CHAPTER FOUR

FINANCIAL MANAGEMENT
AS A FUNCTION OF
EFFICIENT FINANCING OF
SSI\text{s}
CANTENTS

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4.1 INTRODUCTION

Financial management is broadly concerned with the acquisition and use of funds by a business firm. The term "Nature of Financial Management" as applied to financial management refers to its relationship with the closely-related fields of economics and accounting, its functions, scope and objectives. Financial management, as an academic discipline, has undergone fundamental changes in its scope and coverage. In the early years of its evolution it was treated synonymously with the raising of funds. In the current literature pertaining to financial management, a broader scope so as to include, in addition to procurement of funds, efficient use of resources is universally recognized. Similarly, the academic thinking as regards the objective of financial management is also characterized by a change over the years.

Any study on the critical evaluation of finance concerns of small scale industries cannot be complete without giving due consideration to the sources of finance that are available to small scale industries. The importance to a global perspective on the sources is essential to be noted due to the reason that hence forth after the liberalization and globalization policy, even the small scale industries are compelled to operate in a global business environment. The focus of this chapter has been on providing a global perspective to the sources of finance, particularly to small scale industries. The essentially notable fact is that in Iran, the main and only source of finance to small scale industries has been lending from National Banks. However after liberalization many options are found to be available to the small scale industries for meeting the financial requirements. It is surprising that large percentage of small scale industries are not even aware of lease financing and venture capital options, which are much more profitable and appropriate for meeting the financial requirements of small scale industries. Due to this situation it has been felt essential to highlight the various sources of finance that are available to small scale industries.

4.2 FINANCE AND RELATED DISCIPLINES

Financial management, as an integral part of overall management, is not a totally independent area. It draws heavily on related disciplines and fields of study, such as economics, accounting, marketing, production and quantitative methods.
4.2.1 FINANCE AND ECONOMICS

The relevance of economics to financial management can be described in the light of two broad areas of economics: macroeconomics and microeconomics.

4.2.1.1 Macroeconomics

Macroeconomics is concerned with the overall institutional environment in which the firm operates. It looks at the economy as a whole. Macroeconomics is concerned with the institutional structure of the banking system, money and capital markets, financial intermediaries, monetary, credit and fiscal policies and economic policies dealing with, and controlling level of activity within an economy. Since business firms operate in the macroeconomic environment, it is important for financial managers to understand the broad economic environment. Specifically, they should:

1. recognize and understand how monetary policy affects the cost and the availability of funds;
2. be well versed in fiscal policy and its effects on the economy;
3. be aware of the various financial institutions/financing outlets; and
4. Understand the consequences of various levels of economic activity and changes in economic policy for their decision, environment and so on.

4.2.1.2 Microeconomics

Microeconomics deals with the economic decisions of individuals and organizations. It concerns itself with the determination of optimal operating strategies. In other words, the theories of microeconomics provide for effective operations of business firms. The concepts and theories of microeconomics relevant to financial management are, for instance, those involving:

1. Supply and demand relationships and profit maximization strategies;
2. Issues related to the mix of productive factors, "optimal" sales level and product pricing strategies;
3. Measurement of utility preference, risk and the determination of value, and
4. The rationale of depreciating assets.

It is therefore important that financial managers must be familiar with basic microeconomics.
4.2.2 FINANCE AND ACCOUNTING

The relationship between finance and accounting, conceptually speaking, has two dimensions:

1. They are closely related to the extent that accounting is an important input in financial decision-making; and
2. There are key differences in viewpoints between them.

Accounting function is a necessary input of the finance function. That is, accounting is a sub function of finance. Accounting generates information/data relating to operations/activities of the firm. The end-product of accounting constitutes financial statements such as the balance sheet, the income statement and cash flow statement (sources and uses of funds statement).

4.2.3 FINANCE AND OTHER RELATED DISCIPLINES

Apart from economics and accounting, finance also draws for its key day-to-day decisions on supportive disciplines such as marketing, production and quantitative methods.

For instance, financial managers should consider the impact of new product development and promotion plans made in the marketing area since their plans will require capital outlays and have an impact on the projected cash flows. Similarly, changes in the production process may necessitate capital expenditures which the financial managers must evaluate and finance. And finally the tools of analysis developed in the quantitative methods area are helpful in analyzing complex financial management problems.

The marketing, production and quantitative methods are, thus, only indirectly related to and are supportive in nature while economics and accounting are the primary disciplines on which the financial manager draws substantially.

4.3 SCOPE OF FINANCIAL MANAGEMENT

The approach to the scope and functions of financial management is the modern approach which views the term financial management in a broad sense and provides a conceptual and analytical framework for financial decision making. According to it, the finance function covers both acquisitions of funds as well as their allocations. Thus, apart from the issues involved management is the efficient and wise allocation of funds
to various uses. Defined in a broad sense, it is viewed as an integral part of overall management.

Financial management, according to the new approach, is concerned with the solution of three major problems relating to the financial operations of firm, corresponding to the questions of investment, financing and dividend decisions. Thus, financial management, in the modern sense of the term, can be broken down into three major decisions as functions of finance:

- The investment decision;
- The financing decision; and
- The dividend policy decision.

4.3.1 INVESTMENT DECISION

The investment decision relates to the selection of assets in which funds will be invested by a firm. The assets which can be acquired fall into two broad groups (1) long-term assets which yield a return over a period of time in future (2) short-term or current assets, defined as those assets which in the normal course of business are convertible into cash without diminution in value, usually within a year. The first of these involving the first category of assets is popularly known in financial literature as capital budgeting. The aspect of financial decision making with reference to current assets or short-term assets is popularly termed as working capital management.

4.3.1.1 Capital Budgeting

Capital Budgeting is probably the most crucial financial decision for a firm. It relates to the selection of an asset or investment proposal or course of action whose benefits are likely to be available in future over the lifetime of the project. The long-term assets can be either new or old existing ones. The first aspect of the capital budgeting decision relates to the choice of the new asset out of the alternatives available or the reallocation of capital when an existing asset fails to justify the funds committed. Whether an asset will be accepted or not will depend upon the relative benefits and returns associated with it. The measurement of the worth of the investment proposals is, therefore, a major element in the capital budgeting exercise. This implies a discussion of the methods of appraising investment proposals. The second element of the capital budgeting decision is the analysis of risk and uncertainty. They have to be estimated.
under various assumptions of the physical volume of sale and the level of prices. An element of risk in the sense of uncertainty of future benefits is, thus, involved in the exercise. The returns from capital budgeting decisions should, therefore, be evaluated in relation to the risk associated with it.

Finally, the evaluation of the worth of a long-term project implies a certain norm or standard against which the benefits are to be judged. The requisite norm is known by different names such as cut-off rate, hurdle rate, required rate, and minimum rate of return and so on. This standard is broadly expressed in terms of the cost of capital. The concept and measurement of the cost of capital is, thus, another major aspect of capital budgeting decisions. In brief, the main elements of capital budgeting decisions are:

- The long-term assets and their composition;
- The business risk complexion of the firm; and
- Concept and measurement of the cost of capital.

4.3.1.2 Working Capital

Working capital management is concerned with the management of current assets. It is an important and integral part of financial management as short-term survival is a prerequisite for long-term success. One aspect of working capital management is the trade-off between profitability and risk (liquidity). There is a conflict between profitability and liquidity. If a firm does not have adequate working capital, that is, it illiquid and consequently may not have ability to meet its current obligations and, invite the risk of bankruptcy. If the current assets are too large, profitability is adversely affected. The key strategies and considerations in ensuring a trade-off between profitability and liquidity is one major dimension of working capital management. In addition, the individual current assets should be efficiently managed so that neither inadequate nor unnecessary funds are locked up. Thus, the management of working capital has two basic ingredients:

- An overview of working capital management as a whole; and
- Efficient management of the individual current assets such as cash, receivables and inventory.
4.3.2 FINANCING DECISION

The second major decision involved in financial management is the financing decision. The investment decision is broadly concerned with the asset-mix or the composition of the assets of a firm. The concern of the financing decision is with the financing-mix or capital structure or leverage. The term capital structure refers to the proportion of debt (fixed-interest sources of financing) and equity capital (variable-dividend securities / sources of funds). The financing decision of a firm relates to the choice of the proportion of these sources to finance the investment requirements. There are two aspects of the financing decision. First, the theory of capital structure which shows the theoretical relationship between the employment of debt and the return to the shareholders. The use of debt implies a higher return to the shareholders as also the financial risk. A proper balance between debt and equity to ensure a trade-off between risk and return to the shareholders is necessary. A capital structure with a reasonable proportion of debt and equity capital is called the optimum capital structure. Thus, one dimension of the financing decision whether there is an optimum capital structure? And in what proportion should funds be raised to maximize the return to the shareholders? The second aspect of the financing decision is the determination of an appropriate capital structure, given the facts of a particular case. Thus, the financing decision covers two interrelated aspects:

- Capital structure theory; and
- Capital structure decision.

So in this chapter our emphasis is on financing decision aspect.

4.3.3 DIVIDEND POLICY DECISION

The third major decision of financial management is the decision relating to the dividend policy. The dividend should be analyzed in relation to the financing decision of a firm. Two alternatives are available in dealing with the profits of a firm: they can be distributed to the shareholders in the form of dividends or they can be retained in the business itself. The decision as to which course should be followed depends largely on a significant element in the dividend decision, the dividend-pay out ratio, that is, what proportion of net profits should be paid out to the shareholders. The final decision will depend upon the preference of the shareholders and investment opportunities available.
within the firm. The second major aspect of the dividend decision is the factor determining dividend policy of a firm in practice.

To conclude, the traditional approach had a very narrow perception and was devoid of an integrated conceptual and analytical framework. It had rightly been discarded in current academic literature. The modern approach has broadened the scope of financial management which involves the solution of three major decisions, namely, investment, financing and dividend. These are interrelated and should be jointly taken so that financial decision-making is optimal. The conceptual framework for optimum financial decisions is the objective of financial management. In other words, to ensure an optimum decision in respect of these three areas, they should be related to the objectives of financial management.

4.3.4 OBJECTIVES OF FINANCIAL MANAGEMENT

Finance theory, in general, rests on the premise that the goal of a firm should be to maximize the value of the firm to its equity shareholders. This means that the goal of the firm should be to maximize the value of the firm to its equity shares (which represents the value of the firm to its equity shareholders).

What is the justification for this goal? It appears to provide a rational guide for business decision-making and promote an efficient allocation of resources in the economic system. Savings are allocated primarily on the basis of expected return and risk and the market value of a firm's equity stock reflects the risk-return trade-off of investors in the market place. Hence, if a firm makes decisions aimed at maximizing the market value of its equity, it will raise capital only when its, investments warrant the use of capital from the overall point of view of the economy. This suggests that it allocates resources optimally. If a firm does not pursue the goal of shareholder wealth maximization, it implies that its actions result in a suboptimal allocation of resources. This in turn leads to inadequate capital formation and lower rate of economic growth.

Another justification lay be provided for the goal of shareholder wealth maximization. Equity shareholders provide the venture (risk) capital required to start a business firm and appoint the management of the firm indirectly through the board of directors. Hence, it behooves on corporate management to promote the welfare of equity shareholders.
4.4 SOURCES OF FINANCING RELATED TO SSIs

When a firm wants to start or to invest in long-term assets, it must find the means to finance them. The firm can rely to some extent on funds generated internally. However, in most cases internal resources are not enough to support investment plans. When that happens the firm may have to curtail its investment plan or seek external funding. Most firms choose the latter course of action. They supplement internal funding with external funding raised from a variety of sources. The following sources of financing are related to SSIs.

- Working capital financing (Short-term financing);
- Long-term financing.

4.4.1 WORKING CAPITAL FINANCING

The investment in raw materials, stock-in process, finished goods, and receivables (the principal constituents of current assets) often varies a great deal during the course of the year. Hence, the financial manager generally spends a good chunk of his time in finding money to finance current assets.

Typically, current assets are supported by a combination of long-term and short-term sources of finance. Long-term sources of finance primarily support fixed assets and secondarily provide the margin money for working capital. Short term sources of finance, the subject matter of this chapter, more or less exclusively support the current assets.

4.4.1.1 ACCRUALS

The major accrual items are wages and taxes. These are simply what the firm owes to its employees and to the government. Wages are usually paid on a weekly, fortnightly, or monthly basis between payments, the amounts owed but not yet paid is shown as accrued wages on the balance sheet. Income tax is payable and quarterly other taxes may be payable half-yearly or annually. In the interim, taxes owed but not paid may be shown as accrued taxes on the balance sheet.

Accruals vary with the level of activity of the firm. When the activity level expands, accruals increase and when the activity level contracts accruals decrease. As they respond more or less automatically to changes in the level of activity, accruals are treated as part of spontaneous financing.
Since no interest is paid by the firm on its accruals, they are often regarded as a free source of financing. However, a closer examination would reveal that this may not be so. When the payment cycle is longer, wages may be higher. For example, an employee earning $500 per week and receiving weekly payment may ask for a slightly higher compensation if the payment is made monthly. Likewise when the payment period is longer, tax authorities may raise the tax rates to some extent. Even when such adjustments are made, the fact remains that between established payment dates accruals do not carry any explicit interest burden.

While accruals are a welcome source of financing, they are typically not amenable to control by management. The payment period for employees is determined by the practice in industry and provisions of law. Similarly, tax payment dates are given by law and postponement of payment normally results in penalties.

4.4.1.2 TRADE CREDIT

Trade credit represents the credit extended by the supplier of goods and services. It is a spontaneous source of finance in the sense that it arises in the normal transactions of the firm without specific negotiations, provided the firm is considered creditworthy by its supplier. It is an important source of finance representing 25 percent to 50 percent of short-term financing.

I) Obtaining Trade Credit

The confidence of suppliers is the key to securing trade credit. What do suppliers look for in granting trade credit? Among the things that suppliers consider are:

- **Earnings record over a period of time**: If the firm has a fairly good earnings record with a portion of it ploughed back in the business, it is looked upon favourably.

- **Liquidity position of the firm**: Suppliers naturally look at the ability of the firm to meet its obligations in the short run. Such ability is usually measured by the current ratio and the acid test ratio.

- **Record of payment**: If the firm has been prompt and regular in paying the bulk of the suppliers in the past, it is deemed to be creditworthy.

II) Cultivating Good Supplier Relationships

While a good-establishment, successful enterprise may have no difficulty in obtaining trade credit, a new company or one with financial problems will probably face...
difficulty in obtaining it. The confidence of suppliers, a pre-condition for obtaining trade credit, can be earned by discussing the financial situation, by showing realistic plans, and, more important, by honouring commitments. The last point, namely, honouring commitments, is very important. Broken promises erode confidence more than poor operating results. It is better to make modest commitments which may not be fully satisfying to the supplier and honour them rather than make tall promises that gratify the supplier, and fail to honour them.

4.4.1.3 WORKING CAPITAL ADVANCE BY COMMERCIAL BANKS

Working capital advance by commercial banks represents the most important source for financing current assets. This section discusses the following aspects of this source of finance (i) application and processing, (ii) sanction and terms of condition, (iii) forms of bank finance, (iv) nature of security, and (v) margin amount.

I) Application and Processing

A customer seeking an advance is required to submit an appropriate application form. There are different types of application forms for different categories of advances. The information furnished in the application covers, the following: the name and address of the borrower and his establishment; the details of the borrower's business; the nature and amount of security offered. The application form has to be supported by various ancillary statements like the financial statements and financial projections of the firm.

The application is processed by the branch manager or his field staff. This primarily involves an examination of the following factors: (i) ability, integrity, and experience of the borrower in the particular business, (ii) general prospects of the borrower's business, (iii) purpose of advance, (iv) requirement of the borrower and its reasonableness, (v) adequacy of the margin, (vi) provision of security, and (vii) period of repayment.

II) Sanction and Terms and Conditions

Once the application is duly processed, it is put up for sanction to the appropriate authority. The sanctioning powers of various officials-like Branch Manager, Regional Manager, General Manager, etc-are defined by virtue of the position they occupy.
If the sanction is given by the appropriate authority, along with the sanction of advance the bank specifies the terms and conditions applicable to the advance. These usually cover the following: (i) the amount of loan or the maximum limit of the advance, (ii) the nature of the advance, (iii) the period for which the advance will be valid, (iv) the rate of interest applicable to the advance, (v) the primary security to be charged, (vi) the insurance of the security, (vii) the details of collateral security, if any, to be provided, (viii) the margin to be maintained, and (ix) other restrictions or obligations on the part of the borrower. It is a common banking practice to incorporate important terms and conditions on a stamped security document to be executed by the borrower. This helps the bank to create the required charge on the security offered and also obligates the borrower to observe the stipulated terms and conditions.

III) Forms of Bank Finance

Working capital advance is provided by commercial banks in three primary ways (i) cash credits/overdrafts, (ii) loans, and (iii) purchase/discount of bills. In addition to these forms of direct finance, commercial banks help their customers in obtaining credit from other sources through the letter of credit arrangement.

A) Cash Credits/Overdrafts: Under a cash credit or overdraft arrangement, a predetermined limit for borrowing is specified by the bank. The borrower can draw as often as required provided the outstanding do not exceed the cash credit/overdraft limit. The borrower also enjoys the facility of repaying the amount, partially or fully, as and when he desires. Interest is charged only on the running balance, not on the limit sanctioned. A minimum charge may be payable, irrespective of the level of borrowing, for availing this facility. This form of advance is highly attractive from the borrower’s point of view because while the borrower has the freedom of drawing the amount in instalments as and when required, interest is payable only on the amount actually outstanding.

B) Loans: These are advances of fixed amounts which are credited to the current account of the borrower or released to him in cash. The borrower is charged with interest on the entire loan amount, irrespective of how much he draws. In this respect this system differs markedly from the overdraft or cash credit arrangement wherein
interest is payable only on the amount actually utilized. Loans are payable either on demand or in periodical instalments. When payable on demand, loans are supported by a demand promissory note executed by the borrower. There is often a possibility of renewing the loan.

C) Purchase/Discount of Bills: A bill arises out of a trade transaction. The seller of goods draws the bill on the purchaser. The bill may be either clean or documentary (a documentary bill is supported by a document of title to goods like a railway receipt or a bill of loading) and may be payable on demand or after a usance period which does not exceed 90 days. On acceptance of the bill by the purchaser, the seller offers it to the bank for discount/purchase. When the bank discounts/purchases the bill it releases the funds to the seller. The bank presents the bill to the purchaser (the acceptor of the bill) on the due date and gets its payment.

The Reserve Bank of India launched the new bill market scheme in 1970 to encourage the use of bills as an instrument of credit. The objective was to reduce the reliance on the cash credit arrangement because of its amenability to abuse. The new bill market scheme sought to promote an active market for bills as a negotiable instrument so that the lending activities of a bank could be shared by other banks. It was envisaged that a bank, when short of funds, would sell or rediscount the bills that it has purchased or discounted. Likewise, a bank which has surplus funds would invest in bills. Obviously for such a system to work there has to be a lender of last resort which can come to the succour of the banking system as a whole. This role naturally has been assumed by the Reserve Bank of India which rediscounts bills of commercial banks up to a certain limit.

D) Letter of Credit: A letter of credit is an arrangement whereby a bank helps its customer to obtain credit from its (customer’s) suppliers. When a bank opens a letter of credit in favour of its customer for some specific purchases, the bank undertakes the responsibility to honour the obligations of its customer, should the customer fail to do so. To illustrate, suppose a bank opens a letter of credit in favour of A for some purchases that A plans to make from B. If A does not make payment to B within the credit period offered by B, the bank assumes the liability of A for the purchases covered by the letter of credit arrangement. Naturally, B would hardly have any hesitation to
extend credit to A when a bank opens a letter of credit in favour of A. It is clear from the preceding discussion that under a letter of credit arrangement the credit is provided by the supplier but the risk is assumed by the bank, which opens the letter of credit. Hence, this is an indirect form of financing as against overdraft, cash credit, loans, and bill purchasing, discounting which are direct forms of financing. Note that in direct financing the bank assumes risk as well as provides financing.

IV) Security
For working capital advances, commercial banks seek security either in the form of hypothecation or in the form of pledge.

_Hypothecation:_ Under this arrangement, the owner of the goods borrows money against the security of movable property, usually inventories. The owner does not part with the possession of property. The rights of the lender (hypothecate) depend upon the agreement between the lender and the borrower. Should the borrower default in paying his dues, the lender (hypothecate) can file a suit to realize his dues by selling the goods hypothecated.

_Pledge:_ In a pledge arrangement, the owner of the goods (pledgor) deposits the goods with the lender (pledgee) as security for the borrowing. Transfer of possession of goods is a precondition for pledge. The lender (pledgee) is expected to take reasonable care of goods pledged with him. The pledge contract gives the lender (pledgee) the right to sell goods and recover dues, should the borrower (pledgor) default in paying debt.

V) Margin Amount
Banks do not provide hundred per cent finance. They insist that the customer should bring a portion of the required finance from other sources. This portion is known as the margin amount. How is the margin amount established? While there is no fixed formula for determining the margin amount, the following guideline is broadly observed. “The margin is kept lowest for raw materials and highest for accounts receivable”.

VI) Regulation of Bank Finance
Traditionally, industrial borrowers enjoyed a relatively easy access to bank finance for meeting their working capital needs. Further, the cash credit arrangement, the principal device through which such finance has been provided, is quite
advantageous from the point of view of borrowers. Ready availability of finance in a fairly convenient form led to, in the opinion of many informed observers of Iranian banking scene, over-borrowing by industry and deprivation of other sectors.

Concerned about such a distortion in credit allocation the Reserve Bank of India (RBI) has been trying particularly from the mid-sixties onwards, to bring a measure of discipline among industrial borrowers and to redirect credit to the priority sectors of the economy. From time to time, the RBI has been issuing guidelines and directives to the banking sector toward this end.

Important guidelines and directives have stemmed from the recommendations of certain specially constituted groups entrusted with the task of examining various aspects of bank finance to industry. In particular, the following committees have significantly shaped the regulation of bank finance for working capital in India: the Daheja Committee, the Tandon Committee, the Chore Committee, and the Marathe Committee. The key elements of regulation are discussed below.

i) Norms for Inventory and Receivables

In the mid-seventies, the RBI accepted the norms for raw materials, stock-in-progress, finished goods, and receivables that were suggested by the Tandon Committee for fifteen major industries. These norms were based, *inter alia*, on company finance studies made by the Reserve Bank of India, process periods in different industries, discussions with industry experts, and feedback received on the interim reports. These norms represented the maximum levels for holding inventory and receivables in each period.

From the mid-eighties onwards, special committees were set up by the RBI to prescribe norms for several other industries and revise norms for some industries covered by the Tandon Committee. Presently, the RBI has a Standing Committee which revises norms on an ongoing basis. However, these norms are now regarded as guidelines. Banks have discretion to deviate from the norms, taking into account the past holding levels and other factors.
ii) Maximum Permissible Bank Finance

The Tandon Committee had suggested three methods for determining the maximum permissible bank finance (MPBF). To describe these methods, the following notation is used.

- **CA**: Current assets as per the norms laid down;
- **CL**: non-bank current liabilities like trade credit and provisions;
- **CCA**: core current assets - this represents the permanent component of working capital.

The methods for determining are described below:

- **Method 1** \[ MPBF = 0.75 (CA - CL) \]
- **Method 2** \[ MPBF = 0.75 (CA) - CL \]
- **Method 3** \[ MPBF = 0.75 (CA - CCA) - CL \]

iii) Forms of Assistance

Traditionally, bank credit to industry has been mainly in the form of cash credit which was introduced by the Scottish bankers. Under the cash credit system, the bank bears the responsibility of cash management because the borrowers have the freedom to determine their drawals within the cash credit limit provided by the bank.

With a view to bringing about a better discipline in the utilization of bank credit, in 1995 a ‘loan’ system for delivery of bank credit was introduced. Under the new dispensation, within the MPBF so arrived at in terms of the extant guidelines, banks/consortia/syndicates are required to restrict sanction of cash credit limits to borrowers up to a certain portion (which is currently 60 per cent) of the MPBF. Where borrowers desire to avail of bank credit for the balance portion (which is currently 40 per cent) of the MPBF, or any part thereof, this will be considered on merit by banks/consortia/syndicates in the form of a short-term loan (or loans) repayable on demand for working capital purpose for a stipulated period. Banks/consortia/syndicates will have the discretion to stipulate repayment of the short-term loan for working capital purposes by a borrower in instalments or by way of a ‘bullet’ or ‘balloon’ payment. In case the loan is repaid before the due date, it will be credited to the cash credit account.

4.4.1.4 INTER-CORPORATE DEPOSITS

A deposit made by one company with another, normally for a period up to six months, is referred to as an inter-corporate deposit. Such deposits are usually of three types.
• **Call Deposits:** In theory, a call deposit is withdrawable by the lender on giving a day’s notice. In practice, however, the lender has to wait for at least three days.

• **Three-month Deposits:** More popular in practice, these deposits are taken by borrowers to tide over a short-term cash inadequacy that may be caused by one or more of the following factors: disruption in production, excessive imports of raw material, tax payment, delay in collection, dividend payment, and unplanned capital expenditure.

• **Six months Deposits:** Normally, lending companies do not extend deposits beyond this time frame. Such deposits, usually made with first class borrowers, carry an interest rate of around 20-25 per cent per annum.

1) **Characteristics of the Inter-corporate Deposit Market**

   It may be of interest to note the following characteristics of the inter-corporate deposit market.

   **Lack of Regulation:** The lack of legal hassles and bureaucratic red tape makes an inter-corporate deposit transaction very convenient. In a business environment otherwise characterized by a plethora of rules and regulations, the evolution of the inter-corporate deposit market is an example of the ability of the corporate sector to organize itself in a reasonably orderly manner.

   **Secrecy:** The inter-corporate deposit market is shrouded in secrecy. Brokers regard their lists of borrowers and lenders as guarded secrets. Tightlipped and circumspect, they are somewhat reluctant to talk about their business. Such disclosures, they apprehend, would result in unwelcome competition and undercutting of rates.

   **Importance of Personal Contacts:** Brokers and lenders argue that they are guided by a reasonably objective analysis of the financial situation of the borrowers. However, the truth is that lending decisions in the inter-corporate deposit markets are based on personal contacts and market information which may lack reliability. Given the secrecy that shrouds this operation and the non-availability of hand data, can it be otherwise.
4.4.1.5 SHORT-TERM LOANS FROM FINANCIAL INSTITUTIONS
The Financial Institutions such as Insurance Corporation provides short-term loans to manufacturing companies with an excellent track record.

I) Eligibility
A company to be eligible for such loans, should satisfy the following conditions.

- The debt-equity ratio of the company should not exceed 2:1.
- The current ratio of the company should be at least 1:1.
- The average of the interest cover ratios for the past three years should be at least 2:1.

II) Features
The short-term loans provided by financial institutions have the following features:

- They are totally unsecured and are given on the strength of a demand promissory note.
- The loan is given for a period of 1 year and can be renewed for two consecutive years, provided the original eligibility criteria are satisfied.
- After a loan is repaid, the company will have to wait for at least 6 months before availing of a fresh loan.
- The loans carry an interest rate of 18 per cent annum with a quarterly rest, which works out to an effective rate of 19-29 per cent per annum. However, there is a rebate of 1 per cent for prompt payment, in which case the effective rate comes down accordingly.

4.4.1.6 RIGHTS DEBENTURES FOR WORKING CAPITAL
Public limited companies can issue 'rights' debentures to their shareholders with the object of augmenting the long-term resources of the company for working capital requirements. The key guidelines applicable to such debentures are as follows:

- The amount of the debenture issue should not exceed (a) 20 per cent of the gross current assets, loans, and advances minus the long-term funds presently available for financing working capital, or (b) 20 per cent of the paid-up share capital, including preference capital and free reserves, whichever is the lower of the two.
• The debt equity ratio, including the proposed debenture issue, should not exceed 1:1.

4.4.1.7 FACTORING
A factor is a financial institution which offers services relating to management and financing of debts arising from credit sales.

I) Featuring of a Factoring Arrangement
The key features of a factoring arrangement are as follows:

• The factor selects the accounts of the client that would be handled by it and establishes, along with the client, the credit, limits applicable to the selected accounts.

• The factor assumes responsibility for collecting the debt of accounts handled by it. 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.

• The factor advances money to the client against not-yet-collected and no-yet-due debts. Typically, the amount advanced is 70 to 80 per cent of the face value of the debt and carries an interest rate which may be equal to or marginally higher than the lending rate of commercial banks.

• Factoring may be on a recourse basis (this means that the credit risk is borne by the client) or on a non-recourse basis (this means that the credit risk is borne by the factor). Presently, factoring in India is done on a recourse basis.

• Besides the interest on advance against debt, the factor charges a commission which may be 1 to 2 per cent of the face value of the debt factored.

II) Evaluation
Factoring offers the following advantages which makes it quite attractive:

• Factoring ensures a definite pattern of cash inflows from credit sales.

• Continuous factoring may virtually eliminate the need for the credit and collection department.

As against these advantages, the limitations of factoring are:
• The cost of factoring tends to be higher than the cost of other forms of short term borrowing.
• Factoring of debt may be perceived as a sign of financial weakness.

4.4.2 SOURCES OF LONG-TERM FINANCE
The following sources of long-term finance commonly employed by business firms:
• Retained earnings
• Equity capital
• Preference capital
• Debenture capital
• Term loans

4.4.2.1 RETAINED EARNINGS
Depreciation charges and retained earnings represent the internal sources of finance available to the company. If depreciation charges are used for replacing worn-out equipment, retained earnings represent the only internal source for financing expansion and growth. Companies normally retain 30 per cent to 80 per cent of profit after tax for financing growth. Hence, retained earnings can be an important source of long-term financing. The Evaluation of retaining earnings is:

I) Firms point of view:
The advantages retained earning is viewed very favorably by most corporate managements for the following reasons:
1. Retained earnings are readily available internally. They do not require talking to outsiders (lenders or shareholders).
2. Retained earnings effectively represent infusion of additional equity in the firm. Use of retained earnings, in lieu of external equity, eliminates issue costs and losses on account of underpricing.
3. There is no dilution of control when a firm relies on retained earnings.

The disadvantages of retaining earnings are:
1. The amount that be raised by way of retained earnings may be limited. Further, the quantum of retained earnings tends to be highly variable.
2. The opportunity cost of retained earnings is quite high. Remember that retained earnings, in essence, represent dividend foregone by equity shareholders.

II) Shareholders point of view:
The advantages of retained earnings from the shareholders point of view are:
1. Compared to dividend income, the capital appreciation that arises as a sequel to retained earnings is subject to a lower rate of tax.
2. Reinvestment of profits may be convenient for many shareholders as it relieves them to some extent of the problem of investing on their own.

The disadvantages of retained earnings from the shareholders point of view are:
1. Shareholders who want a current income higher than the dividend income may be highly averse to, or may find it inconvenient to, convert a portion of capital appreciation (which results from retention of earnings) into current income, as it calls for selling some shares.
2. Many firms do not fully appreciate the opportunity cost of retained earnings. They impute a low cost to it. As a result, they may, comforted by the easy availability of retained earning, in sub-marginal projects that have a negative NPV obviously such a sub-optimal investment policy hurts the shareholders.

4.4.2.2 EQUITY CAPITAL
Equity capital represents ownership capital as equity shareholders collectively own the company. They enjoy the rewards and bear the risks of ownership. However, their liability, unlike the liability of the owner in a proprietary firm and the partners in a partnership concern, is limited to their capital contributions.

I) Firms point of view:
The most important source of long-term funds, equity capital offers the following advantages:
1. It represents permanent capital. Hence, there is no liability for repayment.
2. It does not involve any fixed obligation for payment of dividends.
3. It enhances the creditworthiness of the company. In general, other things being equal, the larger the equity base, the higher the ability of the company to obtain credit.
The disadvantages of raising funds by way of equity capital are:

1. The cost of equity capital is high, usually the highest. The rate of return required by equity shareholders is generally higher than the rate of return required by other investors.
2. Equity dividends are payable from post-tax earnings. They are not tax-deductible payments.
3. The cost of issuing equity stock is generally higher than the cost of issuing other types of securities. Underwriting commission, brokerage costs, and other issue expenses are high for equity capital.
4. Sale of equity stock to outsiders may result in dilution of the control of existing shareholders.

II) Shareholders point of view:

The advantages of equity investment from the shareholders point of view are:

1. Equity shareholders enjoy the controlling power over the firm.
2. The liability of equity shareholders is limited to the extent of their capital contribution.
3. The rewards of equity capital, representing the ownership interest, can be very high.
4. Equity dividends are accorded preferential tax treatment. Dividend income from equity shares and certain other forms of approved investments is tax exempt up to a certain limit.

The disadvantages of equity investment from the shareholders point of view are:

1. Though equity shareholders enjoy the controlling power over the firm in theory, the real control exercised by them is often weak because they are usually scattered and ill-organized.
2. Equity shareholders cannot contest the dividend decision of the directors.
3. Equity shareholders have a residual claim to income as well as assets- they enjoy the lowest priority.
4. Equity stock prices tend to fluctuate rather widely, making equity investment risky.
4.4.2.3 PREFERENCE CAPITAL

Preference capital represents a hybrid form of financing—it partakes some characteristics of equity and some attributes of debentures. It resembles equity in the following ways:

1. Preference dividend is payable only out of distributable profits;
2. Preference dividend is not an obligatory payment (the payment of preference dividend is entirely within the discretion of directors); and
3. Preference dividend is not a tax-deductible payment.

Preference capital is similar to debentures in several ways:

1. The dividend rate on preference capital is usually fixed;
2. The claim of preference shareholders is prior to the claim of equity shareholders; and
3. Preference shareholders do not normally enjoy the right to vote.

4.4.2.4 DEBENTURE CAPITAL

Akin to promissory notes, debentures are instruments for raising long-term debt capital. Debenture holders are the creditors of the company. The obligation of the company towards its debenture holders is similar to that of a borrower who promises to pay interest and capital at specified times.

4.4.2.5 TERM LOANS

Term loans, also referred to as term finance, represent a source of debt finance which is generally repayable in more than one year but less than 10 years. They are employed to finance acquisition of fixed assets and working capital margin. Term loans differ from short-term bank loans which are employed to finance short-term working capital need and tend to be self-liquidating over a period of time, usually less than one year.

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1 L.C. Gupta, preference shares and company finance, Madras, Institute of Financial Management and Research, 1975, PP. 122-129
2 Prasanna Chandra, Financial Management theory & practice, New Delhi, TATA Mcgraw Hill, 2001, PP. 347, 348
4.4.2.6 COMPARISON OF LONG-TERM SOURCES OF FINANCING

We have looked at the pros and cons of various forms of long-term financing. Table 4.1 provides a summary comparison of the external sources from the point of view of the firm.

Table 4.1 comparison of long-term sources of financing\(^1\)

<table>
<thead>
<tr>
<th>SOURCES</th>
<th>COST</th>
<th>DILUTION OF CONTROL</th>
<th>RISK</th>
<th>RESTRAINT ON MANAGERIAL FREEDOM</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earnings</td>
<td>High</td>
<td>No</td>
<td>Nil</td>
<td>No</td>
</tr>
<tr>
<td>Equity capital</td>
<td>High</td>
<td>Yes</td>
<td>Nil</td>
<td>No</td>
</tr>
<tr>
<td>Preference capital</td>
<td>High</td>
<td>No</td>
<td>Negligible</td>
<td>No</td>
</tr>
<tr>
<td>Debenture capital</td>
<td>Low</td>
<td>No</td>
<td>High</td>
<td>Some</td>
</tr>
<tr>
<td>Term loans</td>
<td>Low</td>
<td>No</td>
<td>High</td>
<td>Moderate</td>
</tr>
</tbody>
</table>

4.4.3 ESPECIAL SOURCE OF FINANCING

4.4.3.1 Financial Institutions

Since independence a number of financial institutions, some operating on an all-country basis and others functioning within their respective states, have been established. They have been reasonably responsive to the growing and varied long-term capital requirements of industry. They have provided the bulk of long-term finance to the industry and encouraged competent new entrepreneurs,... in addition, they have laid emphasis on developing backward regions and have been engaged in promotional activities.

I) Financial Assistance: Direct and Indirect

A) Direct Financial Assistance

Financial institutions provide direct financial assistance in the following ways:

i. External Currency Term Loans: The most significant form of assistance provided by financial institutions, Internal currency term loans are given directly to industrial concerns for setting up new projects as well as for

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expansion, modernization, and renovation projects. These funds are provided for incurring expenditure for land, building, plant and machinery, technical know-how, miscellaneous fixed assets, preliminary expenses, preoperative expenses, and margin money for working capital.

ii. **Foreign Currency Term Loans:** Financial institutions provide foreign currency term loans for meeting the foreign currency expenditure towards import of plant, machinery and equipment, and also towards payment of foreign technical know-how fees. The periodical liability for interest and principal remains in the currency/currencies of the loan/s and is translated into local currency at the prevailing rate of exchange for making payments to the financial institutions.

iii. **Subscription to Equity Shares and Debentures:** In addition to providing term loans (in Internal currency as well as foreign currencies), financial institutions also subscribe to equity as well as debenture capital in a limited way.

iv. **Lease Finance:** A lease represents a contractual arrangement whereby the lessor (the financial institution) grants the lessee the right to use an asset in return for periodic lease payments.

v. **Hire Purchase Finance:** Under a hire purchase arrangement the hirer (the financial institution) gives assets on hire to a user (hirer) who pays periodic hire purchase instalments. On payment of the final hire purchase instalment, the ownership of the assets is transferred from the hire to the hirer.

vi. **Bill Discounting:** Financial institutions discount bills arising from the purchase of capital goods to some extent.

vii. **Short Term Credit:** Asset-based credits of a relatively shorter tenor are now being provided by financial institutions.
viii. **Seed Capital:** Financial institutions provided seed capital to supplement the resources of promoters of small and medium scale industrial units. Support in this form, however, is being phased out.

**B) Indirect Financial Assistance**

Besides providing direct financial assistance, financial institutions extend help to industrial units in obtaining finance/credit through the following ways.

i **Deferred Payment Guarantee:** Financial institutions issue guarantee on behalf of the buyers of industrial machinery to the supplier offering the facility of deferred payments. Should there be a default by the buyer in the payment of deferred installments, financial institutions make the payment and subsequently recover the amount from assisted unit. A nominal commission is charged for providing such guarantee.

ii **Guarantee for Foreign Currency Loans:** Financial institutions provide guarantee for foreign currency loans obtained by industrial concerns from institutions and banks abroad. A nominal commission is charged to the assisted unit for such guarantee.

iii **Underwriting:** As part of the overall financial package, financial institutions generally participate in underwriting equity issues of assisted units. This helps the assisted units in raising funds from the capital market.

**II) Promotional Activities by Financial Institutions**

Interested in developing entrepreneurship, financial institutions have traditionally engaged in a variety of promotional activities like:

- Conducting surveys (along with other financial institutions) of less developed states and union territories to assess industrial potential and identify projects that can be quickly implemented.
- Preparing project profiles to guide entrepreneurs.
- Commissioning feasibility studies on projects identified in the industrial potential surveys.
• Setting up consultancy organizations at state-level, jointly with other institutions, to provide techno-economic consultancy services.

In recent years, however, institutions have been concentrating more on business development. Profit objective has overtaken the concern for promotion or development of entrepreneurship in response to greater competition and application of prudential norms.

4.4.3.2 Leasing and Hire-Purchase

A lease represents a contractual arrangement whereby the lessor grants the lessee the right to use an asset in return for periodical lease rental payments. While leasing a land, buildings, and animal has been known from times immemorial, the leasing of industrial equipments is a relatively recent phenomenon.

A hire-purchase involves, in essence, the purchase of an asset on the understanding that the purchaser (called the hirer) will pay in equal periodic instalments spread over a length of time. In substance, leasing and hire-purchase represent debt financing in different garbs.

Leasing and hire-purchase have emerged as a supplementary source of intermediate to long-term finance. They are provided mainly by non-banking financial companies, financial institutions, and other organizations.

1) Types of Lease Arrangements
Lease arrangements may be broadly divided into two categories:

• Operating leases
• Financial leases (leveraged leases and sale and leaseback arrangements are two important subcategories of financial leases).

i) Operating Leases
An operating lease, or service lease, has the following features:

• It is a short-term lease, the lease period being significantly less than the useful life of the equipment.
• The lease is not fully amortized. Put differently, the lease rentals payable during the lease period are not sufficient to cover fully the cost of the equipment along with an acceptable return thereon.

• The lease is usually cancelable at short notice.

• The lessor is responsible for maintenance, insurance, and taxes.

Manufacturers interested in leasing their own products typically write operating leases. Computers, vehicles, copiers, and furniture are examples of assets that are commonly leased under operating lease arrangements.

ii) Financial Leases

A financial lease, or capital lease, is essentially a form of borrowing. The salient features (characteristics) of a financial lease are:

• It is an intermediate-term to long term non-cancellable arrangement. During the initial lease period, referred to as the primary lease period, which is usually 3 years or 5 years or 8 years, the lease cannot be cancelled.

• The lessee is responsible for maintenance, insurance, and taxes.

• The lease is fully amortized during the primary lease period. This means that during this period the lessor recovers, through the lease rentals, his investment in the equipment along with an acceptable rate of return.

The lessee usually enjoys the option of renewing the lease for further periods for very nominal lease rentals.

Sale and Leaseback: This is a special financial lease arrangement in which a firm (firm A) sells an asset to another firm (firm B) and simultaneously the two firms enter into a financial lease by which firm B leases the asset to firm A. As a result, the seller receives the purchase consideration for the asset (which augments its liquidity position) and also retains the use of the asset in return for periodic lease payments.

Leveraged Lease: Under a leveraged lease arrangement, the lessor borrows a portion of the purchase price of the asset from a lender, which is typically a commercial bank or a financial institution. The loan is secured by the asset and the lease payments. The lender is paid back from the lease payments, often directly by the lessee; the surplus left
after satisfying the claims of the lender goes to the lessor. As owner of the asset, of course, the lessor is entitled to tax shelters associated with ownership.

II) Hire-Purchase Arrangement

Financial companies usually offer the facility of leasing as well as hire-purchase to its clients. The main features of a hire purchase arrangement are as follows:

- The hiree (the counterpart of lessor) purchases the asset and gives it on hire to the hirer (the counterpart of lessee).
- The hirer pays regular hire purchase instalments over a specified period of time. These instalments cover interest as well as principal repayment. When the hirer pays the last installment, the title of the asset is transferred from the hiree to the hirer.
- The hiree charges interest on a flat basis. This means that a certain rate of interest, usually around 14 per cent, is charged on the initial investment (made by the hiree) and not on the diminishing balance.
- The total interest collected by the hiree is allocated over various years. For this purpose the ‘sum of the years digits’ method is commonly employed.

III) Difference Between Leasing and Hire-Purchase

The differences between Leasing and Hire-purchase are as following:

<table>
<thead>
<tr>
<th>Leasing</th>
<th>Hire-purchase</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Depreciation and investment allowance cannot be claimed by the lessee</td>
<td>• Depreciation and investment allowance can be claimed by the hirer</td>
</tr>
<tr>
<td>• The entire lease rental as a tax-deductible expenses</td>
<td>• Only the interest component of the hire purchase instalment as tax-deductible</td>
</tr>
<tr>
<td>• The lessee, not being the owner of the asset, does not enjoy the salvage value of the asset</td>
<td>• The hirer, being the owner of the asset, enjoys the salvage value of the asset</td>
</tr>
</tbody>
</table>
4.4.3.3 Other Sources of Loans Related to SSIs

This chapter primarily focuses on how the prospective small business owner can find the money to get a business up and going. In most cases, small businesses are financed through personal assets or borrowed money. Banks, commercial finance companies, and venture capital companies are perhaps the most well-known sources of capital, but they are certainly not the only ones. In this part, we will look at other possible sources of capital, ranging from the simple, yet expensive, and credit cards to the more complex banker’s acceptances.

I) Life Insurance Companies

In *The Life Insurance Buyer’s Guide*, William D. Brownlie clearly described how life insurance companies work:1 “They receive payments in the form of premiums from a large number of people, invest the premium payments to earn interest, and pay money to the beneficiaries of insureds who have died”. Though the premium dollars that insurance companies take in every year tally up to billions, it is unusual for these companies to invest directly in small business companies as part of their investment portfolios. For the most part, small businesses are too risky and unproven to match insurance companies’ requirements for sound investments. There are many other less risky investments open to life insurance companies.

Life insurance companies make long-term unsecured loans (at rates comparable to bank loan rates) to profitable businesses that have been around for some time and have good track records. A good deal of insurance company money is spread among investments related to larger businesses-e.g., loans for large commercial or residential real estate, common stocks, and corporate bonds. There are, however, a few ways that small business owners can use life insurance to finance their businesses.

Life insurance companies sometimes lend money to businesses to build or purchases commercial real estate. As security on the loan, they hold the mortgages on the property being financed. The insurance companies want to make sure that the value and income potential of the property being financed is strong enough to indicate that the borrower will be able to pay back the loan.

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i) Life Insurance Policy Loans

By far the most common type of loan that a small business owner will have access to through a life insurance company is a policy loan. Business owners who have had life insurance policies in force for several years will have policies with a cash surrender value that they can borrow against. (Term life is a death-benefit-only policy, so no cash surrender value is available to borrow against). The rate of interest on loans depends on when the policy was issued.

One of the advantages of taking out a life insurance policy loan is that you are merely required to pay the interest due on the loan. You are not really required to pay back the principal itself. But the drawback to not paying back the cash value borrowed is that your policy value will be decreased by the amount of loan and accrued interest outstanding. Your beneficiaries will receive that much less when you die. Most people try to pay back the total amount borrowed, to protect their beneficiaries’ proceeds.

Policy loans are excellent sources of capital if you cannot find the money elsewhere. Often, the interest rates available are quite attractive when compared with higher-rate bank loans. But you should keep in mind that the primary reason people buy life insurance is to protect their families or other beneficiaries. Obviously, you should not lose sight of this objective when thinking of life insurance policies as a source of capital.

ii) Life Insurance as a Buy-Out Mechanism

Another interesting use of life insurance as a source of funds is as capital enabling one partner to buy out another, in the event of one partner’s death. It’s a simple arrangement. Say there are two partners in the firm. Each takes out a life insurance policy with a face value equal to half the business value. Each partner names the other partner as beneficiary. When one partner dies, the other partner receives the insurance and uses it to buy out the partner’s share of the business expense. The business pays both partners’ life insurance premiums as a business expense.

Owners can also use life insurance as a means to sell a business to a values employee. The owner and employee arrive at a fair price for the business and take out a life insurance policy on the owner’s life for that amount, naming the employee as beneficiary. The employee pays the premiums, since he or she will ultimately receive the death benefit. When the owner dies, the employee uses the death benefit to buy the
owner’s business from his or her estate. Obviously, this is a viable financing arrangement only for owners who do not want cash in hand immediately and are willing to have the purchase price go to their heirs instead of to themselves.

II) Trade Credit

Small business as often have access to trade credit, an arrangement in which suppliers of goods or services do not require immediate payment but instead offer credit terms for the payment due. Through trade credit a customer is given a discount for paying a bill within a specified period of time. This arrangement is also called cash discount.

Assume that a buyer of some product owes $550. On an invoice dated January 18, the buyer is offered trade credit terms of 2/10 net 30 (sometimes written "2/10 n/30"). This means that if the buyer pays the bill within 10 days after the invoice date (January 28), he or she may deduct a discount of 2 per cent ($11). If the buyer does not pay the bill by January 28, the entire bill must be paid within 30 days of the invoice date (February 17).

The buyer is effectively given a 20-day extension at 2 per cent. That may free up cash for the short term, but if calculated on an annual basis, it adds up to a 36.5 per cent annual rate, mighty steep indeed. Most wise businesspeople would take advantage of the 2 per cent discount rather than pay that kind of annual rate. It is not unheard of, however, to negotiate for a more attractive payment schedule. If you could get the provider of goods to agree to a cash discount of 2/10 net 60, you would end up paying around 14.6 per cent on an annual basis, which in some economic climate might be attractive enough to make you consider stretching the payment out to the full 60 days so that you could have use of the capital in the meantime.

There are three parts to a cash discount:

- The percentage discount being offered
- The time frame for which the discount is offered
- An indication of the date after which the bill becomes overdue

Within industries there are traditional cash discount combinations.
III) Forward Dating

Forward dating is a combination of cash discount and a seasonal discount pricing strategy. The buyer buys and is delivered goods during the off season, but does not have to pay for the goods until the season begins. A manufacturer of ski jacket might decide to fill wholesale and retail orders in summer months, but date the invoice October 1, with terms of 2/10 net 30, as of October 1. If the ski jacket manufacturer can keep the plant running during the summer months, production can be spread out over the year. The wholesalers and retailers do not have to pay their bills until after the season has started and they have begun to receive cash for sold merchandise.¹

IV) Foundations

Foundations have professional investors on board who are looking for relatively safe investments that typically are larger than small business need. The larger foundations will often make loans greater than $1 million to businesses. Like the insurance companies, the people doing the lending for the foundations will look long and hard at the experience of the prospective borrower’s management team, as well as studying the validity of financial projections for the business.

There are, however, thousands of foundations in the United States-some small, some large. While foundations generally make only large investments or loans, each foundation has its own set of criteria. There are many good directories of foundations available in libraries. Browse through the directories and see if you can find a foundation that specializes in making loans to companies like yours. For small businesses it is a long shot, but when you are searching for capital, it is worth a try.

V) Pension Funds

Unfortunately, the average small business owner is unlikely to be the beneficiary of a loan from a pension fund. The pension fund managers make investments (of the pension money invested in their particular fund) and loans to large borrowers who have a proven track record. Often these pension funds loans are in the millions of dollars. Since pension fund managers have a fiduciary responsibility to protect the people who are paying into the pension fund, they must make sound, relatively safe investments.

Like the money of life insurance companies or foundations, pension fund money will typically be used to finance an established company with a track record of success and a solid management team, or at the very least, with an experienced management team that shows strong probability of being a solid borrower.

VI) Commercial Paper Houses

It is unlikely that a small business will be able to take advantage of a commercial paper house’s services, since commercial paper is typically a borrowing mechanism restricted to large companies. In simple terms, the way commercial paper works is that large companies issue unsecured promissory notes (written promises that the singer will pay a specified amount on demand, on a fixed date, with or without interest) with a fixed, short-term maturity. The commercial paper houses sell these promissory notes to other businesses or individuals. They are, in effect, making a loan to the issuing company. The business issuing the commercial paper becomes the borrower.

Borrowing by way of commercial paper can become quite complex. Commercial paper houses often issue new commercial paper to raise money to pay off outstanding commercial paper obligations as they mature. Since bad economic conditions might make paying outstanding obligations difficult, the commercial issuer will often back the commercial paper with a bank line of credit that guarantees the lender that the outstanding obligations can be paid off. Banks often require commercial paper issuers who use a line of credit as backup for their outstanding obligations to place compensating balances (balances used by a business to support a borrowing arrangement with a lending institution) or pay a fee to the bank offering the line of credit.\(^1\)

VII) Credit Unions

Credit unions offer their members an array of financial services similar to those offered by banks. Often, however, credit unions pay slightly higher interest rates on deposits and offer loans at slightly lower interest rates. There are restrictions on how large loan credit unions can make, but for a small business owner seeking some

\(^1\)Jeffrey I. Seglin, Bank Administration Institute Dictionary of Banking, Rolling Meadows, I11: BAI/Andover Parris, 1990, pp. 43-44.
working capital, a credit union may be a possible solution. Credit union membership is based on some common bond among its members; the nature of the bond, whether business, religious, ethnic, community, or something else, is dictated by the charter of the credit union.

VIII) Credit Cards
Credit cards offer small business owners and prospective small business owners’ quick access to cash. You can take a cash advance on your credit card for an amount up to your cash credit limit. If you have more than one bank credit card, you can borrow up to the cash credit limit on each card.

You can use the money you borrow for short-term cash needs or to build up the capital in your company in an attempt to make the company more attractive to a prospective bank lender. For business owners just starting out, with no track record and no other source of finances, credit card advances may be their only way to go forward rather than scratching the idea of starting their businesses.

Interest charges on credit cards vary depending on the bank issuing the card and the state in which that bank is located. Each state sets its own usury laws, and banks must work within the parameters of those laws. In recent years, there have been some good deals on bank credit cards rates, but for the most part, interest rates are still very high. For that reason, it is best to use credit card advances only for emergency cash or short-term needs, and to pay off the debts as soon as possible, since the interest rates can be real killers.

4.4.3.4 Islamic Financing
1) Islamic Banking
Islamic banking involves its performance to collect funds from capital-owner and to lend these collected funds to individuals, enterprises, companies in different sections such as industrial, agricultural, mineral and so on with this claim no interest and on the basis of profit-loss sharing with Islamic law considerations to improve economic development and also Islamic banking system is thinking beyond merely traditional banking.

The first interest-free bank in 1963 in Mit Ghamar in Egypt came into being. Mit Ghamar was a rural area where the people did not place their saving in any bank.
because of this knowledge that the interest has been forbidden in Islam. This pioneering
effort, led by Ahmad El Najjar took the form of a saving banks based on profit-sharing.
The funds in three types of accounts, namely Saving accounts, Investment accounts and
Zakat accounts were accepted to invest directly or in partnership with others in trade
and industry and profit were shared with depositors. After this a number of Islamic
banks came into being such as, the Nasir Social Bank in Egypt in 1971, the Philippine
Amanad Bank in 1973, the Dubai Islamic Bank in 1975, the Faisal Islamic Bank of
Egypt in 1977, Bahrain Islamic Bank in 1979 and as a whole, in Iran and Pakistan the
interest-free bank system took steps in 1981 to cover all banks in above countries.
Today other Islamic banks that have set up in Muslim countries and also in other parts
of the world (such as UK, USA, Australia and so on) are successfully functioning.1

II) Principles of Islamic Banking
The best feature of Islamic banking system is that there is no interest. Muslims
are by Islamic banking orders abolished from deals and transactions that involve Usury
or interest (Riba).2 The original word for usury or interest is Riba that means excess or
addition or increment. Usury means lending at interest or excessive interest and has
been practised in various parts of the world for at least four thousands years and
repeatedly condemned and prohibited mainly on moral, ethical, religious and legal
grounds among the religious institution of Hinduism, Buddhism, Judaism, Christianity
and in very clear and strong language in Islam.

III) Practice in Islamic Banking
As mentioned earlier, the basis of Islamic banking is on interest-free banking
practice and profit/loss sharing and there is a cycle among the depositor, bank and
borrower in where the relationship among these three parties cannot be expressed as a
creditor/debtor relationship and instead of it, the depositor will get this right to share a
proportion of profit with bank in a risk able and unfixed rate and from borrower side the
sharing of profit or loss between bank and borrower.3 More explanation of this process
can be presented as follows;

1 Aftab, M. “Pakistan Moves to Islamic Banking”, The Banker 136, PP.57-60, 1986
i) Inflows of funds:

- Current Accounts: current accounts or demand deposits are similar in withdrawing and depositing to those of conventional banks as Islamic banks have the obligation to return the balance to depositors and they do not pay interest/profit nor do they charge a fee and the deposits are guaranteed.
- Saving Accounts: saving accounts are also similar to those offered by conventional banks and principal of deposits is guaranteed and repayable to account-holder on demand. Generally the depositors assign to the bank this right to invest these deposits to share a proportion (not fixed) of profit arising from investment and otherwise as a current account.
- Investment Accounts: investment accounts are those deposits which are accepted for a fixed period of the time and return depends entirely on the result of the bank's dealings with various business projects, thus the investors agree in advance to share the profit or loss in a given proportion with the bank and even the repayment of capital is related to the results of projects.

ii) Outflows of funds

Financing in Islamic banking system is related to the nature of the projects and relevant sections i.e. services, industry, agricultural and etc. in other words to finance in Islamic banking some contracts for special project in relevant economical sections are deployed. Thus as follows some of these contracts are expressed.²

A) Interest Free Loan/Deposit

Qard-al-hasana is an interest free loan that can be collateralized. Qard-al-hasana is used by banks as a basis for current and saving accounts (see below) and to lend. Borrowers repay only the principal to the bank plus a management fee (set by the Central Bank). Qard-al-hasana loans are granted to institutions, individuals, and bank employees based on the assessment of the needs and directives from the relevant authorities. These loans can be collateralized.

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1 Khalaf, R, "Islamic Banking Survey Supplement", Financial Times, 28 November, 1995
B) Civil Participation

Under this contract the bank and the client negotiate the ratio at which the profits from the financed activity will be distributed between them based on a feasibility study of the expected profitability of the project being financed. This contract is used for financing manufacturing, housing, trade and services. Two versions are presented as to how the contract is executed:

In the first version, the banks and the client determine the profit distribution ratio according to their respective contributions to the project's capital. However, the contract would also specify that the bank will only get a share in the profit equivalent to the rate specified by the Central Bank and would forego to the client all the profits in excess of this rate. Similarly, the client would compensate the bank if actual profits would result in a return to the bank less than the Central Bank rate. Banks also require collateral from the client against potential losses.

In the second version, the bank calculates the Musharaka ratio that would make the return to the bank equivalent to the lending profit rates as mandated by the Central Bank. The client is expected to pay a share equivalent to the agreed profit irrespective of the actual rate of profit and is also required to provide insurance cover for the financed items (i.e. the actual Musharaka ratio will differ from the one specified in the contract).

Banks get collateral on the Musharaka contract indirectly in two ways. When a Musharaka contract is concluded the bank could extend a notional Qard-al-hasana loan against which the bank requires the client to present collateral with value equivalent to that of the Musharaka contract. If the client does not deliver the profit rate that the bank expects on the maturity date, the bank will convert the outstanding balance into a loan and ask the client to pay it in addition to the small Qard-al-hasana loan or risk losing the collateral. The bank also could require the client to present collateral against misconduct, which is permissible under the law.

C) Equity Participation

Under this activity banks acquire shares of existing companies or in newly established companies. The banks normally finance such participation from their own resources; however, it is permissible to have the investment deposit funds also engaged in such activities. There are some restrictions as to the percentage of the bank's
participation in the share capital and this requires the approval of the Central Bank prior to final participation. The bank's income is derived from the dividends declared by the respective companies.

D) Direct Investments

Direct investment means the provision of capital by banks for the implementation of profit making productive and development projects. The banks are not permitted to invest in the production of luxury or non-essential products under this activity. Banks undertake such activities after evaluating and assessing the viability of such projects in terms of economic, financial and technical terms. The banks normally utilize their own resources in committing to such investment projects; however, it is permissible to have the depositors funds also utilized subject to the return being in line with the minimum rate of return determined by the authorities.

E) Muzaraba

Muzaraba is a contract whereby one party (the bank) undertakes to provide capital (cash) on proviso that the other party (the client) employs such capital in trade (buying and selling the financed goods), and both parties share the profit (the distribution of profits and all other issues are handled similar to the Musharaka contract). The Muzaraba is usually of the restricted type where the entrepreneur must use the funds in the transaction that is specified in the contract. However, in practice, the bank has little control on how the funds are used. The client is also required to provide insurance cover on the financed items.

F) Other Investments

The banks invest in Government bonds, public utility bonds, shares and other forms of investments. Such investments are undertaken to utilize surplus funds or because of directives received from the authorities. Banks also continue to receive interest on their pre-1983 banking facilities.

G) Forward Delivery Contract

This is a contract whereby the bank provides funds for the purchase of agricultural goods at a fixed price for a future delivery date. Banks use the Salaf contract mainly to finance agriculture. At the time of entering into the contract, a
Wakala (power of attorney) is given to the farmer to sell the goods (on behalf of the bank) as and when they are ready for sale. The farmer is paid a commission for his services. The farmer is obliged to arrange an insurance cover against any destruction or failure to produce the goods. The farmer is also required to consult the bank in case the price is below the contracted price. In practice, the farmer keeps the price difference if the sale price was higher than the forward price that was specified in the contract; in effect selling the goods to himself at the contract price and reselling them afterwards at a higher price. The bank gets only the profits arising from the premium on the forward price. If the sale price is less than the forward price the bank is expected to carry the loss, although in practice the bank rarely does so.

H) Combined With Instalment Sale

Under this arrangement, the customer pays the price of the subject matter plus the bank's mark-up in instalments over the financing period. The mark-up rate is determined annually by the Central Bank based on the type of industry or services the financing is provided to. The terms of the contract range from one year (e.g. for raw materials) up to 20 years (e.g. for housing). Banks use this contract to provide short, medium and long term financing for manufacturing (the purchase of raw materials, machinery, equipment and installations), housing, and construction. The bank would normally insist on having the financed items insured by the customer for the duration of the contract. The maintenance and other improvements as and when required are paid by the customer. The contracts can be collateralized by the assets that were acquired from the financing provided by the contract.

In case of late payments, a penalty equivalent to an annual 6% applies on the principal, and is calculated on a daily basis by dividing the 6% by 365 days times the duration of the delay. In case of default, the client will be liable for the principal, the mark-up that will be accrued during the remainder of the term, and the 6% annual penalty. If the clients continue to be in default after the expiration of the contract term, a new mark-up rate plus the penalty rate will apply on an annual basis. The bank can choose to foreclose on the client by retaining the collateral.
I) Hire purchase under lease contract  
Hire purchase is a leasing contract where the leaseholder, at the end of the period of the lease and upon fulfilling the conditions specified in the contract, receives the title to the leased property. This contract is usually used in the purchase of property. The bank enters into a contract whereby it acquires the property for the customer, and then enters into an Ijara (lease) contract with the customer who pays rentals (profit plus principal) for the duration of the contract. At the end of the contract (i.e. when the customer has paid the full value of the asset, as agreed in the beginning of the contract) the title is transferred to the customer. The customer (the leaser) is responsible for the maintenance and insurance of the property. The profit rates are based on the margin rates published by the Central Bank. Although, the title of the asset is in the name of the bank, in practice to get possession of the asset in case of default a court order is required.

J) Service Financing Contract  
When banks provide the Jo,aalah facility, they act as a broker for the user of the funds in financing services (with applications mostly in housing but also in trade and manufacturing) and take their profits in the form of a service fee. When used for housing maintenance, the owner of the house would request the bank to arrange maintenance of the property, and the amount is repaid by the customer in instalments. For small amounts third party guarantees are taken while for larger amounts the property is taken as collateral.

K) Mobilization of Funds  
Banks are allowed to mobilize funds by offering different deposit facilities as described below. As per the banking regulations and law all deposits may be guaranteed by the bank.

Demand deposits: These are current accounts that are used primarily for payment services. These deposits are considered as Qard-al-hasana from depositors to the banks and hence cannot earn any return. Current account deposits are guaranteed by banks and can be withdrawn on demand.
Savings deposits: These deposits, like demand deposits, are based on Qard-al-hasana. However, if a specific minimum average balance is maintained for at least three months, depositors will be eligible for a raffle bonus equivalent to 2% (on an annual basis).

Investment deposits: These are income-earning deposits with a maturity of 3 months, 1, 2, 3 and 5 years. In principle, these deposits are based on a Wakala contract, where banks are entrusted by the depositors to manage these funds for a fee, with the depositors bearing the risks. The banks' practice, however, differs significantly. The Central Bank announces at the beginning of the year the expected profit rates for various deposits (in 1999/2000 they were 8%, 14%, 15%, 16%, and 18.5% respectively for deposits of 3 months, 1, 2, 3, and 5 years).

These rates represent the expected profitability of the banking system as a whole. Depositors are compensated according to the pre-announced rates regardless of whether the particular bank they placed their deposits in was profitable or not. If the banks' profits turn out to be higher than the announced rates, they are supposed (at the instruction of the Central Bank) to make additional payments to the depositors, although this has not occurred frequently. In the reverse case where profitability rate is less than expected, depositors will still get returns equivalent to the announced rates.

Special investment deposits: These are deposits of certain organizations (e.g. the pension fund) that are allowed with special government permission. The bank acts as a true manager of these funds (under a Wakala contract), placing them in projects and investments specified by the depositors and transferring all profits to them for a negotiated fee. These funds are permitted to be lent out at rates higher than those announced by the Central Bank, and hence earn higher rates of returns for the depositors. The depositors also carry the risk of loss, although it is highly unlikely.

Special trust deposits: The funds in these deposits are placed (by individuals and organizations) in the bank to be given as Qard-al-hasana (for charity purposes) as per the instruction of the depositors. The bank charges a fee for its services.
Foreign currency deposits: Foreign currency can be placed in demand, savings, or investment deposits for 3 months. Demand deposits do not earn income. Deposits of 3 months earn LIBOR plus 1% (as a maximum). The foreign currency is then placed by the bank in the Central Bank at a rate equal to LIBOR plus 2%.

Inter-bank Market: Banks place surplus funds in other banks. However, aside from lending from commercial banks to specialized banks, this practice is not very common and is usually done at the instruction of, and at terms (rates and maturity) determined by the Central Bank.

So far, the financial management in the conventional set up and in the Islamic banking system has been discussed. The theoretical framework is now applied to the SSIs in Iran, particularly in aspect of the financial and accounting administrative practice as presented in the next chapter.