

CHAPTER - 9

BUSINESS FINANCE

Finance is the life blood and nerve Centre of a business. Business needs money to make money. It is necessary to start, run, expand and modernize any organization. The success of every business depends on how funds are raised in right time, in right quantity, at the least cost and from right sources.

Business Finance

Money required for carrying out business activities is called business finance. Finance is essential for the commencement, existence and growth of the business. 'Business Finance' as an activity or a process which is concerned with acquisition of funds, use of funds and distribution of profits by a business firm. Thus business finance usually deals with financial planning, acquisition of funds, use and allocation of funds and financial controls.

FINANCIAL MANAGEMENT

Financial management is the management of finance in the organization. It means planning and controlling of financial activities in an organization. It involves all managerial activities concerned with acquisition and utilization of funds. It includes each and every aspect of financial activity in the business.

Definitions

"Financial management is the application of the planning and control functions to the finance function" - Howard and Upton

"Financial Management is an area of financial decision making, harmonizing individual motives and enterprise goals" - Westing and Brongham

Financial management involves the application of general management principles to financial operations. It deals with planning, organizing, directing and controlling financial activities.

"The activity concerned with planning, raising, controlling and administering of funds used in the business."

FEATURES OF FINANCIAL MANGEMENT

- Financial management is concerned with procurement, allocation and utilization of funds in proper manner.
- It aims at maximizing profit and wealth of an organization
- Financial management is considered part of general management. In large organisations, its function is performed by a special department called finance department. The chief of this department is known as Finance Manager.

IMPORTANCE OF FINANCE MANAGEMENT(ROLE)

The importance of Financial Management is increasing day by day in all business enterprises irrespective of their size and nature. The future of a business depends on the quality of its Financial Management.

The financial statements like balance sheet and profit and loss account truly depict a firm's financial position and operations result. All most all items in the financial statements are affected directly or indirectly through financial management decisions. Some of the examples are listed below:

1. The size and composition of fixed assets

Excessive investment in fixed assets would result in increase in the size of fixed capital block.

2. The quantum of current assets as well as its break up into cash, inventories and receivables:

An increase in the investment in fixed assets, the working capital requirement also increases. The quantum of current assets and its compositions are also influenced by the decisions taken by the financial management.

3. The proportion between long term and short term funds

Finance management includes the decision about the proportion of long term and short term finance. There is a choice between liquidity and profitability. More profitability means less liquidity. Financial managers consider the choice between liquidity and profitability.

4. Break up of long term financing into debt, equity etc.

Of the total long term finance, the proportions to be raised by way of debt and/or equity are also a financial management decision. The amount of debt, equity share capital, preference share capital is affected by the financing decision which is a part of financing management.

5. All items in profit and loss account; interest, expense, depreciation etc. of the company is using more debt; it has to pay more interest in future. Similarly higher use of equity capital may lead higher payment of dividend.

Thus **financial management is indispensable** due to the following reasons.

1. It helps in acquiring fund and when required at the minimum possible costs.
2. It helps in financial planning(3.) It ensures proper use and allocation of funds
4. It enables to improve profitability through financial control
5. It helps to take effective financial decisions

OBJECTIVES OF FINANCIAL MANAGEMENT

Financial management involves the procurement and use of funds. The overall objectives of financial management are to provide maximum returns to the owners on their investments. This is called maximizing the wealth of owners. Wealth maximization means maximizing the **market value** of equity shares of the company.

Wealth of equity Shareholders = Number of shares held X market price per share

In order to maximize wealth, financial management must achieve the following specific objectives

1. To ensure availability of sufficient funds at a reasonable cost (Liquidity)
2. To ensure effective utilization of funds (Financial control)
3. To ensure safety of funds by creating reserves, reinvesting profits etc. (minimization of risk)

SCOPE OF FINANCIAL MANGEMENT

There are two broad approaches to business finance that determines its scope

1.Traditional approach:- Under this approach the scope of financial management was confined to only procurement of funds . Thus it ignored the important issue of working capital finance and management. This approach did not discuss utilization of funds.It stress on long term capital financing.

2.Modern approach : This approach views finance function in broader sense. It includes both raising of funds as well as their utilization under the purview of finance. According to this approach finance function covers financial planning, raising of funds, allocation of funds, financial control etc. This approach divides financial management into three major decision areas.

1. Investment decisions (Decision pertaining to utilization of funds)
2. Finance Decision (decision pertaining to raising funds)
3. Dividend Function (decision pertaining to distribution of funds)

Financial decision

Financial decision refers to decision concerning financial matters of a business firm. There are many kinds of financial management decision that the firm makes in pursuit of maximizing shareholders' wealth. Viz, kind of assets to be acquired, pattern of capitalization, distribution of firms' income etc. we can classify these decisions into three major groups

1. Investment decisions 2. Financing decisions 3. Dividend decisions

1. Investment decisions: Investment decisions are decision related to the selection of assets in which funds will be invested by a firm. The investment decision relates to how the firm's funds are invested in different assets. Investment decision should be taken only after considering volume of requirements. Returns and risks involved with all these. For this purpose Finance manager analyses various alternatives available for investment and evaluate profitability and risks involved with each of it. Thus investment decisions are based on risk –return analyses

Generally two types of investment decisions are to be taken by Finance Manager. They are decision relating to long term investment and short term investment.

- a. **Long Term Investment decisions** involve decisions to invest money on fixed assets to acquire them. Such decision is known as **management of fixed assets or Capalexpenditure decision or capital budgeting.**
- b. **Short Term Investment Decisions** involve decision to invest money on current assets. (cash, inventory, account receivables etc.) .Such decision is known as **management of current assets or working capital management or liquidity decision.** This decision affect day to day working of business.

CAPITAL BUDGETING

“ Capital budgeting is long term planning for making and financing proposed capital outlays”

-Charles . T. Horngren

The process of making capital budget is known is **capital budgeting.** Capital budget gives an estimate of the amount of capital required for acquiring fixed assets. Capital budget is the statement of expenditure on fixed assets or long term projects and the benefits of which are likely to acquire in future. Capital budgeting decisions are long term investment decisions.

It is highly important in times of

- Replacement of existing assets
- * Purchase of additional assets

Steps in capital budgeting

1. Develop alternative projects for long term investment
2. Evaluate suitability and profitability of these investment projects
3. Selecting the best project for implementation
4. Allocating funds for such selected projects (5) .Evaluation of the projects.

IMPORTANCE OF CAPITAL BUDGETING DECISIONS

Capital budgeting decisions are important due to the following reasons

1. Capital budgeting decisions have long term implications for the firm because they affect the future profitability and growth of the firm.
2. Capital investment decision involves a heavy amount of funds. In most cases the decisions are irreversible and amount invested cannot be taken back without causing substantial loss.
3. Capital budgeting decisions are always intended to make future earnings. Such future earnings are the basis of future competitive strength of a firm

FACTORS AFFECTING CAPITAL BUDGETING DECISIONS

Every decision on capital budgeting has a long term impact on the business. Capital Budgeting involves investment of large amount of money. So capital budgeting requires careful evaluation on the viability of projects. Following factors need to be considered while taking a decision on capital budgeting.

1. **Cash flow of the project:** Investment in long term assets generates cash flows over a period. Cash flows can be cash inflows (receipts) or cash outflows (Cash payments). These cash flows should be carefully analyzed and evaluated before making a capital budgeting decision.
2. **The rate of return:** Rate of return is the criteria for selecting a project. The company compares the return from different investment proposals. Suppose there are two alternative proposals –one with 10% return and the other with 12% return. Under normal circumstances the higher rate of return should be selected.
3. **The investment CriteriaInvolved:** A number of calculations are to be made with respect to amount of investment, interest rate, cash flows, rate of return etc. While making

investment decision. Again different capital budgeting techniques used to evaluate investment proposals(eg: NPV, IRR, payback period).

II. FINANCING DECISIONS: Financial decision is concerned with the functioning of business activities. There are a number of sources from which funds can be raised. Broadly there are two sources shareholders fund (owned fund) and borrowed funds. Owned funds consist of equity share capital, preference share capital and retained earnings. Borrowed funds include debentures, loans and public deposits.

The cost of each type of finance has to be estimated (Flotation cost). Some sources may be cheaper than others. Eg: Debt is considered to be the cheapest of all other sources. Tax deductibility of interest makes it still cheaper. But the debt has to be repaid after a fixed period of time. Interest on debt has to be paid irrespective of profit or loss. The risk of default of payment (Financial risk) is there. There is no such compulsion to pay any dividend on equity shares.

A Finance Manager has to select such sources of funds which will make optimum capital structure. A debt equity ratio should be fixed in such a way that it helps in maximizing the profitability of the concern. A judicious mix of both owned funds and borrowed funds has to be decided.

Generally there are two kinds of financing decisions

- (a) Total amount of capital to be collected through various sources (capitalization)
- (b) The proportion of each source in the capitalization (capital structure)

Factors affecting Financing Decisions

Important factors affecting financing decisions are as follows

1. **Cost**: Obtain the finance from cheaper sources.
2. **Risk**: Risk involved in each source should be evaluated.
3. **Flotation Cost**: Cost of raising finance (Flotation cost) should be lower.
4. **Cash flow position**: A stronger cash flow position normally recommended more of debt financing.
5. **Fixed operating Costs**: If a business has high level of fixed operating cost (eg: rent, insurance, salary), lower debt financing is better. Similarly if fixed operating cost is less, more of debt financing may be preferred.
6. **Control considerations**: More of owned funds dilute the management control over business . Debt financing has no such danger.

7. **State of Capital market:** Health of capital market may also affect the choice of source of fund. During boom period , more people invest in equity. During depression , people does not like to take risk and are not interested in buying equity shares.

III. **DIVIDEND DECISION:** Dividend is that portion of profit which is distributed to shareholders. Dividend decision relates to the appropriation of earned profits. The two major alternatives are to retain the profits or to distribute them to shareholders. A company has to decide how much profit to distribute as dividend and how much to retain for investment in the business. The dividend policy of the company should be to maximize market value per share. Thus the financial manager should determine the optimum dividend payout ratio.

FACTORS AFFECTING DIVIDEND DECISION

1. **Amount of earnings:** It is the main determining factor of dividend policy, because dividend can be paid out of current and past earnings.
2. **Stability earnings:-** A company having stable earnings is in a position to declare higher dividend, otherwise strict dividend policy followed.
3. **Stability of dividend:-** Companies generally follow a stable dividend policy. They follow increasing dividend policy when there is confidence that their earning capacity has gone up.
4. **Growth opportunities:-** Companies having good growth opportunities retain more money. Out of their earnings so as to finance the required investment
5. **Cash flow position:** Dividend involves an outflow of cash. A company may be profitable but short in cash. Availability of enough liquid cash in the company is necessary for declaration of dividend.
6. **Shareholder's preference:** Desire of shareholders for dividends depends upon their economic status. Small shareholders and retired people prefer regular income wealthy investors are interested in capital gain
7. **Taxation policy:**The taxation rate affects the net earnings of a company and thereby its dividend policy also. If tax on dividend is higher, it is better to pay less by way of dividends.
8. **Stock market reactions:**An increase in dividend policy has a positive impact on the share price. It is good news for the investors and hence stock price increase..Decrease in dividend has a negative impact on the share price.
9. **Access to capital market:**-large and deputed companies tend to pay higher dividends than the smaller companies which have relatively low access to the market

10. **Legal constraints:-** As per the provisions of companies Act dividend can be paid only out of current or past profit after providing for depreciation. No dividend can be paid out of capital. Such provisions must be adhered to while declaring the dividend.
11. **Contractual constraints:** Sometimes the creditors may impose certain restrictions on the payment of dividends in future. The company doesn't violate the terms of the loan agreement at the time payment of dividend.

FINANCIAL PLANNING

Financial planning is essentially the preparation of a financial blueprint of firm's future operations. The objectives of financial planning are to ensure that enough funds are available at right time. Financial planning means deciding in advance, the financial activities to be carried on to achieve the basic objectives of the firm. The basic objective of the firm is to get maximum profit out of minimum efforts or maximization of wealth. It is a process which decides in advance the capital requirements and the capital structure. Financial planning usually begins with the preparation of the sales forecast. Financial planning includes short term planning (budget) as well as long term planning (capital expenditure programme).

STEPS IN FINANCIAL PLANNING

1. Determine of long term and short term financial objectives
2. Forecasting the organization's revenues and expenses on long term basis.
3. Formulation of financial policies to quantum of funds, pattern of capitalization, choice of sources etc.
4. Developing financial procedures and programmes
5. Reviewing the financial plan from time to time according to the changed conditions.

OBJECTIVES OF FINANCIAL PLANNING

The objectives of financial planning are

1. To make sure that adequate funds are available at the right time.
2. To ensure that the firm does not raise resources unnecessarily
3. To ensure effective and most profitable use of available fund.
4. To ensure that the cost of funds are minimized through proper mix of different sources of finance.

5. To ensure proper control financial activities through effective policies, programmes and procedures.

IMPORTANCE OF FINANCIAL PLANNING

Financial planning is an important part of overall planning of any business enterprise. A well prepared financial plan is necessary for the success of any business enterprises. The role of financial planning is

1. A sound financial plan helps a business enterprise to avoid the problems of shortage and surplus of funds.
2. It helps in coordinating various business function. All activities of the business ie. Production, sales, distribution etc. depend on the financial plan.
3. It tries to link the present with the future.
4. It provides a link between investment and financing decisions on a continuous basis.
5. It serves as a basis of financial control.
6. It balances the cash flow and out flow of funds thus ensures liquidity of business.
7. It helps to reduce the cost of financing to the minimum.

FUNCTIONS OF FINANCIAL MANGER

1. Estimating Financial requirements
- (2) Determining sources of finance
- (3) Raising required funds
- (4) Utilizing available funds
- (5) Disposal of surplus
- (6) Managing cash
- (7) Controlling funds.

CAPITAL STRUCTURE

Capital structure refers to the mix between owner's funds and borrowed funds. Capital structure refers to the mix or composition of long term sources of funds. Such as equity share, preference shares, debentures etc.

“ **Capital structure or financial structure** of a company refers to the type of securities to be issued and proportionate amount that make up the capitalization” -Gerstenberg

The capital structure of an enterprise may consists of any one of the following

1. Equity only
2. Equity shares and preference shares
3. Equity shares and debentures
4. Equity shares, preference shares and debentures
5. Equity shares, preference shares, debentures and long term loans

It is the duty of the finance manager to see that there is optimum capital structure. A capital structure is said to be optimum when the proportion of debt and equity is such that it results in minimizing overall cost of capital and maximizing the value of the firm.

The proportion of debt in the overall capital is also called **financial leverage**.

$$\text{Financial leverage} = \frac{\text{Debt}}{\text{Equity}} \text{ or } \frac{\text{Debt}}{\text{Debt} + \text{Equity}}$$

Owned capital includes equity shares and preference shares and Borrowed (Debt) capital include loans, debentures, bonds etc.

Essential Features of Appropriate Capital structure

An appropriate capital structure should have the following essential features

1. Maximize shareholder's return. 2. Reduce risk to the minimum
- (3) Flexibility in the structure of capital (4) .Ensure effective control on the organization
- (5) Maintain solvency and efficiency (6) Effective utilization of resources
- (6) Proper debt -equity finance

Factors affecting the choice of capital structure

1. Trading on equity or Financial leverage

Trading on equity refers to the use of the fixed cost sources of funds (debentures, preference shares etc.) in the capital structure of a company, with a view to increase return on equity shares. Hence existing shareholders wisely make use of creditor ship securities to increase their own income. This technique is generally called financial leverage. The EPS (earnings per share) is more when debt is used in capital employed.

2. **Cash Inflow of the business** :- Companies which have regular cash inflow can issue more debt capital as they are in a position to repay the debt regularly.

3. **Interest coverage Ratio (ICR)** :- The interest coverage ratio refers to the number of times Earnings before interest and taxes (EBIT) of a company covers the interest obligation

$$ICR = \frac{EBIT}{\text{Interest}}$$

The higher the ratio, the lower shall be the risk of company.

4. Debt Service Coverage Ratio (DSCR)

A debt service coverage ratio takes care of the deficiencies referred to in the ICR. It is calculated as follows

$$\frac{\text{Profit after tax} + \text{Depreciation} + \text{Interest} + \text{Non cash. exp.}}{\text{preference dividend} + \text{interest} + \text{Repayment obligation}}$$

A higher DSCR indicates better ability to meet cash commitments and that type of company can include more debt capital in its capital structure.

5. **Return on Investment (ROI) :** if the ROI of the company is higher , it can choose to use trading on equity to increase its EPS. ie. Its ability to use debt is greater.
6. **Cost of debt:-** More debt can be used if debt can be raised at a lower rate.
7. **Tax Rate:** Cost of debt is affected by the tax rate. A higher tax rate makes debt relatively cheaper and increases its attraction vis – a vis equity.
8. **Cost of capital** :- The capital structure should provide minimum cost of capital. Usually debt is a cheaper sources of finance when compares to shares. An ideal capital structure is that which has least cost.
9. **Control** :- If the existing equity shareholders does not want to lose control over the company affairs, they would prefer to issue preference shares and debentures to raise more funds. If they are not concerned about control they may issue equity shares to raise funds.
10. **Flotation cost:-** Issue expenses like brokerage, underwriting commission etc. on equity shares are high compared to creditor ship securities. These expenses are called flotation cost. If the company does not want to spend more on floatation, then they issue debenture.
11. **Stock market conditions:** In the times of depression debentures are consider good while equity shares find a better market during raising prices. (Boom period) .
12. **Flexibility:** the capital structure should be designed in such a way that the company should be able to effect changes as and when required. Debt capital is highly flexible as it can increase or reduce very easily.
13. **Risk consideration:** Use of debt increases the financial risk of the business. Financial risk refers to a position when a company unable to meet its fixed financial obligation like payment of interest, dividend on preference shares etc.
14. **Regulatory frame work:-** The structure of capital of a company is also influenced by the statutory requirement applicable to them.
15. **Capital structure of other companies:-** A useful guidelines in the capital structure planning is the debt equity ratios of other companies in the same industry.

Capitalization and capital structure

Capital structure should be differentiated from capitalization. Capitalization refers to total long term investment in the company where as capital structure means the composition of such investment. Capitalization represents the quality of funds while capital structure represents the quality of funds.

Capital Gearing

Capital gearing determines the proportion of various securities in the capitalization. A company is said to be highly geared, when the proportion of equity capital is very small. Similarly a company is low geared, when the proportion of equity capital is very high. In other words gearing is determined based on creditor ship securities in the capital structure

FIXED CAPITAL:

The amount invested in acquisition and development of fixed assets is known as **fixed capital (Blocked capital)**. The money invested in fixed capital is blocked and not available for day to day dealings. Fixed capital is represented by fixed assets like Plant and machinery, land, buildings etc.

Fixed assets are of two types 1. Tangible assets (Land, Buildings, Plant etc.) and 2. Intangible assets (Goodwill, patents, trade mark etc.)

Decision concerning fixed capital are important because

- a) These decisions have effects on long term growth of business
- b) Huge amount of funds are involved.
- c) Such decisions not reversible without incurring heavy loss.

MANAGEMENT OF FIXED CAPITAL

Fixed asset required for a long term period. Therefore it is raised from long term sources of finance. Shares, debentures, Long term loans, **ploughing back of profit** are the main sources of fixed capital. Fixed capital provides the foundation of business and acts as the cushion to absorb the shocks of business. Management of fixed capital involves allocation of firm's capital to different projects or assets with long term implications of the business. These decisions are called **investment decision or capital budgeting decision or management of fixed capital or capital expenditure decisions**.

Investment in these assets means expenditures in acquisition, expansion, modernization, replacement etc. These decisions include purchase of land, building, adoption of advanced technology, expenditure incurred for merge etc. **capital budgeting decisions are significant** because of the following reasons.

1. **Long term growth**: These decisions have long term implications. It affects future profitability and growth of the firm. A wrong decision adversely affects the growth of the business.

2. **Large amount of funds involved:-** It requires huge investment of funds. But the available funds are usually limited. Hence it is important to plan and control capital expenditure.
3. **Risk involved:-** Fixed capital involves investment of huge amounts. It affects the return of the firm as a whole for a long run. So it involves huge risk.
4. **Irreversible decision:-** Once the decision for acquiring permanent assets is taken, it becomes very difficult to reverse that decision. It is possible but with huge losses.

Factors affecting the requirement of fixed capital

The amount of fixed capital varies from business to business. This is determined by the following factors.

1. **Nature of business:-** The nature and character of business determine how much fixed capital is required. Eg: A trading concern needs lower investments in fixed assets compared with a manufacturing organization.
2. **Scale of operations/ size of business:-** A large sized business will generally require huge investment in fixed assets as compared to a small sized business.
3. **Choice of techniques:-** Some industries are capital intensive while others are labour intensive. The requirement of fixed capital would be higher in capital intensive industries.
4. **Technology up gradation:-** In certain industries assets become obsolete sooner. Consequently their replacement becomes due faster. Higher investments in fixed assets may therefore be required for such business.
5. **Growth prospects:-** Higher growth of an organization generally requires higher investments in fixed assets.
6. **Diversification:-** When a firm diversifies its activities, requirements for fixed capital will increase.
7. **Financing alternatives:-** When an asset is taken as lease, the firm pays lease rentals and uses it. By doing so it avoids huge sum required to purchase it and thereby reducing investment in fixed assets.
8. **Level of collaboration:-** At times certain business organizations share each other's facilities. Eg: ATM facility. Such collaboration reduces the investment in fixed assets for each one of the participants.

WORKING CAPITAL

Working capital is the amount of capital which is required for day to day working of a business. Working capital refers to that part of capital which is available and used for carrying out routine business operations or financing current assets such as cash , marketable securities, debtors and inventories. It is also known as **circulating capital** or **revolving capital**. There are two concepts of defining working capital

(a) **Gross working capital** and (b) **Net working capital**

(a) **Gross working Capital** : Gross working capital is the capital invested in total current assets. It is the total investment in all the current assets like cash, inventories, prepaid expenses etc.

(b) **Net working capital**: Net working capital means current assets minus current liabilities. In other words net working capital is the excess of current assets over current liabilities.

Working capital = Current assets- current liabilities (current liabilities are those which are to be paid off within a short period of time ie. One year.)

In net working capital concept, working capital may be positive or negative. When the current assets exceed current liabilities, the working capital is positive, otherwise working capital will be negative.

Factors affecting working capital requirements

1. **Nature of business :-** The amount of working capital depends upon the type or nature of business. A trading organization usually needs a smaller amount of working capital compared to manufacturing organization. This is because in trading concern sales can be effected immediately upon the receipts of goods.
2. **Scale of operation:-** high scale of organization demands high amount of inventory and debtors. Such organization therefore, requires large amount of working capital.
3. **Business Cycle:-** In boom period, when the business is prospering , large amount of working capital is required due to raise in prices, increase in sales etc.. In times of depression the sales decline and large amount of working capital may lie idle.
4. **Seasonal operations:** Industries that produce and sell seasonal goods require large amount of working capital during the peak season.
5. **Production cycle:-** Production cycle is the time span between the receipt of raw material and their conversion into finished goods. Larger the process period of manufacture, larger is the amount of working capital required.

6. **Credit Policy:-** A concern buying raw materials on credit and selling product on cash requires less amount of working capital and vice versa. A liberal credit policy required large amount of working capital.
7. **Operating efficiency:-** If cash, debtors and inventories are efficiently managed, working capital requirement can be reduced.
8. **Availability of raw materials:-** If the raw materials are available freely and continuously, lower stock of materials is required. In addition the time lag between the placement of order and the actual receipt of the material (lead time) is important. Larger the lead time, larger the quantity of material to be stored.
9. **Growth prospects:-** The working capital need of a concern depends on the expansion and growth of its business activities.
10. **Level of competition:** In case market is highly competitive, liberal credit terms may have to be granted to customers. This leads to higher investment in debtors. ie. Require more working capital.
11. **Price level changes:-** During inflation, price level increases and large amounts of working capital is necessary to maintain same quantity of current assets.
12. **Dividend Policy:-** A firm that gives a steady high rate of cash dividend needs more working capital.

Difference between Fixed capital and working capital

Fixed Capital	Working Capital
1. Fixed Capital required for longer period.	1. Working Capital required for short period.
2. It is blocked capital, not available for routine business activities	2. It is working, available for routine business activities.
3. It is required for acquiring fixed assets	3. It is required for buying current assets.
4. It raised through shares, debentures and loans	4. It raised through cash sales, collection from debtors, overdraft etc.

CHAPTER-10

FINANCIAL MARKET

Financial market is the place where financial assets are bought and sold. Financial market act as an intermediary between two group who perform savings and investment functions.

Financial market is defined as

“ an organizational frame work whitin which financial instruments can be bought and sold.”

Financial markets deal in financial assets such as deposits, shares, debentures, funds, commercial paper and so on.

FUNCTIONS OF FINANCIAL MARKET

A financial market is a market for the creation and exchange of financial assets. The important functions of financial market are

1. **Mobilise savings and channelize them into most productive purposes**

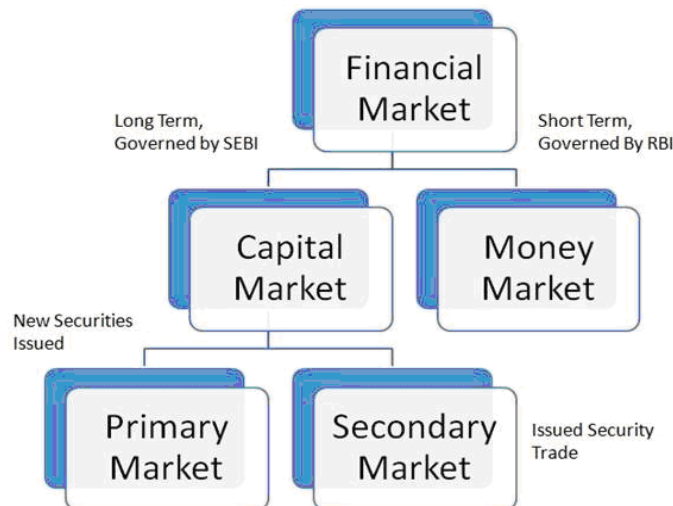
A financial market facilitates transfer of savings from people (savers) to investors. It offers the savers different investment avenues and help to channelize surplus funds into productive purpose.

2. **Facilitating Price discovery:-** The financial market helps in establishing the price of financial assets. The interaction between the suppliers of funds and business firms (investors) determine the price of financial assets.
3. **Providing liquidity to financial assets:-** Financial market provides liquidity to financial assets. It makes the financial assets liquid, so that they can easily be converted into cash whenever required.
4. **Reducing the cost of transaction:-** The valuable information about the securities is provided through financial market. It helps the buyers and sellers of financial securities in saving time, efforts and money in the dealings.

Classification of Financial market

Financial market consists of two major segments

1. **Capital market-** which is a market for medium and long term funds and
2. **Money market-** which is a market for short term funds



MONEY MARKET:

Money market is the market for short term funds. Short term funds are meant for the use for a period up to one year. It constitute major source of working capital finance. Money market securities closesubstitutes for money. It isa market where low risk, unsecured and short term debt instruments that are highly liquid are issued and traded everyday. Money market has no physical location, but its activity conducted through the telephone and internet.

The Indian money market consists of two segments:-**The organized market** and **unorganized market**. The organized market is under the control of **Reserve Bank of India**. Other important players are commercial banks, LIC, General Insurance Corporation, UTI, Public and private Companies etc. the unorganized sector consists of indigenous bankers and money lenders.

MONEY MARKET INSTRUMENTS

1. **Treasury Bills (T- Bills):-** These Bills are issued by Reserve Bank of India (RBI) on behalf of the Government of India. These are short term credit instruments for a period of less than one year. Treasury bills are negotiable instruments and freely transferable. It does not carry interest.They are issued at a price which is lower than their face value and repaid at par. Treasury bills are available for a minimum amount of Rs. 25000 and in multiple thereof.
2. **Commercial paper:-** In India Commercial paper have been introduced in 1989 on the recommendations of Vagal Committee. It an Unsecured promissory note with a fixed maturity period of 15 days to one year. It is sold at a discount and redeemed at par. The original purpose of commercial paper was to provide short term funds for seasonal and working capital funds. It is a negotiable instrument transferable by endorsement and delivery. Fund raised through commercial paper are used to meet the flotation cost. This is known as bride financing.
3. **Call money:-** Call money is a short term finance repayable on demand, with a maturity of one day to 15 days. The day to day surplus funds, mostly of banks are usually trades as call money. Banks may borrow money when they face with temporary shortage of funds. Similarly bank with surplus of funds can also lend for short time period. The interest rate paid for call money loans is known as the call rate. This market is also known as “over the telephone market”.
4. **Certificate of Deposit (CD) :**Certificate of deposit isunsecured,negotiable, short term instruments issue by commercial banks and development financial institutions. The period

of these deposits ranges between 91 days to one year. The denomination of a CD is minimum one lakhs and multiples thereof. Only banks can issue such a certificate. The major difference between CD's and Fixed deposits is that CDs are transferable and tradable and FDs are not.

5. **Commercial bill/ trade Bill/ Bill of exchange :** A commercial bill is a bill of exchange to finance the working capital requirements of business firms. The trader who has received a bill can discount it with his bankers. The bank in turn can rediscount these bills in the commercial bill markets. Rediscounting provides short term liquidity to such banks. When a trade bill is accepted by a commercial bank it is known as a commercial bill.

CAPITAL MARKET

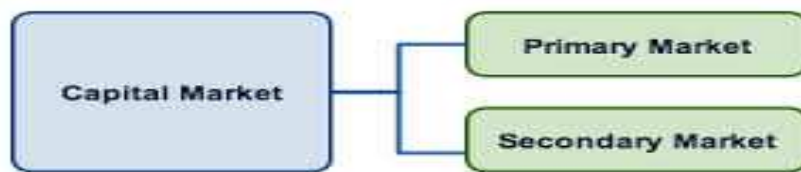
This is the market for medium and long term funds. Financial assets with a maturity of more than year is a part of capital market. It is a market for long term capital. The capital market provides long term debt and equity finance for the government and the corporate sector. A wide variety of instruments is used to raise funds in the capital market. These instruments are ownership securities (Equity shares and preference shares) and creditor ship securities (debentures and bonds). The capital market consists of development banks, commercial banks and stock exchanges.

Distinction between money market and capital market

Money Market	Capital Market
1. It is a market for short term instruments having a maturity period of less than one year.	1. It is a market for medium and long term instrument having a period of maturity more than 1 year.
2. It helps to meet working capital needs	2. It helps in meeting fixed capital needs
3. The participant of money market are RBI, Commercial banks, financial companies and financial institutions	3. The participants of capital market are private companies, foreign investors, banks, Private and public companies and financial institutions
4. The instruments deal with money market is bill of exchange, treasury bills, Certificate of deposits,	4. The instruments deal with capital market are equity shares, preference shares, debentures, bonds etc.

commercial papers.	
5. It is a whole sale market. The instruments have large face value	5. It is a retail market. The instruments have small face value
6. It is normally take place over telephone and other ways	6. Capital market transactions normally take place at stock exchange.
7. Money market instruments yield only a less return	7. Capital market instruments yield a high return.
8. The market regulator is the Central Bank of the country. RBI is the market regulator in India.	8. There is a separate regulator in the capital market. In India SEBI is the market regulator.
9. Money market instruments are much safer with minimum risk of default.	9. Capital market instruments risky both in return and principal repayment.

The Capital market can be divided into two segments (1) Primary Market (2) Secondary market.



(1) PRIMARY MARKET/ NEW ISSUE MARKET (NIM) : It deals with new securities being issued for first time. It is the market for newly issued financial assets. In primary market, if new companies are issuing securities it is known as a “**Initial Public offerings**”(IPO) and existing companies are issuing shares it is known as “**seasoned equity Offerings** (SEO)”. The investors in this market are banks, financial institutions, Insurance companies, mutual funds and individuals. A company can raise capital through the primary market in the form of equity shares, preference shares, debentures and deposits.

Methods of Flotation

There are various methods of floating new issues in the primary market. They are:

1. **Offer through Prospectus:-** This is the most popular method of raising funds by public companies in the primary market. This involves inviting subscriptions from the public through issue of prospectus. The prospectus can be described as a notice,

circular or an advertisement, which is printed and published by the company to inform and invite the public regarding the issue.

The main objects of prospectus are:

- * To inform public about formation of company
- * To invite public to subscribe its securities.
- * To induce public to invest in its securities.

Here the company directly invites the public to subscribe shares and the investors can directly apply for shares.

2. **Offer for sale**:- under this method, securities are not issued directly to the public, but are offered for sale through intermediaries like issuing houses or stock brokers. Thus the intermediaries act as a connecting link between the company and investors. In this case the company sells securities en block at an agreed price to brokers who in turn, resell them to the investing public.
3. **Private Placement**:- Private placement is the allotment of securities by a company to institutional investors and some selected individuals. It means sale of securities privately to friends, relatives, promoters, directors etc. Companies that do not wish to disclose information to the public resort to this type of market. This method is highly economical as there is no need of any kind of advertisement.
4. **Right issue**:- This is a privilege given to existing shareholders to subscribe to the new share issue according to the terms and conditions of the company. It is the right of the existing shareholders to subscribe additional shares when there is fresh issue. The right is known as pre-emptive right. It is considered to be expensive.
5. **E-IPOs** :- A company wishes to issue capital to the public through online system should enter into an agreement with the stock exchange. This method of new issue is called e-IPOs. SEBI appointed brokers should receive the applications and forward them to the company. A registrar to the issue should be appointed. He should have electronic connectivity with the exchange.

SECONDARY MARKET

The secondary market is also known as the stock market or stock exchange. Secondary market is the market for the purchase and sale of second hand or existing securities. These securities are already floated in the primary market. It helps existing investors to disinvest and fresh investors to enter the

market. It also provides liquidity and marketability to existing shareholders. Securities are traded, cleared and settled within the regulatory provisions prescribed by SEBI. In India The National Stock Exchange(NSE), Bombay Stock Exchange(BSE), Over The Counter Exchange of India(OTCEI), Regional Stock exchanges and the Depositories are the major components of the secondary market.

DIFFERENCE BETWEEN PRIMARY MARKET AND SECONDARY MARKET

Primary Market	Secondary Market
1. It deals with new securities	1. It deals with existing securities
2. Securities are sold only once	2. It provides regular and continuous market
3. Investors can only purchase securities	3. Investors could purchase and sell securities from stock exchanges
4. It provides capital to the companies	4. Issuing company does not have any direct role
5. It does not have any physical existence	5. Stock Exchanges have physical existence
6. It links the issuing company and investors	6. Transactions are made between investors.

STOCK EXCHANGE

Stock exchange is an organized market where the second hand securities are bought and sold. These stock exchanges are located in 23 important cities in India. Securities include shares, debentures and bonds issued by companies and government. Stock exchanges help companies raise finance, provide liquidity and safety of investment to the investors and enhance the credit worthiness of individual companies. Stock exchange is described as the mart of the world.

Meaning

According to securities Contract (regulation) Act 1956 “ Stock Exchange is an association, organization or body of individuals, whether incorporated or not established for the purpose of assisting , regulating and controlling business in buying , selling and dealing in securities”

FUNCTIONS OF STOCK EXCHANGE

1. **Provide liquidity and marketability to existing securities:**The basic function of stock exchange is the creation of a continuous market where securities are bought and sold. This provides liquidity and easy marketability to already existing securities in the market.

2. **Pricing securities** : Stock exchanges serve as a **barometer of the economy** which indicates market prices of securities. A stock exchange is a mechanism of constant valuation through which the prices of securities are determined.
3. **Safety of transaction**: Stock exchanges have different measures and mechanisms to ensure fair dealings and protection of the interest of the investors.
4. **Contributes to economic growth**:- Stock exchanges help in enhancing economic growth by allocating savings to the most efficient avenues of production.
5. **Mobilisation of savings**: A stock exchange helps in mobilizing surplus funds of individuals and institutions for investment in securities. Wide publicity of stock exchange operation promotes savings and investment.
6. **Spreading of equity cult**: The stock exchange can play a vital role in ensuring wider share ownership by regulating new shares, better trading practices and taking effective steps in educating the public about investments.
7. **Providing scope for speculation**: The stock exchange provides sufficient scope within the provisions of law for speculative activity in a restricted and controlled manner.

TRADING AND SETTLEMENT PROCEDURE

Till a few years ago trading on a stock exchange took place through a 'public outcry or auction system.' In the trading ring brokers assembled in a face to face manner and made a bargain on price of securities. The members were called by the name brokers.

At present, trading in stock exchange is carried on with the help of computers. This is popularly known as '**On line trading**'. Stock exchanges have its main computer system with many terminals. In the case of screen based system there is no need for buyers and sellers to meet at a physical location to trade. They can trade through the computerized trading screens available with the trading members. Buy and sell orders received from different brokers are automatically matched and matching orders are executed.

Advantages of electronic trading system/ screen based Trading / Online Trading

1. **It ensures Transparency** : The investors can check the exact price at which the transactions occurred. It ensures transparency

2. **Efficient Information:-** The computer screen instantly displays the share price, capital market developments that influences share prices etc. This increases the efficiency of information
3. **Efficient operation:** Since it reduces time, cost and effort it increases the efficiency of operation.
4. **Wide coverage:-** This system enables a large number of participants to trade with each other. People from all over the country can buy or sell securities through brokers and members without knowing each other.
5. **A single platform:-** All the trading centres spread all over the country have been brought into one trading platform. i.e. The stock exchange on the computer.

Steps in the trading and settlement procedure

The Securities and Exchange Board of India (SEBI) introduced the T + 5 rolling settlement in the equity market in July 2001 and subsequently shortened the settlement cycle to T + 3 in April 2002. SEBI further reduced on 1st April 2003 the settlement cycle to **T + 2**, hoping to reduce the risk in the market and protect the interest of investors.

T + 2 settlement means that settlement of account should be made within 2 days from the date of transaction.

The following steps are involved in the screen based trading for buying and selling of securities.

1. Select a broker and enter into agreement with him. The investor should furnish certain other details. These include PAN (permanent Account Number), date of Birth, address, education qualifications, occupation, residential status, bank account number. etc.
2. The investor has to open a 'demat' account with a Depository Participant (DP). DP may be a broker, bank or financial institution. This account is necessary for holding and transferring securities in the 'demat' form.
3. The investor places an order with the broker to buy or sell shares. An order confirmation slip is issued to the investor by the broker.
4. The broker will go online and connect to the main stock exchange and match the share with best price.

5. Execution of order through the computer terminal. The broker will issue a trade confirmation slip to the investor.
6. Within 24 hours of trade, the broker issues a contract note. It contains the number of shares bought or sold, its price, date and time of deal and brokerage charges
7. The investor has to deliver the share sold or pay cash for the share bought. This should be done after receiving the contract note. This is called Pay in day.
8. After that the broker settles the transaction on T + 2 day. The settlement cycle is on T + 2 day on a rolling settlement. This is called the pay –out day. The broker has to make payment to the investor within 24 hours of the pay out day.
9. Effecting changes in the demat accounts. I.e. Add/delete the number of shares purchased/sold in the demat account.

Depository: The depository is an organization where securities of a shareholder are held in electronic form. This is same as a bank holding money of depositors. The depository holds electronic custody of securities and makes arrangements for transfer of ownership of securities on the settlement day by means of book entries. In India there are two depositories National Securities Depositories Ltd (NSDL) and Central Depository service Limited (CSDL).

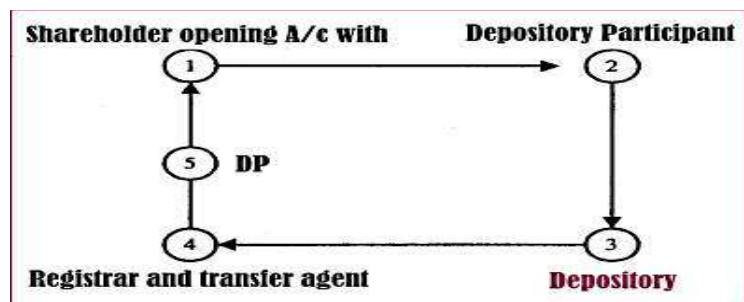
Depository participant (DP): A DP is an agent of the depository and functions as the connecting link between depository and investors. A DP is responsible for maintaining the investors' securities account with the depository and handles the account in accordance with the instructions of the investor.

Decentralization/ Scrip less trading

Decentralization is a process by which paper share certificate are converted into electronic form. It is an electronic record of share ownership. To trade in dematerialized form, a 'demat account' is to be opened. Only registered shareholders can apply for dematerialization. Once the shares are dematerialized, they will be credited to the investors account with the depository.

Working of Demat System

1. Select and approach a certified DP (Depository Participant) and submit account opening form along with necessary documents
2. The physical share certificate along with dematerialization request form (DRF) is to be given to the DP.
3. DP intimates the depository of the request through electronic media.
4. DP submits the share certificate along with DRF to the registrar.
5. Registrar validates request , updates records and informs depository.
6. Depository credits the DP account and inform the DP
7. DP updates the investor account and informs the investor.



Dematerialisation process

*** **Rematerialisation:** Rematerialisation known as 'remat'. reverse of demat. ie. Getting physical certificate from the electronic securities.

Stock market index: A stock market index is a barometer of market behavior. It can also be used as a benchmark for evaluating portfolios of investors. It reflects market direction and indicates day to day fluctuation in stock prices. In Indian markets the BSE SENSEX and NSE NIFTY are important indices

Some important Global Stock Market indices are DOW JONES, NASDAQ ,S and P 500 Index, FTSE 100 etc.

Stock exchange in India

There are 23 stock exchanges in India including National stock exchange (NSE) and Over The Counter Exchange Of India (OTCEI).. out of these Bombay Stock Exchange is the oldest one. (1875)

National Stock Exchange (NSE)

The National Stock exchange of India Ltd (NSE) is an Indian's largest stock exchange located at Mumbai. NSE was incorporated in 1992 and was recognized as a stock exchange in 1993 under Securities Contracts (Regulation) Act 1956. NSE was set up by IDBI, ICICI, IFCI, LIC and other financial institutions.

NSE is a public limited company and it has nationwide coverage and therefore functioning across the country. NSE launched **capital market segments in 1994** and futures and options(**derivatives**) in 2000.

Features of NSE

1. NSE is a public limited company
2. NSE is an integrated stock market system with nation wide coverage.
3. NSE has two segments. Viz wholesale debt market and capital market.
4. NSE has ring less screen based trading system (Online trading System)
5. NSE index is called Nifty.
6. NSE is the first exchange in the world to use satellite communication technology for trading.

Objective of NSE

1. Establish nationwide trading facility for all types of securities (both capital and money market securities)
2. Ensure equal access to all investors all over the country through communication network.
3. Provide fair, efficient, speedy and transparent transaction using electronic trading system.
4. Enable shorter settlement cycles and book entry settlement.
5. Meet International benchmarks and standards.
6. NSE provides a fully automated screen based trading system with national reach.

Market segments of NSE

NSE has two segments

1. **Whole sale debt market Segment (WDM):** provides trading facilities in whole range of debt investments (money market instruments such as T-bills, Commercial bills, Commercial paper, Certificate of deposit etc.). Membership to WDM limited to only corporates.
2. **Capital market Segments:** Provides trading facilities in capital market instruments such as shares, debentures, bonds etc.

Some Common stock market terms

Bourses - Another name for stock market.

Bull: An optimistic trader , expects a rise in prices and make profits.

Bear:- A pessimistic trader, expects a decrease in prices

Badla:- It is a carry forward system of settlement particularly in BSE.

Penny stocks: securities with no values, But whose trading results in speculation.

Odd Lot Trading : Trading in multiples of 100 stocks or less.

OVER THE COUNTER EXCHANGE OF INDIA (OTCEI)

The OTCEI is a company which commenced trading in 1992. It is subject to the provisions of companies act 1956. It was set up to address the problems of small investors and small business enterprises. It is fully computerized, transparent, single window exchange. This exchange is established on the lines of NASDAQ(National association of securities Dealers Automated Quotations) , the OTC exchange in USA. It has been promoted by UTI, ICICI, IDBI,IFCI,LIC,GIC,SBI etc.

Features of OTC exchange

1. It has nationwide network.
2. It does not have trading ring (no geographical place)
3. It provides electronic based trading.
4. It offers more transparency and quick trading facilities to investors.
5. It provides greater liquidity of the securities of small companies.

Objectives/ Advantages of OTCEI

1. To provide a nationwide investor base to small companies
2. To enable small companies to raise capital at low cost.
3. It offers transparent dealings in securities
4. It offers quick trading facilities to investors.
5. It ensures liquidity to securities listed in OTC exchange
6. It provide a single trading platform for investors throughout the country.

7. It offers freely and quick settlement and delivery system.

BSE(Bombay Stock Exchange)

Bombay stock Exchange (BSE) is the oldest Stock exchange in Asia. It was launched in the year 1875 in the name of “ **the Native Share & Stock Brokers Association**”.Currently about 6000 companies have been listed in BSE. In 1957, the BSE become the first stock exchange to be recognized by the Indian Government . In 1986 , it developed the BSE Sensex Index .The trading platform of BSE is known as **BSE On Line Trading (BOLT)**system(introduced in 1995).

Objective of BSE

1. To provide an efficient and transparent market for trading in equity , debt instrument, derivatives and mutual funds.
2. To provide a trading platform for equities for small and medium enterprises.
3. It safeguards market integrity through electronically driven exchange.
4. To confirm an international standard.

Common features of NSE and OTCEI

1. **Nationwide coverage:** Both the NSE and OTCEI provide nationwide reach to investors
2. **Screen based trading:** Transaction at NSE/OTC are fully computerized
3. **Ring less:** The companies of NSE/OTC dealers are linked to the central computer of the NSE/OTC through a satellite network.
4. Both have headquarters at **Mumbai**
5. **Incorporate bodies:** NSE and OTC both have been established as companies.
6. Both NSE and OTCEI **ensures transparency** in dealing securities.

SENSEX :The Sensex is the benchmark index of the BSE. Since BSE has been leading exchange of the Indian secondary market, the SENSEX has been an important indicator of the Indian stock market. If Sensex rises, it indicates the market is doing well. It is also a measure of the state of the Indian economy. The SENSEX ,launched in 1986, is made up of 30 of the most activity traded stocks in the market

SEBI(SECURITIES AND EXCHANGE BOARD OF INDIA)

Securities and Exchange Board of India (SEBI) is the regulatory and developmental agency of Indian capital market. It was established in 1988 and was given statutory status through the securities Exchange Board of India Act 1992. SEBI was set up to protect the interest of investors promote the development of stock market and regulate it. Its headquarters is at Mumbai.

Reasons for the establishment of SEBI: The capital market has witnessed a tremendous growth during 1980's. This leads to a variety of malpractices on the part of companies, brokers, merchant bankers, investment consultants etc. These malpractices and unfair trading practices had eroded investors' confidence and multiplied investors' grievances. Therefore government of India decided a separate regulatory body known as SEBI, so as to control malpractices and unfair trade practices in the security market.

Objectives of SEBI

SEBI is meant to be a supervisory body for regulating and promoting the securities market of India. The main objectives of SEBI are as follows

1. To promote fair dealings by the users of securities
2. To protect the rights and interest of investors
3. To prevent trading malpractices
4. To regulate and develop a code of conduct and fair practices by intermediaries like brokers, merchant bankers etc.
5. To stimulate competitors and encourage innovation

Functions of SEBI

Functions of SEBI are classified as protective functions, regulatory functions and developmental functions. These functions reveal the objectives of SEBI, such as to protect, develop and regulate the market. Because of these functions SEBI is often called watch dog of capital market.

I. Protective Functions

1. Prohibition of fraudulent and unfair practices relating to securities market like making misleading statement, price rigging etc.
2. Prohibiting insider trading in securities

3. Undertaking steps for investor protection
4. Promotion of fair practices and code of conduct in securities market.

II. Development Functions

1. Promote investor education programmes
2. Promote training of intermediaries
3. Promote online trading
4. Promote fair practices in capital market
5. Conduct researches on capital market and publish useful information
6. Permit primary market operations through stock exchanges

III. Regulatory Functions

1. Register of brokers and sub brokers and other players in the market
2. Registration of collective investment schemes and mutual funds
3. Regulation of stock brokers, portfolio exchanges, underwriters and merchant bankers
4. Levying fees or other charges for carrying out the purposes of the Act.
5. Collect information about functioning of stock exchanges and undertake inspection, enquires and audit of them.

*** **price rigging:** price rigging is the process of creating artificial demand for securities in order to increase their market value.

*** **Insider trading:** Insiders are those persons closely related to the company such as directors, managers etc. who can very easily know the price sensitive information about the company. Based on that they either sell or buy securities of such a company. Their transactions is called insider trading.

*** **cochin stock exchange -1978**