitation to public to subscribe to equity shares, debentures or other instruments by issue of prospectus.

Qualified Institutional Buyer's (Quibs)

Only Investors eligible for investment by private placement this mechanism is provided there to restrict private placement of securities to Quibs.

Renunciation

When others/outsiders are authorized to exercise the Rights by the persons who are entitled for Rights Issues.

Right Issue

When invitation to subscribe equities, debentures or other instruments is made only to existing shareholders.

SEBI

Securities **E**xchange **B**oard of **I**ndia.

Secured debentures

The debenture is a instrument which is transferable by endorsement and delivery. It represent debt of the Company where such debentures are secured by charge fixed and floating or by specific mortgage, such debentures are said to be secured debentures.

Sovereign Rating

Rating derived from assessment of a country's risk. Such country risk is assessed based on financial performance of economies, government finances, political scenario and future outlook. Such Sovereign rating is carried out by international rating agencies such as standard and poor, Moody's etc.

Tax free bonds
Interest earned on such bonds is not liable to tax.

Taxable bonds/debentures
When interest earned on debentures is taxable.

Unsecured debentures
When the security is not created, the debentures are unsecured and are classified under unsecured borrowings.

Working Capital margin
The shareholders/promotes/Entrepreneurs are required to contribute certain percentage sourced from sources of funds. (To know more about us visit KalpeshClasses.com)

Zero conform debenture
This is a debenture where no interest is payable, but the issue price is at a discount to the face value of the debenture.

Zero date
The beginning of Project for mutation.