In a modern business the most important decision that has to be taken at the time of execution of a project is the selection of the means of financing the same. The funds needed are both short term and long term in nature. The business is in continuous need of financial resources to meet the day to day revenue expenditure and working capital requirements. These requirements are usually met by funds available from short term sources where the period varies between 1 to 3 years or is recurring in nature. Apart from this, the need of finance for purchase of capital assets like plant and machinery, land and building are usually met from long term sources which are either contributions of ownership capital of share capital or are borrowings from external sources for a definite term, usually varying between 5 to 7 years. These are therefore called term loans and are 'one-time' in
nature. The organisation will need term loan again when it goes for expansion, modernisation or establishment of a new unit. As the business grows it also generates internal resources like retained earnings to meet the requirement of funds for capital expenditure. It may, however, be mentioned that in exceptional cases both long term and short term funds may come to uphold respectively a suitable portion of working capital and fixed capital as well.

Short term and long term sources of finance are discussed below:

I. **Short Term Sources**:

The various short term sources of finance of an organisation are as follows:

(A) Trade Credit

(B) Acceptance credit

(C) Bank overdrafts

(D) Short term loans
(A) **TRADE CREDIT**

Trade credit indicates the allowance of time which the supplier agrees to give to the buyer for payment of the bill for supply of goods or services. Therefore, though the materials received have started generating revenue to the organisation payment for this material is not required to be made immediately. Though trade credit is an important source of short term finance to a company, taking the national balance
sheets or may be international balance sheets, it all boils down to the fact that one company's debt is another company's credit. Study has revealed both in India and abroad that large companies are usually the greatest beneficiaries of trade credit. Report of Wilson Committee way back in 1975 indicated that large companies owed more to the trade creditors than were owed to them, as in the ratio of 2:1. One of the important reasons for many small industries falling sick is due to liquidity problem they face because of non payment of bills in time by large companies. Small companies are not in a bargaining position as most often they have to yield to the pressure of their big brothers both in terms of rates and credit. A study by the Reserve Bank of India of 1883 non financial large Public Limited Companies and 1027 Small Private Limited Companies, all in the Private Sector, revealed that trade credit as a source of finance has increased in size by one and a half times in 1985-86 compared to that in 1983-84, in the case of the public limited companies, whereas it remained more or less stagnant in the case
of private limited companies. Credit worthiness is a qualitative assessment and it is here that large companies steal a march over their small brethren.

The following chart shows an operating cycle for generation of trade creditors and trade debtors:

The above chart shows how addition of trade creditors and trade debtors increase the cycle and how simple the process would have been
had there not been any question of trade debtors and trade creditors, as shown by the dashed lines.

Trade credit of course cannot be considered to be available free of cost and can be calculated by considering a cash discount that is being foregone. The cost will depend on the number of days for which credit facility was enjoyed by foregoing the discount under the following formula:

\[
\text{Percentage of discount for prompt payment (X)} \times \frac{365}{100 - X}
\]

Credit period allowed after adjusting period allowed for prompt payment.

Thus, if discount allowed for prompt payment is 10 per cent, credit period allowed is 30 days and a period allowed for availing discount 3 days, then the cost of credit will be:
This is being increasingly used by large companies and acts as an important source of working capital to the company. The system works as follows:

(a) The Company draws a bill of exchange on a buyer.

(b) The accepting bank of the buyer endorses its acceptance on the face of the bill thus undertaking to pay the bill at the given time.

(c) The bill now becomes eligible for discounting by a discount house.

(d) The bill is discounted by the Company at the discount house.
(e) The accepting bank is the holder of the bill on due date.

(f) The company pays the discount house and the buyer pays the accepting bank in accordance with their respective facilities.

In India the Industrial Development Bank of India has introduced a rediscounting scheme while the Industrial Credit and Investment Corporation of India Limited makes similar facility available to its customers under 'Line of Credit' facility.

(C) BANK OVERDRAFTS

Capital structure of a company is usually a suitable mix of equity capital and borrowed funds in which overdraft and short-term loans form an important part.

Bank overdraft is an important component in the basket of short-term finances available and is very widely used all over the world including
India. Under this simple arrangement holder of Bank's Current Account can draw cheques over and above the current balance in the account up to a specific limit, usually against the security of the company's current material assets. Under the system letter of hypothecation is taken by the banks and the goods are allowed to remain in the custody of the borrower. The borrowing limit is fixed after determining the margin to be provided by the borrowers on the value of the goods hypothecated. There are, however, some element of discretion at play in the bank fixing the margin. While a first class company will be able to claim a lower margin, a moderate organisation will be required to provide a higher one. Though the system has the advantage of being very simple in operation, the serious disadvantage is with which an imprudent borrower may overuse the facilities, the banks' concern being more in the security for the facility rather than the purpose for which the overdraft is taken. In India, this drawback is sought to be overcome by implementing the recommendations of Tandon Committee (formed under the Chairmanship
of Mr. P.L. Tandon) which had formulated various norms for granting overdraft facilities. The Committee was formed in July 1974 to suggest inventory norms for different industries and to recommend sources for financing minimum working capital requirements and to suggest modifications in the existing variation of financing the same. The Committee classified the inventories in 5 groups and concluded that there were no norms for maintaining inventories and receivables by the borrowing firms which resulted in the borrower carrying inventories in excess of normal limit. The Committee suggested norms for holding of inventories and receivables and recommended that these should be constantly reviewed.

Another Committee which reviewed the cash credit system in India was formed in 1979 under the Chairmanship of Mr. K.B. Chore. Chore Committee's recommendations can be said to be the adoption of some parts of Tandon Committee's recommendation with certain modifications. Tandon Committee has, in fact, recommended 3 methods for meeting the working capital gap with the intention of gradually strengthening the current ratio of the
organisation from 1:1 to 1.3:1 and then to further strengthening all the ratios. Chore Committee has recommended a minimum growth of 1.33:1 in all cases.

Norms for cash credit availability are gradually becoming more and more stringent in India which have forced the buyers to look to other sources of short-term finance.

Banks, however, provide short term accommodation to their constituents to overcome temporary fund requirements. Terms of security are very flexible and usually depend on the credit worthiness of the organisation. In the case of a Company with very good credit rating such short term accommodations are against hundi or a promissory note. In some cases personal guarantee of a director might be necessary.

(D) **SHORT TERM LOANS**

Short term loan is one with a duration not
exceeding three years obtainable from a bank or a finance company. Capital structure of a company usually comprises of suitable mix of equity capital and different types of loan funds in which short term loans is a part. The task and formality involved in arranging a loan will depend on:

(a) the amount of loan,

(b) the borrower,

(c) the security,

(d) the purpose for which the loan is required, and

(e) the current financial climate.

In India, with a view to bringing commercial banks into the mainstream of economic development with definite social obligations and objectives, ownership and control of 14 major banks in the country with deposits exceeding Rs 500 million each were acquired by the Government in July 1969. Six more commercial banks were nationalised by April 1980. The
nationalised banks have priorities fixed by the Government where loan is to be granted on urgency basis. These are related to exports, technology upliftment, increase in productivity, recycling of waste or by-products, investment in small scale sector and generation of employment. Loans are granted on the basis of loan agreement and security documents executed with the bank and disbursement of the loan is made according to the agreed terms.

Short term funds are also available from finance companies against higher interest charge compared to banks. However, their terms are more flexible depending on the status of the borrower. Finance companies therefore act as lenders of the last resort to certain sectors. There are certain businesses where returns are higher and where the borrower will not mind paying some additional interest charges, like transport hiring. It is in these areas that finance companies have a thriving business. The loans granted by them, though for the purpose of acquiring fixed assets are not for very
long periods and can be appropriately described as short term loans.

Short term loan is essentially used for financing current assets. Current assets can be 'hard-core' which are more or less permanent in nature like maintenance of minimum stock level or cash balance for smooth business operation. Any requirement over and above the 'hard-core' limit is fluctuating. 'Hard-core' portion depends on the volume of activity, production process or technology and credit period under the company's own policies. 'Hard-core' current assets can be financed either from long term or short term sources, depending on the nature of the product and understanding with the banker. Though the company would prefer long term loans for such financing because of interest advantage, the lender usually has preference for short term loans to reduce risk.

It may however, so happen that the lender may agree to long term loan if the borrower is...
willing to pay higher interest rate applicable on short term loans. This sometimes appears to be the solution to keep both sides happy - the lender because of the higher interest rate that he gets and the borrower because of the risk of renewal of short term loan that is not involved.

Short term loans in India are costlier than long term ones though in certain areas the rates are matching. For instance, the interest on three year public deposits at 14% per annum as per Rule 3(1)(c) of Companies (Acceptance of Deposit) Rules 1975, is same as interest on seven year debentures, except that whereas the former is unsecured the latter is not.

(E) CREDIT FACTORING

This financial service, first developed in the USA, involves purchase of an acknowledged debt by a credit factor against a charge. Credit
factors assist in:

(i) Credit control,

(ii) Ensuring against bad debt,

(iii) Providing fund against invoice,

Factoring is useful to companies whose management team is specialised in production or marketing but not in finance, in which case management can concentrate on production leaving the finance to be taken care of in the hands of the factor. One problem with factoring is that the company gradually depends too heavily on the services of a credit factor and it becomes difficult to do away with their services at a later date.

(F) **INVOICE DISCOUNTING**

The service is similar to the credit factor's providing of fund against invoice. Companies give invoices to financial houses for their
discounting the invoice and use the resources brought in thereby as short term funds. Fund is provided by finance house to the extent of 80% of the invoice value interest rate being usually higher than the normal.

The facility is very easy to work and is also easily available.

(G) HIRE PURCHASE

This facility is well known and is availed of very frequently. The price that the buyer pays in every instalment includes part of the cost price and interest on the capital cost.

It is with the payment of the final instalment that the buyer exercises the option to purchase the asset and, until then, the asset belongs to the supplier. At the time of rising prices it becomes very beneficial to the Company to purchase assets on hire purchase
basis at a pre-determined agreed price which will improve Company's cash flow. The interest on hire purchase payment being chargeable expense, cash flow is further improved by way of lower taxes. The point to be noted is that as the transfer of ownership of asset takes place only on payment of the final instalment, depreciation benefit is available only after such payment is made.

In India, hire purchase method is becoming increasingly popular. According to Reserve Bank of India Bulletin, the number of hire purchase finance companies increased from 133 in 1961 to 276 in 1981 and 412 in 1986.

(H) LEASING

The asset can be made available in three ways:

(a) by acquiring it against payment;

(b) by acquiring it on hire purchase, and
In leasing arrangements, the user gets the continuing right of using the asset against rent, without acquiring ownership rights. From the operating point of view, the aim of the company is the facility of undisruptable use of the asset as long as it is required, rather than ownership of the asset. This arrangement saves the company of unnecessary blockage of funds and also makes utilising to the company the option of availing the latest improved model of the asset all the time. This is particularly useful in areas like computers where technology changes very fast. Total rental being deductible expense, cash flow improves significantly. On many occasions the lessee is given the option to purchase the asset at an agreed price after a given period. The greatest drawback of the arrangement is that the leasing gives the lessee the right to use the asset but not that of ownership to it and, as such, no depreciation benefit can be available on this asset nor can
be used as security for term loan. The basic features of leasing arrangements are:

(a) arrangement is entered into usually with customers who will have some commercial use of the assets.

(b) assets are usually income-producing or cost-saving;

(c) rentals are paid in equal instalments at given intervals;

(d) assets are procured according to customers' requirements and specification;

(e) insurance is usually arranged by leasee.

(I) CORPORATE CREDIT CARD

Many organisations and banks offer credit card facilities to individuals and also to companies to be used by their selected executives. These cards are used by the executives for
purchases reimbursible by the company and the company also settles the bill taking advantage of the normal credit facilities available under the credit card arrangements. Though in a very small way, this also acts as a source of finance for the corporate sector.

(J) INTER CORPORATE LOANS

There are occasions where companies have surplus funds for temporary periods which are not needed for investments immediately but may be required with short notice. One option available is the use of such surplus funds for eliminating or retaining overdraft. However, one inherent danger in this is that the limit of overdraft is usually based on the utilisation of overdraft limit by concerned companies over a period of time and such reduction in limit by utilising surplus funds may affect the company's prospect of increasing the overdraft limit with the bank.
Such surplus funds are, however, also sometimes used by investing them in bonds or units of Unit Trust of India which can be easily converted into cash at the instance of The Unit Trust itself. However, another option in the matter that is available is to use these surplus funds for the purpose of giving loans to some companies which are in need of short term funds. These are basically unsecured loans for short periods usually less than one year and are repayable at call thereafter. Rate of interest is competitive compared to that of overdrafts and thus such inter corporate loans become a popular means of financing both for the lender who finds it a profitable avenue of using surplus funds and the borrower whose temporary liquidity crunch is overcome.

(K) PUBLIC DEPOSIT SCHEME

In India Section 58A of the Companies Act, 1956 provides for the option to the non-banking non-financial companies to invite deposits from
the members of the public and shareholders to the extent of 25% and 10% respectively of the company's paid-up capital and free reserves. Companies (Acceptance of Deposit) Rules were formed and introduced in 1975 which govern and regulate these deposits. These Rules allow deposit for a period not exceeding 3 years at an interest not exceeding 14% per annum. The deposits are unsecured, and for the purpose of raising them, the only formality required to be observed is to file with the Registrar of Companies an advertisement (or statement in lieu of advertisement) as approved by the Board, before its publication in the newspapers inviting the public and shareholders to make a deposit. This is one reason why it has become popular with the corporate sector. It is also popular with the investors because of shorter duration of deposit and higher interest rate compared to bank deposits.
TRADE ADVANCE

It is the usual practice in business to pay some advance to the supplier against the order placed as a token of confirmation that the supply will be honoured and also to partly finance the order. This is particularly applicable to job orders where the amount of advance is also very high as the supplier has to make it according to customer's specification and it cannot be sold easily if the customer fails to lift it. The amount of trade advance depends on the nature of the product and also intensity of the customer's need.

SECURITY DEPOSIT

There are many sources of security deposit - dealers, some classes of employees, customers for the use of certain facilities etc. Refundable with or without interest, these security deposits act as a source of fund to a company though its impact may not be very significant.
II. Long Term Finance

A firm may borrow funds either on short, medium or long term basis. The long term funds are mostly needed for:

(a) financing long term fixed assets,

(b) providing 'hardcore' finances, and

(c) taking over a new business.

Sources of long term funds may be:

(i) EXTERNAL or

(ii) INTERNAL

(i) External Sources

(a) Share Capital or

(b) Borrowed Capital

(i) (a) Share Capital

Share Capital represents the owner's contribution to the total financial
requirements of the business. Share capital structure of a company is governed by provisions of the Companies Act. Prior to 1956, the Indian Companies Act, 1913 allowed the share to be ordinary, preference or deferred. While ordinary share capital had to bear the brunt of fluctuations in business fortunes in the form of higher or lower dividend, preference share capital secured dividend payments every year at a fixed rate, irrespective of the company's profit position. Preference shares may be cumulative or non-cumulative, redeemable or irredeemable. While cumulative preference shares allow dividend to accumulate in case the company fails to pay dividend in any one year due to inadequacy of profit, non-cumulative preference shares do not provide such benefit and the dividend lapses in case it is skipped over for any year.

In case of redeemable preference shares the capital sum of the share is
refunded to the shareholder after an agreed period while in the case of irredeemable preference share the capital continues in perpetuity.

Deferred shares were basically promoter's shares and it had a disproportionately higher voting rights compared to ordinary shares. These shares, however, can no longer be issued after the amendment of the Companies Act, 1956 which allows the shares to be either equity or preference.

The basic distinction between debt and equity arises from the response to risk and uncertainty. Risk aversion is a common sentiment though it is dependent on the uncertainty involved and the attitude of the investor towards risk and uncertainty. A variety of instruments for long term finances has developed over the years, the oldest amongst them being preference shares. Preference shares have
characteristics of both loan and capital; loan, because a fixed rate of return is paid on these shares; capital, because dividend paid on these shares is appropriated against the profit and not charged against it. In the case of non-cumulative preference shares, shareholders even take the risk of missing their dividend as the profit in one year may not permit payment of preference dividend and thus the preference shareholder also has to take a risk like the equity shareholder. It also has the characteristic of continuing in perpetuity like equity capital. Though redeemable preference shares look like debts as the liability is wiped out after an agreed period, their rightful place is really between equity capital and debt. Their turn for earning dividend comes in preference to that of equity shares but after payment of interest on debt. Their rank is similarly placed for repayment at the time of liquidation. Once a popular instrument, preference shares have now
fallen from grace and both companies and investors shun it, though for different reasons. As an appropriation against profit, the company cannot charge payment of preference dividend as expenditure in the company's books and thus avail of tax benefits. Investors find the predetermined rates of dividend on preference shares mostly unattractive as the same dividend rate continues for longer time and in the case of irredeemable preference shares in perpetuity. Preference shares are usually quoted in the Stock Exchange below par, thus effective return is higher than the fixed dividend rate. Effective return can be found out by the following:

\[
R = \frac{D}{V}, \quad \text{or} \quad R = \frac{D}{V} - 1
\]

where \( R \) is an effective rate of return, of which \( D \) is dividend and \( V \), the market value of preference shares. Thus if 10% preference shares of Rs 100/- each with paid up value of Rs 10
lakhs is quoted as Rs 95 per share, effective rate of return will be:

\[
\text{Rs 1 lakh} \quad - \quad \text{Rs 9,50,000}
\]

or

\[
\frac{\text{Rs 1,00,000}}{\text{Rs 9,50,000}} = 10.53\%
\]

For redeemable preference shares, in case redemption is on a premium the market tendency is to have higher prices nearer the time of redemption, of course considering the effective return to be obtained vis-a-vis return from alternative investment opportunity.

One variety of preference shares has been introduced in the country in 1985, called Convertible Cumulative Preference Shares (CCP). Objectives of the issue are to cover capital cost of new projects, expansion or diversification of existing products, normal capital expenditure requirements and also financing working capital need. These shares which are
deemed to be equity shares for the purpose of calculating debt equity ratio carry preference dividend of 10% till they are converted into equity shares which has to be completed after three years but within five years from the date of issue. In case of any arrear preference dividend, liability of the company to pay this dividend continues even after conversion of shares into equity. The quantum of issue cannot exceed equity offer made by the company to the public for subscription. CCP shares offer good source of funds for new projects because of low rate of dividend payable at the initial stage, which also carries an attraction of the equity issue around the time the project is commissioned. The problem however, still remains that the dividend is allowed only on appropriation of profit and cannot be charged to revenue as an example. However, dividend rate being very low compared to interest rates in the case of debentures, the position still remains attractive, though it has not become very.
popular in the industrial circle. Tata Chemicals is the only company which has of late come out with issuing CCP shares.

Basic difference between investments in preference shares and that of equity is that in the case of the former the return is known while in the case of the latter it remains uncertain. Equity capital is still considered the most popular source of finance both by company and by the investors. The company finds it attractive as dividend payment is directly related to the company's performance while the investors finds it attractive to the effect that a better profit earning will yield higher return in the form of dividend apart from giving opportunity to profit price difference by selling the shares in the stock market. Apart from giving an opportunity to make a margin at the stock exchange, cost of equity capital is usually higher than cost of fixed
interest capital for two reasons. Firstly equity investors require additional reward for the extra uncertainty of equity investments and second there is no tax benefit derived from the payments, it being appropriation of profit. The following example will clarify in the case of Debenture of Rs 100/- carrying interest @ 15 per cent:

<table>
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<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest will be</td>
<td>Rs 15.00</td>
</tr>
<tr>
<td>Less Company tax @ 50%</td>
<td>Rs 7.50</td>
</tr>
<tr>
<td></td>
<td>Rs 7.50</td>
</tr>
<tr>
<td>Income in hands of the investor</td>
<td>Rs 15.00</td>
</tr>
<tr>
<td>Less personal tax @ of 30 per cent</td>
<td>Rs 4.00</td>
</tr>
<tr>
<td>Investors return</td>
<td>Rs 10.50</td>
</tr>
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</table>

Effective cost of borrowing to the company is therefore 7.5 per cent and investors rate of return is 10.5 per cent.
Now let us look at an investment in equity. Considering the uncertainty let us estimate that the investor who wishes to have an effective return of 15 per cent for this, considering the same personal tax to the investor, the company needs to pay a gross dividend on 21.43. In view of dividend being appropriation of profit after tax the company has to make a gross earning of 42.86, assuming corporate tax of 50 per cent. This will be compared with the cost of 7.50 when the company pays fixed interest rate.

Equity share capital base can be created by public issue, rights issue or bonus issue. In the Companies Act, when a company goes for original subscription no offer can be made to the public unless a prospectus is filed with the Registrar of Companies under Section 60 of that Act. A part of the share capital may be reserved for subscription by promoters, part by non residents, employees
For the listing of the public issues, formalities are required to be compiled within terms of Section 73 of the Companies Act and according to the listing agreement with the Stock Exchange which will also determine the ratio in which the shares should be allotted in case the issue is over subscribed.

Rights Issue

In terms of Section 81 of the Companies Act, 1956, any further issue of shares by a company will have to be offered to the existing shareholders in the ratio of their respective holdings as on a determined date, unless the shareholders pass a resolution authorising the Board of Directors to issue the shares otherwise. In the case of Rights Issue though the share basis is

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expanded the per cent of shareholding of an individual shareholder remains unchanged as the shareholding of an individual shareholder increases in the same proportion. However, there is a possibility of a shareholder renouncing the right in favour of another person who may or may not be a shareholder in which event the ratio gets distorted in respect of certain shareholders.

Rights issue forms an important source of finance for an organisation as shares are offered to existing members who are already aware of the working and prospects of the company. There is no requirement for publicity or payment of brokerage and the question of payment of dividend will arise only if the company makes profit to justify dividend. So far as the company is concerned it has to provide for a higher dividend amount in view of the expanded capital base. A diluted version of the Rights Issue is Offer for Sale which takes place primarily to enable a foreign promoter to
comply with the requirements of the Foreign Exchange Regulations Act. In the case of such Offer for Sale, which has to be made with the approval of the Reserve Bank of India in the case of foreign promoters, the capital base does not change though the shareholding pattern changes. In view of this, Offer for Sale cannot be considered a source of finance. Similarly issue of Bonus shares which is made by capitalisation of reserve does not also improve liquidity but is instead a source of greater pressure on funds if the company wants to pay at least the same rate of dividend. Bonus issue is payment of dividend in kind and is helpful for shareholders as it gives him an opportunity for higher dividend income as also capital gains in future.

II (i) Borrowed Capital

There could be three major sources of borrowed capital viz:
1. Bank Financing

Bank Financing may be in the form of an overdraft which provides an important and significant source of short term financing or term loan, mainly to finance capital projects repayable in fixed periodical instalments. Usually term loans upto Rs 5 crores are available from the banks, while loans of higher amounts are made available through a consortium of financial institutions with one institution acting as lead institution.

2. Institutional Financing

Of the various financial institutions Life Insurance Corporation of India, Unit Trust of India and General Insurance Corporation of India act as investment institutions while, Industrial Development Bank of India, Industrial
Finance Corporation of India, The Industrial Credit and Investment Corporation of India Limited and Industrial Reconstruction Bank of India act as lending institutions. All the above institutions have been formed under Special Status of the Parliament, except The Industrial Credit and Investment Corporation of India Ltd which is incorporated under the Companies Act. All these institutions are wholly owned by the Government of India.

One of the shortcomings of institutional finance is the requirement of documents which takes time to be collected and, hence, delays disbursement of loans. To overcome this, arrangements for bridge loan is usually made with the bank or institutions based on sanction letters to cover fund requirements during the interim period.
3. **Debentures**

The most common means for raising borrowed funds is issue of debentures which may be either convertible or non-convertible and can be offered to the public or to the members on Rights basis. In the case of convertible debentures, part of the holding of the debentures is converted into equity. However, in the case of non-convertible debentures, the amount of debentures remains as borrowed fund till redeemed. In certain cases even the interest is converted into equity. Convertible Debentures are particularly helpful in the case of project finances as the interest on the said debentures can be capitalised and, if these are converted into equity immediately on commissioning of the project, the investors' future gets tied to the prospect of the concerned project and
the investor gets return only if the project does well. Thus commitment for interest payment can be avoided. In the case of Rights Debentures it may not be possible to obtain total subscription from the shareholders in which event permission can be obtained from the Controller of Capital Issues for private placement of debentures to the extent it remains unsubscribed. Such private placement can be arranged with the Financial Institutions and Banks and arrangements can also be made for underwriting for the unsubscribed part which will devolve on the offer of Rights to the extent of the shortfall.
Three important internal sources of funds are:

(a) Depreciation,

(b) Tax Planning, and

(c) Retained Earnings.

(a) **Depreciation**

Depreciation is, as it is usually meant, loss of value suffered by an asset as a result of wear and tear, obsolescence or simply passage of time. The first two cases affect assets like plant and machinery, vehicles, tools etc; while the third affects assets such as copy right patents, lease holding property. According to some authorities, the third type is, no doubt, a kind of amortisation but not exactly depreciation. According to them, it is a different kind of amortisation. The Institute of Chartered Accountants of England and Wales defines depreciation as "that part of
the cost of fixed assets to its owner which is not recoverable as the asset is finally put out and used by him". Thus, depreciation is a process of allocation of cost of assets minimising its estimated value after the useful life of the asset.

Depreciable assets should substantiate three conditions:

1. it is expected to be used in more than one accounting period;

-2. it has limited useful life; and

3. is held by entrepreneurs for production of goods and services.

Earlier a popular method of providing depreciation was to create a Sinking Fund where depreciated amount was tied up and which became available for use at the end of the useful life of the asset concerned. However, liquid resources being costly, it is found to
be more useful by allowing the fund to be used in the business for providing greater leverage than to tie up the fund or tie up resources in Sinking Fund. Thus depreciation provided in business becomes available as a source of fund. It should be borne in mind that depreciation is only a fiscal incentive and does not result in actual outflow of funds. There are, however, incentives which have been introduced one being a scheme on depreciation reserve with the Industrial Development Bank of India (IDBI), introduced under Section 32 of the Income Tax Act, 1961. Investment allowance introduced earlier was replaced by investment deposit account maintained with IDBI from 1 April 1987. However, this investment allowance scheme has been re-introduced in selected industries again in 1988.

Another way depreciation acts as a source of fund is those being charged
against profit, taxable profit comes down and thus there is lower taxable profit and therefore lower payment on taxes which improves cash flow position. Similarly lower profit is available for appropriation as dividend and thus some liquid resource becomes available for internal use.

**Tax Planning**

Tax planning acts as a potential source of financing. Many fiscal incentives which are available allow deduction from taxable profit and thus reduce the tax burden. Chapter 6A of the Income Tax Act, 1961 starting from Section 80A and ending with Section 80U lists out the various deductions which are allowed in computation of total income. Again special tax limits are available for export, users of recognised research and development and investments in certain businesses like mineral oil. In fact provision for depreciation and investment allowance could be considered
also for fiscal incentives which are available for indigenous use in tax planning.

Some of the examples of fiscal incentives allowed through tax benefits are those available under Section 88H and 88I of the Income Tax Act. Under the former any new industrial undertaking established in a centrally declared backward district is eligible for enjoying Income Tax relief by way of deduction of 20% of profits for a period of 10 years. Under the latter, new industrial undertakings are entitled to Income Tax relief by way of deduction of 25% of the profits for a period of 8 years. The benefits of both these sections are available cumulatively to industrial undertakings established in notified backward districts.

Retained Earnings

One of the important internal sources
of funds for all forms of business are retained earnings, also called ploughed back profits. These are, as a matter of fact, net income, after tax, arising from day to day operation of the business which are not drawn out by proprietor or paid out as dividend.

There are several motives which work behind accumulation of retained earnings. In a business one has to maintain a stable dividend. Shareholders usually prefer stable return on their investments; but since earnings of business fluctuate from year to year, retention of profit during a good year helps in covering up shortfall of a bad year. Raising of capital from the market is nowadays an important composition. It becomes too costly for money being spent on advertisements, printings, brokerage and administration of the scheme. A healthy retention policy can help in sufficient internal generation of fund to avoid public issues.
There is a feeling that retention stimulates investment, due to which the Government also encourages retention during inflation as a check against spending. Directly related to retained earnings is company's dividend policy and the next chapter deals with dividend policy and retained earnings and their role in the corporate finances.
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**CHAPTER I**

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<td>Reserve Bank of India</td>
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