FINANCIAL MANAGEMENT

II SEM

UNIT 1

MEANING OF FINANCE

Finance may be defined as the art and science of managing money. It includes financial service and financial instruments. Finance also is referred as the provision of money at the time when it is needed. Finance function is the procurement of funds and their effective utilization in business concerns

Definition: According to GUTHMANN and DOUGALL, business finance may be broadly defined as "the activity concerned with the planning, raising, controlling and administering the funds used in the business." Financial decisions refer to decisions concerning financial matters of a business firm. There are many kinds of financial management decisions that the firm makers in pursuit of maximizing shareholder's wealth, viz., kind of assets to be acquired, pattern of capitalization, distribution of firm's income etc.

We can classify these decisions into three major groups:

- Investment decisions
- Financing decision.
- Dividend decisions.
- Working capital decisions.

NATURE OF FINANCE FUNCTION:

In most of the organizations, financial operations are centralized. This results in economies.

II. Finance functions are performed in all business firms, irrespective of their sizes /legal form of organization.

III. They contribute to the survival and growth of the firm.

IV. Finance function is primarily involved with the data analysis for use in decision making.

V. Finance functions are concerned with the basic business activities of a firm, in addition to external environmental factors which affect basic business activities, namely, production and marketing.

VI. Finance functions comprise control functions also

VII. The central focus of finance function is valuation of the firm. Finance makes use of economic tools. From Micro economics it uses theories and assumptions. From Macroeconomics it uses forecasting models. Even though finance is concerned with individual firm and economics is concerned with forecasting of an industry.

SCOPE OF FINANCIAL MANAGEMENT: The main objective of financial management is to arrange sufficient finance for meeting short term and long term needs. A financial manager will have to concentrate on the following areas of finance function.

1.Estimating financial requirements: The first task of a financial manager is to estimate short term and long term financial requirements of his business. The amount required for purchasing fixed assets as well as needs for working capital will have to be ascertained.

2.Deciding capital structure: Capital structure refers to kind and proportion of different securities for raising funds. After deciding the quantum of funds required it should be decided which type of securities should be raised. A decision about various sources for funds should be linked to the cost of raising funds.

3. Selecting a source of finance: An appropriate source of finance is selected after preparing a capital structure which includes share capital, debentures, financial institutions, public deposits etc. If finance is needed for short term periods then banks, public deposits and financial institutions may be the appropriate. On the other hand, if long term finance is required then share capital and debentures may be the useful.

4. Selecting a pattern of investment: When funds have been procured then a decision about investment pattern is to be taken. A decision will have to be taken as to which assets are to be purchased? The funds will have to be spent first on fixed assets and then an appropriate portion will be retained for working capital and for other requirements.

5. Proper cash management: Cash management is an important task of finance manager. He has to assess various cash needs at different times and then make arrangements for arranging cash. Cash may be required to purchase of raw materials, make payments to creditors, meet wage bills and meet day to day expenses. The idle cash with the business will mean that it is not properly used.

6. Implementing financial controls: An efficient system of financial management necessitates the use of various control devices. They are ROI, break even analysis, cost control, ratio analysis, cost and internal audit. ROI is the best control device in order to evaluate the performance of various financial policies.

7. Proper use of surpluses: The utilization of profits or surpluses is also an important factor in financial management. A judicious use of surpluses is essential for expansion and diversification plans and also in protecting the interests of shareholders. A balance should be struck in using funds for paying dividend and retaining earnings for financing expansion plans.

EVOLUTION OF FINANCE FUNCTION: Financial management came into existence as a separate field of study from finance function in the early stages of 20th century.

The evolution of financial management can be separated into three stages:

1. Traditional stage (Finance up to 1940): The traditional stage of financial management continued till four decades. Some of the important characteristics of this stage are:

i) In this stage, financial management mainly focuses on specific events like formation expansion, merger and liquidation of the firm.

ii) The techniques and methods used in financial management are mainly illustrated and in an organized manner.

iii) The essence of financial management was based on principles and policies used in capital market, equipment’s of financing and lawful matters of financial events.

iv) Financial management was observed mainly from the prospective of investment bankers, lenders and others.

2.Transactional stage (After 1940): The transactional stage started in the beginning years of 1940‟s and continued till the beginning of 1950‟s. The features of this stage were similar to the traditional stage. But this stage mainly focused on the routine problems of financial managers in the field of funds analysis, planning and control. In this stage, the essence of financial management was transferred to working capital management.

3.Modern stage (After 1950): The modern stage started in the middle of 1950‟s and observed tremendous change in the development of financial management with the ideas from economic theory and implementation of quantitative methods of analysis.

Some unique characteristics of modern stage are: i) The main focus of financial management was on proper utilization of funds so that wealth of current shareholders can be maximized.

ii) The techniques and methods used in modern stage of financial management were analytical and quantitative. Since the starting of modern stage of financial management many important developments took place. Some of them are in the fields of capital budgeting, valuation models, dividend policy, option pricing theory, behavioural finance etc.

GOALS OF FINANCE FUNCTION

Effective procurement and efficient use of finance lead to proper utilization of the finance by the business concern. It is the essential part of the financial manager. Hence, the financial manager must determine the basic objectives of the financial management. Objectives of Financial Management may be broadly divided into two parts such as:

1. Profit maximization 2. Wealth maximization.

1. Profit Maximization Main aim of any kind of economic activity is earning profit. Profit is the measuring techniques to understand the business efficiency of the concern. Profit maximization is also the traditional and narrow approach, which aims at, maximizing the profit of the concern.

Profit maximization consists of the following important features. 1. Profit maximization is also called as cashing per share maximization. It leads to maximize the business operation for profit maximization.

2. Ultimate aim of the business concern is earning profit, hence, it considers all the possible ways to increase the profitability of the concern.

3. Profit is the parameter of measuring the efficiency of the business concern. So it shows the entire position of the business concern.

4. Profit maximization objectives help to reduce the risk of the business. Unfavourable

Arguments and Drawbacks for Profit Maximization

The following important points are against the objectives of profit maximization:

(i) Profit maximization leads to exploiting workers and consumers.
(ii) Profit maximization creates immoral practices such as corrupt practice, unfair trade practice, etc.

(iii) (iii) Profit maximization objectives leads to inequalities among the stake holders such as customers, suppliers, public shareholders, etc.

Profit maximization objective consists of certain drawback also:

(i) **It is vague**: In this objective, profit is not defined precisely or correctly. It creates some unnecessary opinion regarding earning habits of the business concern.

(ii) **It ignores the time value of money:** Profit maximization does not consider the time value of money or the net present value of the cash inflow. It leads certain differences between the actual cash inflow and net present cash flow during a particular period.

(iii) **It ignores risk**: Profit maximization does not consider risk of the business concern. Risks may be internal or external which will affect the overall operation of the business concern.

Wealth Maximization

Wealth maximization is one of the modern approaches. The term wealth means shareholder wealth or the wealth of the persons those who are involved in the business concern. Wealth maximization is also known as value maximization or net present worth maximization. This objective is an universally accepted concept in the field of business.

Stockholder‟s current wealth in a firm = (Number of shares owned) x(Current Stock Price share)

Favourable Arguments for Wealth Maximization

(i) Wealth maximization is superior to the profit maximization because the main aim of the business concern under this concept is to improve the value or wealth of the shareholders.

(ii) Wealth maximization considers the comparison of the value to cost associated with the business concern. Total value detected from the total cost incurred for the business operation. It provides extract value of the business concern.

(iii) Wealth maximization considers both time and risk of the business concern.

(iv) Wealth maximization provides efficient allocation of resources.

It ensures the economic interest of the society. Unfavourable Arguments for Wealth Maximization

(i) Wealth maximization leads to prescriptive idea of the business concern but it may not be suitable to present day business activities.

(ii) Wealth maximization creates ownership-management controversy.

(iii) Management alone enjoy certain benefits.

(iv) The ultimate aim of the wealth maximization objectives is to maximize the profit.

(v) Wealth maximization can be activated only with the help of the profitable position of the business concern.

MAXIMIZING VS SATISFYING

As shareholders are the real owners of the organization, they appoint managers to take important decisions with the objective of maximizing shareholder’s wealth. Though

organizations have many more objectives, but maximizing stock price is considered to be an important objective of all for many firms.

1) **Stock price maximization and social welfare**: It is advantageous for society, if firm maximize its stock price. But, firm must not have any intentions of forming monopolistic market, creating pollution and avoiding safety measures. When stock prices are maximized, it benefits society by:
   - **i)** **To greater extent the owners of stock are society**: In past, ownership of stock was with wealthy people in society. But now, with the tremendous growth of pension funds, life insurance companies and mutual funds, large group of people in society have ownership of stock either directly or indirectly. Hence, when stock price is increased, it ultimately improves the quality of life for many people in society.
   - **ii)** **Consumers benefit**: It is necessary to have effective low-cost businesses which manufacture good quality of goods and services at the cheapest cost possible to maximize stock price. Companies which are interested in maximizing stock price must satisfy all requirements of customers, provide good services and innovate new products finally; it must increase its sales by creating value for customers. Some people believe that firms increase the prices of goods while maximizing stock price. But it is not true; in order to survive in competitive market firms does not increase prices otherwise they may lose their market share.
   - **iii)** **Employees benefit**: In past years, it was an exception that decreases in level of employees lead to increase in stock price, but now a successful company which can increase stock price can develop and recruit more employees which ultimately benefits the society. Successful companies take advantage of skilled employees and motivated employees are an important source of corporate success.

   2 Managerial Actions to Maximize Shareholder's Wealth: In order to identify the steps taken by managers to maximize shareholder's wealth, the ability of the organization to generate cash must be known. Cash flows can be determined in three ways; they are:

   i) Unit Sales: In first determinant, managers can increase the level of their sales either by satisfying customers or by luck, but which will not continue in long run.

   ii) After Tax Operating Margins: In second determinant, managers can generate cash flows by increasing operating profit which is not possible in competitive environment or by decreasing direct expenses.

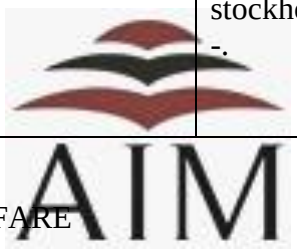
   iii) Capital Requirements: In third determinant, managers can increase cash flows by decreasing assets requirements which ultimately results in increase of stock price. Investment and financing decisions have an impact on level, timing and risk of the cash flow of firm and finally on stock price. It is necessary for manager to make decisions which can maximize the stock price of the firm.

2) **Maximizing Earnings Per Share is Beneficent or Not**: In order to maximize stock price, many analyst focus on cash flows by evaluating the performance of the company

and also focus of EPS as an accounting measure. Along with cash flow, EPS also plays an important role in identifying stockholder's value.

DIFFERENCE BETWEEN PROFIT AND WEALTH MAXIMIZATION

Goal	**objectives**	**Advantages**	**Disadvantages**
Profit maximization	Large amount of profits	Easy to calculate profits. Easy to determine the link - between financial decisions and profits.	Emphasizes the short term -Ignores risk or uncertainty. Ignores the timing of Returns. -Requires immediate Resources.
Stockholder- wealth maximization	Highest market value of common stock	Emphasizes the long term Recognizes risk uncertainty. Consider stockholders return -.	-Offers no clear relationship Between financial decisions and stock price. Can lead to management return. anxiety and frustration



PROFIT VS. WEALTH VS. WELFARE

PROFITMAXIMIZATION	WEALTH MAXIMIZATION	WELFARE MAXIMIZATION
Profits are earned maximized, so that firm can over-come future risks which are uncertain.	Wealth is maximized, so that wealth of share-holders can be maximized.	Welfare maximization is done with the help of micro economic techniques to examine a locative distribution.
Profit maximization is a yards stick for calculating stockholder's current wealth is social welfare is evaluated efficiency and economic prosperity of the concern. the value of shares in the activities of individuals in	In wealth maximization stockholder's current wealth is evaluated in order to maximize by calculating economic the value of shares in the market.	In welfare maximization, social welfare is evaluated by calculating economic activities of individuals' in the society.
Profit is measured in terms of efficiency of the firm.	Wealth is measured in terms of market price of shares.	Welfare can be measured in two ways, either by pare to efficiency or in units or dollars.

Profit maximization Involves problem uncertainty because profits are uncertain.	Wealth maximization involves of problems related maximizing shareholder's wealth or wealth of the firm	Wealth maximization involves problem of combining the utilities of different people

Functions and role of finance manager.

A financial manager of a large organization has a very crucial responsibility to shoulder as he has to take all decision about raising & utilization of resources have been taken efficiently and at no time resources should remain idle. As the size of organization grows and volume of financial transactions increases, his role and functions assumes greater importance. The key functions of a financial manager can be as follows:

PRIMARY FUNCTIONS Key management functions

Planning –A financial manager has to make financial planning in the form of short term and long term plans and frame policies relating to sources of finance, investment of funds including capital expenditure and distribution of profit.

Organizing –creating and monitoring proper organizational structure of finance looking to the needs of organization. Coordination –A financial manager has to coordinate with all other department so that no department suffers for want of funds.

Controlling –A financial manager has to fix/ set standards of performance, compare actual with standards fixed and exercise control on differences. He can apply techniques of budgetary control and for this; he has to develop a system of collecting/ processing/analyzing information. Functions relating to finance: Acquisition/raising of funds –He has to ensure adequate quantum of funds from right source, right cost, right time, right form and at minimum cost.

Allocation/ investment of funds –In fixed assets (long term assets) through appropriate techniques of capital investment as well as allocation of funds in current assets like cash, receivables, inventory short term investment keeping in view liquidity & profitability. Distribution of income (profit) –In the form of dividend (dividend decision) and retained earnings for growth and development of business.

Subsidiary functions: Besides core functions as above, a financial manager has to perform following equally important functions such as:

Maintaining liquidity –Adequate liquidity need to be maintained for paying obligations in time as well as meeting day to day expenses and for this, he has to keep close eyes on cash in-flows, cash out flows. Hence cash budget and cash for-casting becomes his important function. Profitability – For ensuring adequate profit and maximizing shareholders wealth a financial manager has to look in to: ¬ Profit planning ¬ Price fixation of goods & services ¬ Cost of funds/capital ¬ Cost control

FUNCTIONS OF MODERN AGE FINANCIAL MANAGER Achieving corporate goals Goals of different departments have to be achieved to increased market share of company's products.

Financial projections / fore casting for next 5-10years consisting of cost & revenues for coming long term period keeping in view companies long term plans.

Corporate Governance for image building in themes of all stake holders of the company, transparency in systems procedure and adherence of laws as well as rules & regulations.

Merger and acquisitions initiative ¬ For including new product lines ¬ Technological tie-up/ collaboration with foreign firms ¬ Financial restructuring for increasing profitability ¬ Tie-up arrangements for greater penetration in new markets in the country & abroad.

Risk management ¬ Preparing strategies for combating risks arising out of internal &external factors.

A Financial manager has to keep close eyes on risk factors as a result of policy changes not only in the country but also due to developments taking place in foreign countries. This has become important due to globalization effect.

Financial engineering: A Financial manager has to keep himself abreast with new techniques of financial analysis and new financial instruments coming in market. In financial engineering, a financial manager has to work on finding out solutions to the problem through complex mathematical models and high speed computer solutions.

Sources of finance:

Internal Sources (Owned Capital)

- **Retained Earnings:** Profits reinvested back into the business instead of being paid as dividends.

External Sources (Borrowed or Investment Capital)

Debt Capital (Borrowed Funds)

- **Bank Loans & Overdrafts:** Traditional borrowing with interest.
- **Bonds & Debentures:** Issuing debt securities to the public or institutions.
- **Trade Credit:** Delaying payments to suppliers.
- **Public Deposits:** Accepting funds from the public for a fixed period.
- **Leasing:** Renting assets instead of buying them.

Equity Capital (Ownership Funds)

- **Equity Shares:** Selling ownership stakes (e.g., through IPOs).
- **Venture Capital & Angel Investors:** Funding from specialized firms or high-net-worth individuals for equity.
- **Crowdfunding:** Raising small amounts from many people online.

Other Sources

- **Government Grants & Subsidies:** Funds provided by the government.
- **Factoring:** Selling accounts receivable for immediate cash.
- **Customer Advances:** Receiving payments upfront for future goods/services.

Classification by Time Period

- **Short-Term (Working Capital):** Trade Credit, Commercial Paper, Bank Overdrafts.
- **Long-Term (Fixed Assets, Expansion):** Equity, Debentures, Term Loans, Retained Earnings.

The main sources of short-term financing are (1) trade credit, (2) commercial bank loans, (3) commercial paper, a specific type of promissory note, and (4) secured loans.

Hire Purchase (HP) is a financing agreement where you pay a deposit and then regular installments to use an expensive item (like a car or machinery) until the full price plus interest is paid, at which point you gain full ownership; it's like renting with an option to buy, common for businesses and consumers to acquire assets without immediate full payment, but involves higher total costs due to interest and risks of repossession if payments are missed.

How it works

- **Deposit:** You pay an initial down payment to the seller.
- **Possession:** You get to use the item immediately.
- **Installments:** You pay fixed monthly payments, which cover both the principal cost and interest.
- **Ownership:** The seller retains ownership until the final installment is paid; then, ownership transfers to you.
- **Default:** If you stop paying, the seller can repossess the goods, and your payments are treated as hire charges.
- **characteristics**
- **Contract:** A contract to hire goods with an option to purchase them.
- **Cost:** The total hire purchase price is often higher than the cash price due to added interest.
- **Usage:** Popular for expensive items like vehicles, machinery, and electronics.
- **Types:** Can be for consumer (personal) or business (commercial) use.

Pros & Cons

- **Pros:** Access to expensive goods with small initial outlay, predictable budgeting, useful for business growth.
- **Cons:** Higher overall cost (interest), risk of losing asset on default, ownership only at the end.

Leasing is a contract where an owner (lessor) lets someone (lessee) use an asset, like property, vehicles, or equipment, for a set period in exchange for regular payments (rent). It allows users to access assets without buying them outright, spreading costs over time, while the owner retains ownership and receives consistent income. Leases involve specific terms, conditions, and often options to return, renew, or purchase the asset at the end.

- **Lessor:** The legal owner of the asset.
- **Lessee:** The party who pays to use the asset.
- **Asset:** Anything from real estate, cars, machinery, to software.
- **Lease Term:** The duration of the agreement.
- **Rent/Rental Payments:** Periodic payments made by the lessee.

Common Types

- **Financial Lease (Capital Lease):** Long-term, transfers most risks/rewards to the lessee, often for high-value assets, with a purchase option at the end.
- **Operating Lease:** Shorter-term, generally for use during a portion of the asset's useful life, often includes maintenance, and the asset returns to the lessor.
- **Sale and Leaseback:** A company sells an asset and immediately leases it back from the buyer.

Advantages

- **Access without Ownership:** Use assets without large upfront costs.
- **Capital Preservation:** Conserves working capital for businesses.
- **Budgeting:** Predictable monthly expenses help with financial planning.
- **Tax Benefits:** Lease payments can often be tax-deductible.

- **Flexibility:** Easier to upgrade equipment and avoid obsolescence.

Potential Drawbacks

- **Cost:** Over the entire term, leasing can sometimes be more expensive than buying.
- **Credit Impact:** Lease applications involve credit checks.
- **Loss of Asset:** Defaulting can lead to asset recovery and damage to credit.

Venture capital:

Venture capital (VC) is private equity financing for high-growth potential startups and early-stage companies, where investors provide capital in exchange for an ownership stake (equity). VCs aim for high returns by backing innovative businesses (often tech-focused) that traditional lenders might avoid, offering significant risk but potential for huge success, alongside mentorship and expertise, with the goal of eventual profitable exit through IPO or acquisition.

- **Funding Pool**: VC firms raise money from Limited Partners (LPs) like institutions, wealthy individuals, etc., to form a fund.
- **Investment**: General Partners (GPs) invest this fund into promising startups, usually in rounds like Seed, Series A, etc..
- **Equity**: Instead of loans, VCs take equity (shares) in the company, becoming part-owners.
- **Support**: They offer strategic guidance, industry connections, and operational expertise to help the company grow rapidly.
- **Exit Strategy**: The ultimate goal is a profitable exit, often via an Initial Public Offering (IPO) or acquisition, returning significant profits to the LPs and GPs.
- **characteristics:**
- **High Risk, High Reward**: Many startups fail, but successful ones can generate massive returns, covering losses.
- **Growth Focus**: Targets companies with potential for rapid, scalable growth, often in tech, biotech, or disruptive models.
- **Beyond Money**: Provides crucial mentorship and network access, not just cash.
- **Equity-Based**: Investors become partners, sharing the upside and downside.

The Funding Lifecycle

Venture capital is typically deployed in sequential rounds as a company matures:

1. **Seed Stage:** Used for initial product development and market research.
2. **Early-Stage (Series A & B):** Focused on commercialization, building a team, and scaling a proven product.
3. **Late-Stage (Series C+):** Large capital injections to drive massive expansion or prepare for an exit.
4. **Exit Stage:** Investors realize their gains through an **Initial Public Offering (IPO)** or by being **acquired** by a larger corporation.

Private equity (PE) involves investment funds pooling capital from wealthy individuals and institutions to buy, improve, and sell private companies (or take public ones private), aiming for high returns by enhancing operations, restructuring, or growth, often using significant debt (leveraged buyouts) to amplify gains over a long-term horizon, making it a less liquid, alternative investment class.

How it Works

1. **Fundraising**: PE firms raise vast sums from institutional investors (pensions, endowments) and high-net-worth individuals into a closed-end fund, typically lasting about 10 years.
2. **Acquisition**: The firm uses this capital, plus significant borrowing, to acquire controlling stakes in target companies, often using the target's own assets as security for loans (Leveraged Buyouts).
3. **Value Creation**: Once owned, the firm actively works to increase the company's value through operational improvements, strategic changes, new leadership, or expanding into new markets.
4. **Exit Strategy**: After several years (e.g., 5 years), the firm sells the improved company (via IPO, sale to another company, etc.) to realize profits for investors, taking a share (carried interest).

Strategies

- **Buyouts**: Acquiring a majority stake (often 100%) in established companies.
- **Growth Equity**: Minority investments in mature companies needing capital for expansion, not control.

- **Venture Capital**: Investing in early-stage startups (distinct from core PE).
- **Distressed Investing**: Buying stakes in struggling companies to turn them around.

Investors

- Pension Funds, Sovereign Wealth Funds, Endowments, Insurance Companies, High-Net-Worth Individuals.

International Financial Management:

International Financial Management (IFM) is the strategic handling of financial activities (investing, financing, risk management) for businesses operating across borders, navigating complexities like currency exchange, differing regulations, and global markets to maximize value. It involves managing foreign exchange risk, international capital budgeting, global cash flow, and compliance with diverse tax/legal systems, essential for multinational corporations (MNCs).

Aspects of IFM

- **Foreign Exchange Risk:** Managing losses from fluctuating exchange rates using tools like futures, options, and swaps.
- **International Capital Budgeting:** Deciding on long-term investments (like building a factory abroad) while considering country-specific risks and returns.
- **International Working Capital Management:** Optimizing cash flows, inventory, and receivables across different countries.
- **Global Financing:** Sourcing funds from international capital markets.
- **Taxation & Regulations:** Complying with varying tax laws and financial regulations in each country.
- **Country Risk:** Assessing political, economic, and financial stability risks in foreign markets.

Importance of IMF

- **Globalization:**

  Increased cross-border trade and investment make IFM vital for MNCs.

- **Value Maximization:**

  Helps companies leverage global opportunities to enhance shareholder wealth.

- **Complexity Management:**

  Addresses the higher risks and complexities of operating in multiple economies.

- **Innovation:**

Exposure to global markets drives innovation in financial products and strategies.

Core Activities

- **Forecasting:** Predicting exchange rates, interest rates, and economic trends.
- **Hedging:** Using financial instruments to offset currency and interest rate risks.
- **Investment Analysis:** Evaluating foreign direct investment (FDI) opportunities.
- **Transfer Pricing:** Setting prices for internal transactions between subsidiaries in different countries.

In essence, IFM applies financial management principles in a complex, interconnected world to achieve corporate goals.

Financial Planning:

Financial planning within financial management is the strategic process of setting financial goals (personal or business), assessing current resources, and creating an actionable roadmap (budgeting, saving, investing, managing risk) to achieve those objectives, ensuring long-term security and efficient resource allocation. It's a holistic approach, turning broad visions into concrete steps, from retirement savings to company expansion, by aligning spending, investments, and risk management with future needs.

Components of Financial Planning:

- **Goal Setting:** Defining clear short-term (emergency fund, vacation) and long-term (retirement, education, home, expansion) financial targets.
- **Financial Assessment:** Analyzing current income, expenses, assets, and liabilities (cash flow, debt).
- **Budgeting & Cash Flow:** Creating a plan for spending and saving to control money flow.
- **Investment Strategy:** Choosing appropriate vehicles (stocks, mutual funds, real estate, etc.) to grow wealth.
- **Risk Management:** Planning for the unexpected through insurance (life, health, disability) and emergency funds.
- **Tax Planning:** Utilizing tax-efficient strategies to minimize liabilities.
- **Retirement Planning:** Saving and investing specifically for post-working life.

Role in Financial Management:

- **For Individuals:**

Provides financial security, peace of mind, and a clear path to life goals like buying a home or retiring comfortably.

- **For Businesses:**
  Guides resource allocation, outlines investment needs, and ensures financial viability and growth by aligning financial actions with strategic objectives.
  In essence, financial planning turns abstract financial desires into a structured, manageable journey, making informed decisions about money for both personal and organizational success.

  Behavioural Finance:

  Behavioral finance studies how psychology, emotions, and cognitive biases influence financial decisions, challenging traditional finance's assumption of rational investors; it explains irrational behaviours like panic selling, herd mentality, and loss aversion, showing how biases like anchoring and overconfidence lead to market anomalies, helping individuals and markets understand deviations from pure logic.

  Core Concepts

- **Psychological Factors:** Emotions (fear, greed) and mental shortcuts (heuristics) drive choices, not just data.
- **Cognitive Biases:** Systematic errors in thinking, such as:
  - **Loss Aversion:** Feeling losses more strongly than equivalent gains, leading to holding losing stocks too long.
  - **Overconfidence:** Overestimating one's ability to predict markets.
  - **Herding:** Following the crowd, even against better judgment (e.g., panic selling).
  - **Anchoring:** Relying too heavily on initial information (like a stock's purchase price).
  - **Confirmation Bias:** Seeking information that confirms existing beliefs.
  - **Framing:** Reacting differently based on how choices are presented (gain vs. loss).
- **Market Inefficiencies:** Biases can cause prices to deviate from their true value, creating market booms or busts.

  Importance:

- **Understanding Yourself:** Helps investors recognize their own mental traps (e.g., selling winners too soon, holding losers too long).

- **Improved Decisions:** Encourages developing systematic, reflective processes (focusing on the *process*, not just outcomes) to counteract reflexive, emotional choices.
- **Market Explanation:** Provides reasons for market anomalies not explained by traditional economic theories.

Capital Market:

A capital market is a financial marketplace connecting those with capital (investors) and those needing long-term funds (companies, governments) through trading financial instruments like stocks and bonds, facilitating economic growth by channelling savings into productive investments via primary (new issues) and secondary (existing trades) markets.

Functions

- **Mobilizes Savings:** Channels money from savers (investors) to borrowers (businesses, governments).
- **Provides Capital:** Allows companies and governments to raise long-term funds for expansion, infrastructure, and innovation.
- **Facilitates Trading:** Offers platforms (like stock exchanges) for buying and selling securities.
- **Promotes Growth:** Fuels economic development, job creation, and entrepreneurship.

Components

- **Securities:** Stocks (equity) represent ownership, while bonds (debt) represent loans.
- **Primary Market:** Where new securities are first issued and sold (e.g., an Initial Public Offering - IPO).
- **Secondary Market:** Where previously issued securities are traded between investors (e.g., stock exchanges like NSE/BSE).
- **Intermediaries:** Investment banks, brokers, and venture capitalists help connect parties.

MONEY MARKET:

A money market is a segment of the financial market for short-term borrowing and lending (typically under a year) using highly liquid, low-risk debt instruments like Treasury Bills (T-bills) and Commercial Paper, enabling institutions and individuals to manage cash flow, fund immediate needs, and earn steady returns, acting as a vital link between surplus cash and short-term funding gaps. It's distinct from the stock market (capital market) as it focuses on short-term debt rather than long-term equity.

- **Working of Money Market.**
- **Lenders/Investors:** Entities with excess cash (corporations, banks, individuals) invest in money market instruments to earn interest.
- **Borrowers:** Governments, banks, and large companies borrow funds for short-term needs like working capital.
- **Instruments:** Key instruments include:
  - **Treasury Bills (T-bills):** Short-term government debt.
  - **Commercial Paper (CP):** Unsecured short-term debt from corporations.
  - **Certificates of Deposit (CDs):** Bank-issued time deposits.
  - **Repurchase Agreements (Repos):** Short-term borrowing using securities as collateral.
- **Trading:** Transactions happen over the phone or electronic systems, not necessarily physical locations, focusing on high creditworthiness and commitment.

Features

- **High Liquidity:** Instruments can be quickly converted to cash.
- **Low Risk:** Low default risk due to short maturities and quality issuers.
- **Short-Term Focus:** Deals with maturities usually less than one year.

Participants

- Governments, banks, corporations, money market mutual funds, and institutional investors.
- Retail investors can access it indirectly via money market funds.

Micro Finance:

Microfinance provides essential financial services like small loans (microcredit), savings, and insurance to low-income individuals and groups often excluded by traditional banks, aiming to foster financial inclusion, empowerment, and poverty reduction by supporting entrepreneurship and self-sufficiency. These services help underserved populations, particularly in developing countries, build assets, increase incomes, and improve living standards through collateral-free loans for business, education, or other needs.

Key Aspects of Microfinance

- **Services Offered**:

  Primarily small loans (microcredit), but also savings accounts, micro insurance, money transfers, and checking accounts.

- **Target Audience**:

  Low-income individuals, micro-entrepreneurs, the unbanked, and marginalized communities, often women, who lack collateral for conventional loans.

- **Core Purpose**:

  To promote financial inclusion and economic empowerment, helping people move out of poverty by providing capital for income-generating activities.

- **How it Works**:

  MFIs offer small, often collateral-free loans with flexible repayment schedules, sometimes using group lending models with joint liability, to mitigate risk.

- **Impact**:
  Empowers individuals, creates self-reliance, supports small businesses (like farmers buying seeds or tailors buying fabric), and contributes to broader poverty reduction goals.

Microfinance & Financial Inclusion

- Addresses the gap left by traditional banks, where serving low-income clients is seen as uneconomical.
- Aims to bring 1.7 billion financially excluded adults into the formal financial system.

History & Evolution

- Roots in cooperative banking, popularized by Muhammad Yunus and the Grameen Bank in Bangladesh, earning Yunus the Nobel Peace Prize.
- Has become mainstream, with diverse providers like banks, NBFCs, and NGOs participating, notes MFIN INDIA.

Financial Information System:

A Financial Information System (FIS) is a structured way (often software) for businesses to collect, process, store, and analyze financial data, transforming raw numbers into actionable insights for decisions on budgeting, investments, and overall performance, by generating reports, forecasts, and analyzing trends to improve efficiency and compliance. It integrates people, procedures, data, software, and controls to manage financial resources effectively, supporting functions from basic bookkeeping to complex financial modeling.

Functions

- **Data Management:** Inputs, stores, and tracks financial transactions (income, expenses, assets).
- **Reporting:** Generates essential reports like balance sheets, income statements, cash flow statements, and budgets.
- **Analysis:** Calculates financial ratios, identifies trends, performs financial modeling, and forecasts future performance.
- **Decision Support:** Provides data for managers to make informed choices about allocating funds, managing investments, and strategic planning.
- **Automation:** Automates tasks like account maintenance, reducing manual effort.
- **Control & Compliance:** Ensures adherence to financial standards and facilitates audits.

Components

- **People:** Users, managers, IT staff.
- **Procedures:** Rules and workflows for data handling.
- **Data:** Raw financial figures and records.
- **Software:** Accounting software, ERP modules (like SAP), analytics tools.
- **Hardware:** Computers, servers, networks.
- **Internal Controls:** Security measures and audit trails.

Benefits

- **Enhanced Decision-Making:** Real-time insights for better choices.
- **Increased Efficiency:** Faster processing, less manual work.
- **Improved Risk Management:** Identifies risks through simulations and forecasts.
- **Better Compliance:** Easier adherence to regulations.

Examples of Use

- Cash Management: Tracking inflows/outflows.
- Capital Budgeting: Evaluating long-term investments.

- Financial Planning: Creating budgets and forecasts.

UNIT – II

Fintech (financial technology) refers to the integration of technology—such as AI, block chain, and mobile applications—into financial services to enhance, automate, and streamline processes for consumers and businesses. It transforms traditional banking, payments, and investing, shifting from backend infrastructure to user-centric, on-demand digital solutions.

Key Aspects of Fintech

- **Definition:** A blend of "financial" and "technology," encompassing innovative solutions that are often more agile and accessible than traditional banking.
- **Key Areas:** Digital payments (PayPal, Stripe), personal finance management, robo-advising (Betterment), peer-to-peer lending (SoFi), and cryptocurrencies.
- **Core Technologies:**

  Artificial intelligence (AI), machine learning, block chain, and cloud computing are used to enhance security and efficiency

  .

- **Evolution:** While it started with backend technology, it shifted towards consumer-focused, mobile-first, and decentralized financial services.
- **Impact:** Fintech makes services faster and more efficient, expanding access to financial services for previously underserved populations.

Major Fintech Categories

- **Payments & Transfers:** Digital wallets, peer-to-peer apps, and international money transfers.
- **Neo-banking:** Digital-only banks with no physical branches (e.g., Chime).
- **Insurance Tech:** Technology used to streamline insurance processes.
- **Wealth Tech:** Automated investment services (robo-advisors).
- **Regulation Tech:** Technology that helps firms comply with financial regulations.

The industry continues to grow as technology changes how money is moved, managed, and invested.

Digital Currency

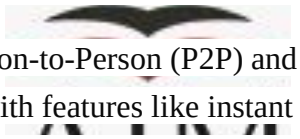
Digital currency in banking refers to Central Bank Digital Currencies (CBDCs) like India's Digital Rupee (e₹), a government-backed digital form of physical cash offering secure, instant transactions via digital wallets for everyday use, aiming for efficiency and financial inclusion, and distinct from decentralized cryptocurrencies, with banks acting as intermediaries distributing and managing them. It integrates digital money into the existing financial system, enabling features like 24/7 payments and potentially reducing costs, though research explores impacts on banking stability, notes Science Direct.

Key Aspects in Banking:

- **Central Bank Digital Currency (CBDC):** The primary form, like the RBI's e₹, directly issued by the central bank, making it legal tender and equivalent to physical notes.
- **Digital Wallets:**

  Users store and transact CBDCs using digital wallets provided by participating commercial banks (e.g., SBI, HDFC, Yes Bank) on their mobile devices

  .



- **Transaction Types:** Supports Person-to-Person (P2P) and Person-to-Merchant (P2M) payments, often using QR codes, with features like instant settlement and offline functionality.
- **Role of Banks:** Banks act as intermediaries, distributing the digital currency, managing customer wallets, and facilitating transactions, similar to handling physical cash.
- **Efficiency & Security:** Offers real-time, final settlement, potentially cutting costs and risks associated with traditional payment systems, notes ScienceDirect.
- **Distinction from Crypto:** Unlike decentralized cryptocurrencies (like Bitcoin), CBDCs are centralized, backed by the central bank, and retain the intrinsic value and trust of sovereign currency, notes RBI.
- **Interoperability:** CBDCs are increasingly designed to work with existing payment systems, such as UPI in India, allowing users to scan both UPI and CBDC QR codes.

Examples & Future:

- **India's Digital Rupee (e₹):** Currently in pilot phases, testing retail (CBDC-R) for public use and wholesale (CBDC-W) for interbank transfers, notes Federal Bank.
- **Potential Impacts:** Explored for improving financial inclusion, increasing payment system efficiency, and modernizing monetary systems

Digital Rupee is the electronic version of our currency which can be used to carry out transactions or store value digitally, similar to the manner in which currency notes can be used in physical form.

The most well-known cryptocurrency is Bitcoin. Bitcoin was launched in 2009, a year after a report that described the Bitcoin system was released under the name Satoshi Nakamoto. The system was designed to electronically mimic features of a cash transaction.

10 Largest Cryptocurrencies by Market Capitalization

- Bitcoin (BTC) Market Cap: $458 billion. ...
- Ethereum (ETH) Market Cap: $216 billion. ...
- Tether (USDT) Market Cap: $66 billion. ...
- USD Coin (USDC) Market Cap: $54 billion. ...
- Binance Coin (BNB) Market Cap: $52 billion. ...
- Ripple (XRP) ...
- Cardano (ADA) ...
- Binance USD (BUSD)

CRYPTOCURRENCY

Cryptocurrency in India is legal to trade and invest in as a digital asset, but it is not considered legal tender and is not regulated by the RBI. Income from crypto is taxed at a flat 30%, with a 1% TDS on transactions. The sector is regulated under anti-money laundering laws, with FIU-IND overseeing exchanges.

Key Aspects of Crypto in India (2025-2026):

- **Legal Status:** While not banned, the government does not recognize crypto as currency. The Supreme Court overturned a previous ban in 2020.
- **Taxation:** A 30% tax applies to all income from digital assets, and losses cannot be offset against other income. A 1% TDS is applicable on all transfers.
- **Regulation:** The Financial Intelligence Unit (FIU-IND) monitors exchanges to prevent money laundering and terrorism financing.
- **Market Growth:** Despite regulatory uncertainty, India has one of the fastest-growing crypto markets globally, with high interest in tokens like Bitcoin and Ethereum.
- **Risks:** Investors face high volatility, potential scams, and strict tax compliance, with little to no legal recourse in case of exchange hacks or fraudulent activities.
- **Banking:** While not explicitly forbidden, banks often impose restrictions on transactions related to crypto exchanges.

Popular Indian exchanges include CoinDCX and others, which comply with local regulations.

Financial modeling is creating a mathematical representation (usually in Excel) of a company's historical and projected financial performance to aid in forecasting, valuation, budgeting, and investment decisions, using core financial statements and assumptions to predict future outcomes like revenue, expenses, and cash flows. It's a crucial tool for assessing business viability, making data-driven choices, and understanding financial health for both internal management and external investors.

Key Components & Process

- **Data & Inputs**:

  Uses historical financial statements (Income Statement, Balance Sheet, Cash Flow) and key assumptions (growth rates, costs).

- **Model Building**:

  Involves structuring the spreadsheet, often starting with inputs and working backward to a dashboard of outputs.

- **Outputs**:

  Forecasts future financial health, profitability, and key performance indicators (KPIs).

- **Types**:
  Common models include Three-Statement Models, Discounted Cash Flow (DCF), Leveraged Buyout (LBO), and Merger (M&A) models.

Common Uses

- **Valuation**: Estimating a company's intrinsic worth or investment value.
- **Forecasting**: Predicting future revenue, expenses, and cash flow.
- **Budgeting & Planning**: Allocating resources and setting financial targets.
- **Decision Making**: Assessing the financial impact of new projects, investments, or strategic changes.
- **Risk Management**: Analyzing potential market, credit, or operational risks.

Financial modelling is the process of creating a mathematical representation, typically in a spreadsheet like Microsoft Excel, of a company's historical financial performance to **forecast its future performance**. This data-driven approach is crucial for making informed business and investment decisions, as well as for strategic planning and risk management.

- **Decision-Making:** Financial models help company leaders make data-driven decisions about investments, budgets, and projects by forecasting potential outcomes and identifying risks.
- **Valuation:** A primary use is determining the value of a business or asset for potential sale, acquisition, or investment purposes.
- **Core Components:** Models integrate key financial statements: the **income statement**, **balance sheet**, and **cash flow statement**, along with supporting schedules and assumptions about future prospects.
- **Risk Management:** By running different scenarios (e.g., best case, worst case, base case), businesses can assess the impact of various economic or operational changes on their finances and plan for uncertainties.

Types of Financial Models

Different models serve specific purposes in various industries.

- **Three-Statement Model:** The foundational model that links the income statement, balance sheet, and cash flow statement. It is the basis for most other models.
- **Discounted Cash Flow (DCF) Model:** Used to estimate a company's intrinsic value by projecting future cash flows and discounting them to their present value.
- **Comparable Company Analysis (CCA):** Values a company by comparing its financial ratios and metrics (like P/E ratios) to those of similar publicly traded companies.
- **Leveraged Buyout (LBO) Model:** A complex model used to assess the feasibility and potential returns of acquiring a company using a significant amount of borrowed money.
- **Merger & Acquisition (M&A) Model:** Analyzes the financial impact of a merger or acquisition on the combined entity, often focusing on the effect on earnings per share (EPS).
- **Budget & Forecasting Models:** Used for internal planning, helping to estimate future revenues and expenses and track performance against goals.

Best Practices

Effective financial modelling involves a disciplined and methodical approach to ensure accuracy and clarity.

- **Plan and Outline:** Define the purpose and scope of the model before building to ensure the appropriate level of detail.
- **Use Accurate Data & Reasonable Assumptions:** Start with reliable historical data and make realistic, well-documented assumptions about future trends.

- **Keep it Simple and Transparent:** Avoid overly complex formulas. Use clear labeling, consistent formatting, and supporting schedules to make the model easy to audit and understand.
- **Incorporate Scenario and Sensitivity Analysis:** Build in flexibility to test how changes in key variables affect outcomes, helping manage uncertainty.
- **Validate and Review:** Regularly test the model's accuracy by comparing its outputs with actual results and seek peer review to minimize errors.

HURDLE RATE:

A hurdle rate, which is also known as the minimum acceptable rate of return (MARR), is the minimum required rate of return or target rate that investors are expecting to receive on an investment.

The hurdle rate is determined by assessing the cost of capital, risks involved, current opportunities in business expansion, rates of return for similar investments, and other factors that could directly affect an investment.

Most companies use their weighted average cost of capital (WACC) as a hurdle rate for investments. This stems from the fact that companies can buy back their own shares as an alternative to making a new investment, and would presumably earn their WACC as the rate of return. In this way, investing in their own shares (earning their WACC) represents the opportunity cost of any alternative investment.

Another way of looking at the hurdle rate is that it's the required rate of return investors demand from a company. Therefore, any project the company invests in must be equal to or ideally greater than its cost of capital.

A more refined approach is to look at the risk of individual investments and add or deduct a risk premium based on that. For example, a company has a WACC of 12% and half its assets are in Argentina (high risk), and half its assets are in the United States (low risk).

If the company is looking at one new investment in Argentina and one new investment in the United States, it should not use the same hurdle rate to compare them. Instead, it should use a higher rate for the investment in Argentina and a lower one for the investment in the U.S.

COMMITTEE REPORTS

1. Dehejia Committee 1969
2. Tandon Committee Reports 1974 Lending Practices

a. Inventory and receivable norms

b. Maximum permissible bank finance

i. First Method of Lending i

i. Second Method of Lending

iii.Third Method of Lending

c. Style of Credit

d. Information and Reporting System

3. Chore Committee Reports 1980

4. Marathe Committee reports 1982

5. Chakravarthy committee Reports 1985

6. Kannan Committee Reports 1997

7. Recent RBI Guidelines Learning

Objectives After reading this lesson you should be able to ы Understand why banks are charging different interest rates for long-term and short-term loans. ы Understand the recommendations of different committees for working capital. ы Identify the Maximum Permissible Bank Finance (MPBF) for working capital requirements.

Estimate maximum permissible bank finance available under different methods of lending. ы Know recent trends adopted by RBI with regards to working capital. ы How to regulate working capital finance under the FAST TRACK SYSTEM? ы What is the working capital policy in liberalized scenario? Need for working capital banking policy? Banks provide finance to industrial entrepreneurs in India, in addition to financial institutions. They provide finance in two ways – long-term loans to invest in the permanent assets and short-term loans for working capital finance.

However the interest rates are different for the two different loans – a higher interest rate for long-term loans and a lower interest rate for working capital loans. This is because of two reasons. One, the long-term loans carry high risk and more administrative cost; second, when banks accept deposits from the public they pay higher interest for long-term deposits than for short-term deposits. By taking the advantage of the low interest rates for working capital loans, invariably most of the industrial entrepreneurs entered different banks.

After using the short-term loans for working capital, they diverted to fixed assets also since it carries low interest rate than long-term loans. This results in low economic growth, loss for the banks and also failure of the individual entrepreneurs to grow. Hence the bank credit working capital has been subjected to various rules, regulations and controls.

The RBI has appointed different study groups from time to time to suggest ways and means of making the bank credit an effective instrument for economic growth, industrialization as well as to improve the profit of the banking sectors.

The current chapter discusses the various committees constituted by the RBI for the purpose of providing working capital finance. Reports submitted by the following committees are

significant in this respect: 1. Dehejia Committee Report 1969. 2. Tandon Committee Report 1974. 3. Chore Committee Report 1980.

. Marathe Committee Report 1982. 5. Chakravarthy Committee Report 1985. 6. Kannan Committee Report 1997.

1. Dehejia Committee A study group under the chairmanship of V.T. Dehejia was constituted in 1968 in order to determine "the extent to which credit needs of industry and trade were inflated and to suggest ways and means of curbing this phenomenon". The committee submitted its reports in September 1969.
   Findings The important findings of the committee are given below.
   1. Higher growth rate of bank credit to industry than the rise in industrial output.
   2. Banks in general sanctioned working capital loans to the industry without properly assessing their needs based on projected financial statements. 3. There was also a tendency on the part of industry to divert shortterm bank credit to some extent for acquiring fixed assets and for other purposes. 4. The present lending system facilitated industrial units to rely on short-term bank credit to finance for fixed assets. Recommendations On the basis of the above findings the following recommendations were made by Dehejia Committee to bring about improvements in the lending system: 1. Credit application should be appraised by the bankers with reference to present and projected total financial position as shown by cash flow analysis and forecast submitted by borrowers. 2. The total cash credit requirement is divided into two parts namely (i) Hard core components representing the minimum level of raw materials, finished goods and stores which the industry requires for maintaining a given level of production and which is made on a formal term loan basis. (ii) Short-term components representing the fluctuating part of current assets.
2. In order to avoid the possibility of multiple financing, a customer should deal with only one bank. However if the credit requirement is more the committee recommended the adoption of "Consortium arrangement". The recommendations given by Dehejia Committee could not be implemented, further in view of unprecedented inflation during 1974 the demand for bank credit rose sharply. Most of the banks had to freeze the credit limit and therefore a need was felt to have a close look at the entire bank credit system. A Committee was, therefore appointed by RBI in July 1974, under the chairmanship of Shri P.L.Tandon. 2. Tandon Committee A study group under the chairmanship of Shri P.L. Tandon was constituted in 1974 by the RBI in order to frame guidelines for bank credit. The terms of reference of the committee were as follows. Terms of reference 1. To suggest guidelines for commercial banks to follow up and supervise credit from the point of view of ensuring proper end-use of funds and keeping a watch on the safety of advances. 2. To make recommendations for obtaining periodical information that may be obtained by banks from the borrower. 3. To make suggestions for prescribing inventory norms for different industries. 4. To suggest criteria regarding satisfactory capital structure and sound financial basis in relation to borrowings. 5. To suggest whether the existing patterns of financing working capital requirements by cash credit / overdraft system, etc. are required to be modified, if so, to suggest modifications. Findings On the basis of the reference given above, the committee studied the existing system of working capital finance provided to industry and identified the following as its major weaknesses. 1. The banks do not have any credit appraisal or planning. It is the borrower who decides how much he would borrow.

3. . The security-based approach to lending has led to division of funds to purchase of fixed assets. 3. Bank credit is treated as the first source of finance rather than being taken as a supplementary to other sources of finance. 4. The working capital finance should be made available only for a short period, as it has otherwise, led to accumulation of inventories with the industry. Recommendations The report was submitted on 9th August 1975 and it is a landmark in the history of financing working capital by commercial banks in India. The Tandon Committee made comprehensive recommendation regarding the bank lending practices, which can be broadly classified into four groups'. Important features of the Tandon Committee recommendations based on the fixation of norms for bank lending to industry are as follows. Norms for Bank Lending 1. Inventory and receivable norms The borrowers are allowed to keep reasonable current assets particularly inventory and debtors. The normal current assets based on economic ordering levels and certain level of safety should be financed by banker. Finance to borrower in the form of working capital should not be made available for profit making or to keep excess inventory. Similarly the bank should finance the bills receivable, which are in line with the practices of the borrower's industry. The norms have been worked out according to the time element. The limit of the raw materials is expressed as so many months of total consumption in the year. The work-inprogress limit determined as so many months of cost of production, the finished goods and bills receivable limits are determined by cost of sales and credit sales respectively. The Tandon Committee has suggested norms for fifteen industries. 2. Lending norms or Maximum Permissible Bank Finance (MPBF) Tandon Committee introduced the concept of MPBF in the working capital finance by banker. The Committee suggested that bank should attempt to supplement the borrowers' resources in financing the current assets. It has recommended that the current assets first should be

financed by trade creditors and other current liabilities. The remaining current assets, which is called working capital gap, should be financed particularly by bankers in the form of bank credit and through longterm borrowings or owner's funds. In the context of this approach, the committee has suggested three alternative methods for working out the MPBF. Each successive method reduces the involvement of short-term bank credit to finance the current assets

4. Chore Committee Having implemented the recommendations of the Tandon committee, the RBI constituted another working group under the chairmanship of Shri K.B. Chore, Chief Officer, Department of Banking operation and development, RBI. Terms of reference 1. The committee was asked to review the cash credit system in recent years with particular reference to the gap between sanctioned limit and the extent of their utilisation. 2. To suggest alternative types of credit facilities, which should ensure greater credit discipline and enable the banks to relate credit limits to increase in output or other production activities. Recommendations Continuation of existing credit The existing system of three types of lending namely, cash credits, loans and bills should be retained. No bifurcation of credit limit Bifurcation of cash credit limit into a loan component and a fluctuating cash credit component has not found acceptance either on the part of the banks or the borrowers. Therefore the committee recommends withdrawing bifurcation of accounts. Separate limit for peak and non-peak level

requirements The banks have been asked to fix separate credit limits wherever feasible for the normal non-peak level and peak level credit requirements and indicate the periods during which the separate limits would be utilised by the borrowers. If, however, there is no pronounced seasonal trend, peak-level and normal requirements should be treated as identical and limits should be fixed on that basis. It should be noted that peaklevel and non-peak level concepts apply not only to agriculture-based industry but also to certain other consumer industries where the demand may have pronounced seasonal tendencies. Within the limits sanctioned for the peak-level and non-peak level periods the borrowers should
indicate before the commencement of each quarter the requirements of funds during that quarters. The statement so submitted by the borrowers should form the basis for quarterly review of the accounts. Submission of Quarterly Statements The quarterly statements should be submitted by all the borrowers enjoying working capital limit of Rs.50 lakhs and above and they will have to bring gradual additional contribution based on second method of lending as prescribed by the Tandon Committee. Marathe committee The RBI, in 1982, appointed a committee under the chairmanship of Marathe to review the working of credit authorization scheme (CAS) and suggest measure for giving meaningful direction to the credit management function of the RBI. The RBI with some modifications has accepted the recommendations of the committee. Recommendations The principal recommendations of the Marathe committee include: 1. The committee has declared the third method of lending as suggested by the Tandon committee to be dropped, hence, in future, the banks would provide credit for working capital according to the second method of lending. 2. The committee has suggested the introduction of the 'Fast-Track Scheme' to improve the quality of credit appraisal in banks. It recommended that commercial banks can release without prior approval of the reserve bank 50% of the additional credit required by the borrowers (75% in case of export oriented manufacturing units) where the following requirements are fulfilled: (a) The estimate/projections in regard to production, sales, chargeable current asset, current liabilities other than bank borrowings, and net working capital are reasonable in terms of the past trends and assumptions regarding most likely trends during the future projected period. (b) The classification of assets and liabilities as 'current' and 'noncurrent' is in conformity with the guidelines issued by the Reserve Bank of India. (c) The projected current ratio is not below 1.33:1. (d) The borrower has been submitting quarterly information and operating statement (form 1, form 2, and 3) for the past six months within the prescribed time and undertakes to do the same in future also. (e) The borrower undertakes to submit to the banks his annual account regularly and promptly. Further, the bank is required to review the borrower's facilities at least once in a year even if the borrower does not need enhancement in credit facilities. 5. Chakravarthy Committee The Reserve Bank of India appointed another committee under the chairmanship of Mr. Chakravarthy to review the working capital of the monetary system of India. The committee submitted its report in April 1985. The committee made two major recommendations in regard to the working capital finance 1. Penal Interest for Delayed Payment The committee has suggested that the government must insist all public sectors units, large private sector units and government departments must include penal interest payment clause in their contracts for payment delayed beyond a specified period. The penal interest may be fixed at 2

percent higher than the minimum lending rate of the supplier's bank. 2. Classification of credit limit under three different heads The committee further suggested that the total credit limit to be sanctioned to a borrower should be considered under the three different heads: (1) Cash credit I to include supplies to government, (2) Cash credit II to cover special circumstances and (3) Normal working capital limit to cover the balance credit facilities. The interest rates proposed for the three heads are also different. Basic lending rate of the bank should be charged to cash credit II, and the normal working capital limit be charged as below: (a) For cash credit portion: Maximum prevailing lending rate of the bank. (b) For bill finance portion: 2% below the basic lending rate of bank.
(c) For loan portion: The rate may vary between the minimum and maximum lending rate of the bank. 6. Kannan committee In view of the ongoing liberalisation in the financial sector, the Indian Banks Association (IBA) constituted a committee headed by shri. K.Kannan, chairmanship and managing director of bank of Baroda to examine all the aspects of working capital finance including assessment of maximum permissible bank finance (MPBF). The committee submitted its report on 25th February 1997. It recommended that the arithmetical rigidities imposed by Tandon committee (and reinforced by chore committee) in the form of MPBF computation so far in practice, should be scrapped. The committee further recommended that freedom to each bank should be given in regard to evolving its own system of working capital finance for a faster credit delivery so as to serve various borrowers more effectively. It also suggested that line of credit system (LCS), as prevalent in many advanced countries, should replace the existing system of assessment/fixation of sub-limits within total working capital requirements. The committee proposed to shift emphasis from the liquidity level lending (security based lending) to the cash deficit lending called desirable bank finance (DBF). Some of the recommendations of the committee have been already been accepted by the Reserve Bank of India with suitable modifications. Recommendations The important measures adopted by RBI in this respect are given below: ьі Assessment of working capital finance based on the concept of MPBF, as recommended by Tandon committee, has been withdrawn. The bank have been given full freedom to evolve an appropriate system for assessing working capital needs of the borrowers within the guidelines and norms already prescribed by reserve bank of India. ьі The turnover method may continue to be used as a tool to assess the requirement of small borrowers. For small scale and tiny industries, this method of assessment has been extended upto total credit limits of Rs 2 crore as against existing limit of 1 crore.
Banks may now adopt cash budgeting system for assessing the working capital finance in respect of large borrowers. ьі The banks have also been allowed to retain the present method of MPBF with necessary modification or any other system as they deem fit. ьі Banks should lay down transparent policy and guidelines for credit dispensation in respect of each broad category of economic activity. ьі The RBI's instrument relating to directed credit, quantitative limits on lending and prohibitions of credit shall continue to be in force. The present reporting system to RBI under the Credit Monitoring Arrangement (CMA) shall also continue in force.