FINANCIAL SERVICES

Unit I

Leasing, Types of Leasing, Accounting, Tax and Legal aspects of Leasing, Leasing agreements, Evaluation of a Lease agreement from both the Lessee's and Lessor's point of view

Unit II

Hire Purchase, Determination of EMI, IRR, Flat rates, Floating rates, Diminishing Balance and such others, Factoring, Forfeiting, Investment decisions in accounts receivables, Securitization

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Insurance – Life and General, the concept of Premium, risk and return, Mutual Funds – Organization, Functions, schemes, risk and returns

Unit V

Introduction to Merchant Banking Services: Corporate Counseling, Project Counseling, Loan Syndication, Technology tie-ups, Bought-out deals, Rehabilitation of sick units, Merchant Banking in India - SEBI guidelines, Issue Management

References

1. Merchant Banking by J. C. Verma
2. Hand book for SEBI Guidelines - ICSI Publication
3. NABHI'S book on SEBI Guidelines.
4. Strategic Perceptions in Leasing and Hire-Purchase-Vinod Kothari
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UNIT I

FINANCIAL SYSTEM:

The evolution of the financial system in India is nothing but the reflections of its political and economic history. The evolution process has been influenced by the factors of urbanization of society, advent or large scale industrialization, introduction of railways and telegraphic communications in the 19th century, nationalization of financial institutions in 20th century and implementation of information technology on the eve of the 21st century.

A merchant banker is a key intermediary in the financial market. He facilitates the issuers of securities (companies) to raise capital from the financial market by selling the securities. He offers a package of services related to the capital raising activity. That is the reason why merchant banking is often identified with capital issue activities of companies. As a matter of fact, SEBI definition of the term 'merchant banker' emphasizes the aspect of issue management.

AN OVERVIEW OF INDIAN FINANCIAL SYSTEM

Financial system is a system to canalize the funds from the surplus units to the deficit units. Deficit units are a case where current expenditure exceeds their current income. There are other entities whose current income exceeds current expenditure which is called as Surplus units.

An efficient financial system not only encourages savings and investments, it also efficiently allocates resources in different investment avenues and thus accelerates the rate of economic development. The financial system of a country plays a crucial role of allocating scarce capital resources to productive uses. Its efficient functioning is of critical importance to the economy. Financial System

• It is a system for the efficient management and creation of finance. According to Robinson, "Financial system provides a link between savings and investment for the creation of new wealth and to permit portfolio adjustment in the composition of the existing wealth". According to Van Horne, "Financial system is defined as the purpose of financial Merchant Banking and Financial Services markets to allocate savings efficiently in an economy to ultimate users – either for investment in real assets or for consumption".

Thus the financial system mainly stands on three factors:

Money is the unit of exchange or medium of payment. It represents the value of financial transactions in qualitative terms.

Credit on the other hand, is a debt or loan which is to be returned normally with interest. Finance is monetary Wealth of the state, an institution or a person. Comprising these factors in a systematic order forms a financial system.

Objectives of Financial System/Service

- Accelerating the growth of economic development.
- Encouraging rapid industrialization
- Acting as an agent to various economic factors such as industry, agricultural sector, Government etc.
- Accelerating rural development
- Providing necessary financial support to industry
- Financing housing and small scale industries
- Development of backward areas, infrastructure and livelihood
- Imposing price control in need

Functions of financial system are distributed from creation of money to efficient Management. It is the sum total of the functions of the various intermediaries.

The functions of financial system can be classified into two broad categories:

1) Controlling functions

2) Promotional functions.

Structure of Indian Financial System

Financial system is a system of arranging different types of funds required for the Business. It deals about the following:

1) Financial Institutions

2) Financial Markets

3) Financial Instruments

4) Financial Services

♣ Financial Institutions

The Commercial Banks form the structure of financial institutions in India. They can be classified as under:

Central Bank

o Banking and Non-Banking Companies

o Financial Institutions

o Non-Banking Financial Intermediaries

o Co-operative Banks

o Regional Rural Banks

♣ Financial Markets

(a) Capital Market: It is the market for long term funds i.e., raising capital for Companies through issue of shares and debentures. The Capital market can further divided into

(a) Primary Market and

(b) Secondary Market

Classification of Capital Market

(i) Primary Market: It is the market for primary needs of the company. The Company sells its shares at the time of promotion and the investors directly buy the shares from the company through application.

(ii) Secondary Market: It is the market for secondary needs of the company. The sale and purchase of securities i.e., shares and debentures will take place through the recognized stock exchanges.

(b) Money Market: It is a market for short term funds. Money market provides working capital.

(c) Foreign Money Market: It is a market for foreign exchange which is bought and sold. In India the foreign market is controlled by Reserve Bank of India. Foreign Exchange Management Act (FEMA) deals with foreign exchange.

(d) Government Securities Market: It is a market for Government securities like Treasury Bills and Bonds. Treasury Bills are bills issued for meeting the short term revenue expenditure of the Government.

♣ Financial Instruments Financial instruments include both instruments and products. Instruments include cheques, drafts, letter of credit, travellers' cheques, commercial papers, GDR's, Bonds etc. Products may be in the form of Credit Cards, Debit Cards etc. Classification of Financial Instruments

(a) Negotiable Instruments: A negotiable instrument is an instrument that is transferable from one person to another. Negotiable instrument may be a bearer instrument or an order instrument. A negotiable instrument may be promissory notes, bills of exchange or cheques etc.

(b) Commercial Paper: A commercial paper is one which is issued by leading financial institution which can be taken by any borrower and discounted with commercial banks. (c) Bill of Lading: It is a document signed by the carrier, acknowledging shipment of the goods and Containing the terms and conditions of carriage.

(d) Letter of Credit: It is a letter by the importer bank guaranteeing the credit worthiness of the importer.

(e) Travellers' Cheque: It is a cheque issued by banks to the traveling public which can be cashed at ease.

♣ Financial Services

Financial service, as a part of financial system provides different types of finance through various credit instruments, financial products and services. It enables the user to obtain any asset on credit according to his convenience and at a reasonable interest rate. The following are the few components of financial services/system: ¬

- Asset Liability Management
- Leasing and Hire Purchase
- Housing Finance ¬ Portfolio Management
- Credit Card and Credit Rating

- Book Building and Mutual fund
- Factoring and Forfaiting

The Progress of any economy mainly depends on the efficient financial system of the country. Indian economy is no exception of this. This importance of the financial sector reforms affirms an effective means for solving the problems of economic, financial and social in India and elsewhere in the developing nations of the world.

The financial system names at establishing and providing an effective linkage between depositors and investors. It includes all the financial institution and markets involved in

1) Moving savings from savers to borrowers
2) Transferring sharing and insuring risks.

Features of financial system

1) The financial system provides a linkage between depositors and investors thus encouraging both savings and investments promotes .
2) The financial system facilitates expansion of financial markets overtime
3) The financial system promotes channelization of financial resource for protective purpose
4) The financial system contributes towards healthy function of the economy.

1.1 Leasing

A lease may be defined as contractual arrangement or transaction in which a party owing an asset (lessor) provides the asset for use to another (lessee) over a period in return for periodic payment (rentals). Leasing is not confined to domestic trade alone. It has gone beyond the frontiers of a country. In olden days, leasing was in the form of charter party arrangement where in the entire ship is taken on lease either for a particular period or for a particular voyage. In rural belts , agriculture land are given in lease for a specified period. In tamilnadu temple lands were on lease for a considerably longer period .in chiefly served as a source as income for the temples.

Lease financing is one of the important sources of medium- and long-term financing where the owner of an asset gives another person, the right to use that asset against periodical payments. The owner of the asset is known as lessor and the user is called lessee.

An agreement between two parties whereby one party allows the other to use his/ herproperty for a certain period of time in exchange for a periodic fee. The propert y covered ina lease is usually
realstate or equipment such as an automobile or machinery. There aretwo main ki nds of leases. A capitallease is longterm and ownership of the asset transfersto the lessee at the end of the lease. An operatinglease, on the other hand, is shortterman d the lessor retains all rights of ownership at all time

Leasing

The hiring out by one firm (the lessor) of an ASSET such as a factory building, p ieceof machinery or vehicle to another firm (the lessee) in return for the payment o f an agreed rental.The lessor retains the ownership of the asset concerned and will repossess the asset on the expiryof the contract, or beforehand should the client req uire a replacement. A leasing arrangement canbe useful to a client company in so f ar as it enables it to employ assets without having to tie uplarge amounts of capital for long periods of time.

Meaning & designing leasing:

Leasing is the process by which a firm can obtain the use of certain fixed asset on contractual payment called lease rents. The owner of the asset grants the right to use that asset to another person in return for rentals. Leasing thus essentially involves the divorce of ownership from the economic use of an asset or equipment.

Leasing is a device financing the cost of the asset. It is a contract in which a specific equipment required by the lease is purchased by the lesser (financier) from a manufacturer or vendor selected by the lessee.

Lessor: the lessor nominal owner of the asset. He is the financier.

Lessee: lessee has the possession and use of the asset that is being leased on payment of the specified rentals over a predetermined period of the time. The lessee is free to choose asset according to his requirements. In concise lessee is a receiver of the services of the asset under the lease contract

1.2 Essential element of leasing

1) **Lessor and lessee:** there are two part is to a contract of lease, financing, namely, lessor & lessee. lessor is the nominal owner of the asset" position and economic use of that asset are equipment vests in the lessee. The lessee is the receiver of the asset under the lease arrangement. He is essentially of the user of the asset.

Lessors as well as lessees may be individuals, partnership, jointed stock company , corporation or financial institutions. Sometimes that may be jointed lesser or joint lessee where amount of finance in enormous.

2) **Lease broker:** in addition to **Lessor and lessee ,**there may be a lease broker. He act as an intermediary in arranging lease deals. Merchant banking divisions of certain foreign banks in India, subsidiaries of some Indian banks and provide merchant bankers are acting as lease brokers. The charge certain percentage of fee for their services.

3) **Lease financier:** lease contract may involve a lease financier. He refinances the lessor either by providing term loans or by subscribing to equity or under specific refinance scheme

4) **Lease property:** the asset , property are equipment to be leased is the subject manner of contract of lease financing . the asset may be automobile, plant & machinery, equipment, land & buildings, factories and running business ,aircraft , so on. The asset may be of assesses choice.

5) **The divorce of ownership from user:** leasing essentially involves he divorce of ownership from the economic use of anasset or equipment. During the lease tenure the ownership of the asset vests with the lessor but its use is allowed to the lessee. On the expiry of the lease period , the asset reverts to the lessor.

6) **terms of lease:** the lessee arrangement remains a operation for a period . every lease should have a defined period . the lease period may stretch over the

entire economic life of the asset it is known as the financial lease. The period may be shorter from the useful life of the asset. It is known as the operating lease.the lease may be perpetual. It is with an option at the end of the lease period to renew the lease from the further specific period

7) **lease rentals:** lease rentals is consideration which the lessee pays to the lessor form the lease truncation . lease rentals compensate the lessor for his investment in the asset. In the form of deprecation , the interest on investment , repairs and so forth borne by the lessor and servicing charges over the lease period.

1.3 Classification of lease:

Lease transcations may differ on the basis of risks and rewards numbers of parties to the transcation, domicile of the equipment manufacturer, lessor and the lessee and so on. On the basis of these variations leasin can be grouped into

1. Financial lease and operating lease
2. Sales and lease back and direct lease
3. Single investor lease and leveraged lease
4. Domestic and international lease.

1. Financial lease and operating lease:

Financial lease:

According to the Indian Accounting Standard (IAS -17) in a finance lease, the lessor transfers to the lessee, substantially all the risks and rewards incidential to the ownership of the asset. Financial lease involves payment of rentals over the lease period sufficient to amortise the capital outlay of the lessor and leave some profit. The lessor is only the financier and is not interested in the asset. The lessor is able to recover the investment in the lease and derive the profit. So it is known as full payment lease. Assets involved in ships, aircrafts, railway wagons, land , buildings, machinery and so on. The lease period cannot be cancelled.

Operating lease:

If the lease does not transfer all the risks and rewards incidental to ownership it is known as operating lease. The lease uses the asset for a specific period. The lessor bears the risks of obsolescence and incidental risks. There is an option to either party to terminate the lease after giving due notice.

According to indian accounting standard (IAS 17) an operating lease is not same in the financial lease. The lessor does not transfer all the risks and rewards incidental to the ownership of the asset and cost of the asset is not fully amortised during the primary lease period. The lessor provides services attached to the lease asset such as maintainence, repair, and technical advice. For this reason the operating lease is also known as service lease.

It is used for computers, office equipments, automobiles, trucks, telephones and so on. The period of the lease is shorter than the economic life of the leased asset. Lease rental are not sufficient to amortise the cost of the assets. They cover only the cost of the services attached to lease asset. The lessor does not rely on the single lessee for recovery of his investment.

FINANACIAL LEASE Vs OPERATING LEASE

SL NO	FINANACIAL LEASE	OPERATING LEASE
1	**The** asset is exclusively for the use of particular lessee	The asset is meant for the number of lessees
2	The lease period may stretch over the entire the economic life of the asset	The lease period is shorter than the useful life of the asset
3	The lessee has option to purchase the equipment	The lessee had no such option

	at the end	
4	Lease period is non-cancellable	The lessor is free to cancel the lease at any time
5	The liability for repair, maintenance and insurance of equipment rest with the lessee	The lessor maintains the leased asset and provides service such as support staff, insurance, fuel and so on
6	Rentals are sufficient to amortize the capital outlay of the lesser and leave some profit	Lease rents are not sufficient to totally amortize the cost of the asset
7	The assets leased includes ships , aircraft, railway wagons, land, building, heavy machinery etc.	The assets leased includes mobile cranes with operators , chartering of aircraft including the provision of crew , fuel & support services and so on
8	The lessor is only a financier. usually he is not interested in the asset	The lesser has ultimate interest in the residual value of the asset.

2. Sales and lease back and direct lease:

Sales and lease back:

It is an indirect form of leasing. The owner of an equipment sells it to a leasing company (lessor) which leases it back to the owner (lessee). For example, bank sell safe deposit value in their custody to the leasing company at a market price higher than the book value. The leasing company in turn offers these lockers on a long term basis to the bank. The bank sub leases the lockers to its customers. The sale and lease back arrangement can be in the form of finance lease or operating lease.

Direct lease:

In direct lease, the lessee and the owner of the equipment are two different entities. A direct lease may be bipartite lease or tripartite lease.

Bipartite lease:

There are two parties to lease transcations

i. Equipment supplier cum lessor and

ii. Lessee

Tripartite lease:

There are three parties in the lease agreement

i. Supplier
ii. Lessor
iii. And lessee

A variant of tripartite lease is the sales aid lease in which the equipment supplier arrange for lease finance by

i. Providing reference about the customer to the leasing company
ii. Negotiating the terms of the lease with the customer and completing all the formalities on behalf of the leasing company.
iii. Writing the lease on his own account and discounting the lease receivables with the designated leasing company.

3. Single investor lease and leveraged lease:

Single investor lease:

There are two parties to the lease transcation the lessor and lessee. The leasing company funds the entire investment by an appropriate mix of debt and equity funds. The debt raised by the leasing company to finance the asset is without resource to the lessee. In case of default in the servicing debt by the leasing company, the lessee is not liable.

Levearaged lease: there are three parties to leveraged lease:

1. Lessor (equity investor)
2. Lender and
3. Lessee

The equity buy the asset the borrowing with full recourse to the lessee and without any recource to it.

The lender obtains an assignment of the lease, the rrentals payable by the lessee and a first mortaged asset on the leased asset.

The truncation is routed through the trustee who looks after the interest of the lender and lessor.

4.Domestic lease and international lease:

Domestic lease: if all parties to the lease arrangement, namely, equipment, supplier, lessor & the lessee are domiciled in the same country, it is domestic lease.

international lease: if the parties to lease transaction are domiciled in different countries caller international lease

import lease:in an import lease **,**lessor & lessee are domiciled in the same country but the equipment supplier in the same country.

Cross-border lease: lessor & the lessee are domiciled in the different country. Cross border lease is affected currency risks and also prone to country risks.

1.4 Players in leasing industry:

1. Independent leasing companies
2. Other finance companies
3. Manufacturer lessors
4. Financial institutions
5. In house lessors
6. Commercial banks.

1. Independent leasing companies: it derives a major part of income from leasing. They have colloborations with overseas partners. They offers services through direct advertisement, personal contracts, lease brokers including foreign banks and merchant banks.
2. Other finance companies: to avail tax concessions, a large number of finance and investment companies carry on leasing business.
3. Manufacturer and lessor : Manufacturing companies have either setup independent leasing out fits or through separate divisions carry on leasing business to promote the sale of their own products.
4. Financial institutions: the development the financial institutions both at all india state levels carry on leasing business.
5. In house lessor: Big business houses have formed captive leasing companies for provisions of lease finance to group companies.
6. Commercial banks : Under section 19 (1) of the banking regulation act, 1949 the commercial bank in india can set up subsidiary for carrying on leasing activities. The SBI was to start a subsidiary for leasing business in 1986.

A **lease** is a contractual arrangement calling for the lessee (user) to pay the lessor (owner) for use of an asset.**Leasing** is a process by which a firm can obtain the use of a certain fixed assets for which it must pay a series of contractual, periodic, tax deductible payments.

1.5Finance Lease Accounting Journal Entries

The finance lease accounting journal entries below act as a quick reference, and set out the most commonly encountered situations when dealing with the double entry posting of finance or capital leases.

In each case the finance lease accounting journal entries show the debit and credit account together with a brief narrative. For a fuller explanation of journal entries, view our examples section.

typical Finance Lease Accounting Journal Entries

Account	Debit	Credit
Fixed assets	XXX	
Lease liability		XXX
Cash		XXX

To record a fixed asset funded by lease finance and a cash deposit

Account	Debit
Depreciation expense	XXX
Accumulated depreciation	

XXX

Journal entry to record depreciation

Account	Debit	Credit
Lease Liability	XXX	
Interest	XXX	
Cash		XXX

To record a rental payment split between principal and interest

Account	Debit	Credit
Insurance expense	XXX	
Maintenance expense	XXX	
Cash		XXX

To record periodic expenses

Account	Debit	Credit
Rental expense	XXX	
Cash		XXX

Operating lease rental payment

1.6 TAX ASPECTS IN LEASING:

The principal objective of the Income Tax Leasing Rules is to regulate the business activities in the leasing industry. Although precise figures are not available, it is estimated that funding provided by non-bank financial institutions was around RM21bil in 1997. It is further estimated that one third or RM7bil of this total was provided by leasing or factoring companies.

Definition

A lease can be defined as a contract between the owner of an asset (referred to as a lessor) and the hirer (lessee) for the letting of (leasing) an asset. The contract would allow the lessee to use the asset for a specified period of time.

The lessee pays a predetermined monthly rent to the lessor for possession and use of the asset. The lessor, throughout the lease period, would retain the legal ownership of the leased asset.

A lease term means the period for which the lessee has contracted for use of an asset. In situations where a lease arrangement has been terminated earlier than its agreed expiry date, the lease term is the actual period of the lease.

A special purpose asset means a leased asset where no other use can use the same asset without making alterations or adjustments to the existing structure or land. For income tax purposes, a special purpose asset which is an integral part of the building shall be deemed to be a movable property.

Mode of purchase

A prospective user of an asset has three options: to purchase an asset outright, to by it on hire-purchase, or to lease it. The mode of purchase of the asset would depend on several factors such as availability of cash, nature and cost of

asset, duration of use and, of course, tax benefits.

Tax Benefits

Outright purchase.

A user who purchases an asset outright will not be allowed a direct deduction for tax purposes. Instead, he will be allowed a capital allowance computed on a straight lien basis.

The initial allowance is 20% of cost incurred in the year while the annual allowance vary between 10% and 40%, depending on the nature of the asset.

The rate of allowance for motor vehicles is 20% while computers used for the business are given an increased annual rate of 40%.

Hire-purchase

A user who acquires an asset on hire-purchase terms is deemed to be the owner of the asset (Paragraph 46 Schedule 6 ITA). The user will, therefore, be given capital allowances on the capital potion of the cost.

The income tax provisions, however, limits the qualifying expenditure, in respect of motor vehicles (other than commercial vehicles) to RM50,000.

Lease

When a user leases and asset, the rental payable each year will be an allowable deduction from the gross income over the period of the lease.

As for car leasing, any sums paid by way of rental in excess of RM50,000 is disallowed (Sec 39(1)(k) ITA). This restriction does not apply to commercial vehicles

Special treatment

The Director-General of Inland Revenue (DGIR) is given powers to make rules regarding the tax treatment of leased assets.

Separate business source

The leasing rules provide that leasing income shall be deemed to arise from a separate business source, distinct from income from other business activities.

It follows that capital allowances in relation to the leasing business cannot be used to set-off from other business sources.Moreover, the gross income of a lessor will be deemed to accrue evenly over the period of the lease term.

The normal deduction rules laid down in the ITA will govern the allowability of expenditure in respect of the lessors trade. In general, the expenses are permitted if they are wholly and exclusively incurred in the production of income.

Terminal payments

Where any terminal payments are made by the lessee to the lessor as compensation for terminating the lease, such payments would be deemed taxable income in the hands of the lessor.

Lease or Purchase Every year taxpayers face the problem of determining whether payments are for rent or for the purchase of property. The issue is whether the transaction is a valid tax lease or a conditional sales contract.

Whether the agreement is a conditional sales contract depends upon the intent of the parties. Intent is based upon all of the facts and circumstances existing at the time the agreement is made. Determining Intent Generally, an agreement will be considered a conditional sales contract rather than a lease if any of the following is true (these factors are based on a lack of “economic substance” for a lease to exist):

1. The agreement applies part of each payment toward an equity interest the “lessee” will receive.

2. The “lessee” gets title to the property upon the payment of a stated amount required under the contract.

3. The amount the “lessee” pays to use the property for a short period of time is a large part of the amount that would have to be paid to get title to the property.

4. The “lessee” pays much more than the current fair rental value of the property.

5. The “lessee” has the option to purchase the property at a nominal price compared to the value of the property at the time the purchase option is exercised.

6. The “lessee” has the option to buy the property at a nominal price compared to the total amount the “lessee” has to pay under the lease.

7. The lease designates some part of the payments as interest, or part of the payments are easy to recognize as interest.

Example 1. Facts: Fred Smith is a farmer who needs to acquire a building in which to store his equipment. Fred has determined that there are two options available to him. He could have the building built by a local contractor or enter into a contract with a leasing company that would have the building built for him and lease the building from that company. After a review of both options, Fred has decided to enter into the leasing contract. The lease that Fred signs

contains the following terms and conditions:

Fred gives the leasing company rights of access to the property.

- The lease is for seven years beginning November 1, 2014, and ending October 31, 2021. The lease payments are even amounts of $4,800, payable on November 1 of each year.
- Fred is required to pay all real estate taxes, insurance, and repairs on the building.
- At the end of the lease term, the lease may be renewed for additional periods of one year, each at a rental equivalent to the fair rental value of the building at that time; the building may be purchased for the fair market value; or the lease is terminated and lessor maintains the ownership of the building. Answer: Fred may treat this as a true tax lease. The transaction described above meets the lease requirements. In addition, Fred does not have a bargain purchase option, Fred did not furnish any cost of the building to the leasing company, and he did not lend any of the funds necessary to acquire the building to the leasing company (or guarantee the debt). Because there is an option to purchase at fair market value, the transaction is classified as a lease for tax purposes.

Legal aspects of leasing

As there is no separate statue for equipment leasing in India, the provisions relating to bailment in the Indian Contract Act govern equipment leasing agreements as well section 148 of the Indian Contract Act defines bailment as:

"The delivery of goods by one person to another, for some purpose, upon a contract that they shall, when the purpose is accomplished, be returned or otherwise disposed off according to the directions of the person delivering them. The person delivering the goods is called the 'bailor' and the person to whom they are delivered is called the 'bailee'.

Since an equipment lease transaction is regarded as a contract of bailment, the obligations of the lessor and the lessee are similar to those of the bailor and the bailee (other than those expressly specified in the least contract) as defined by the provisions of sections 150 and 168 of the Indian Contract Act. Essentially these provisions have the following implications for the lessor and the lessee.

1. The lessor has the duty to deliver the asset to the lessee, to legally authorise the lessee to use the asset, and to leave the asset in peaceful possession of the lessee during the currency of the agreement.
2. The lessor has the obligation to pay the lease rentals as specified in the lease agreement, to protect the lessor's title, to take reasonable care of the asset, and to return the leased asset on the expiry of the lease period.

1.7 Lease Agreements:

A lease agreement is simply a contract between a landlord and a tenant that states what the tenant will pay monthly for rent and for how long. Lease agreements, like many contracts, tend to intimidate some people because much of the language in the contract can be confusing. However, if you have a basic understanding of what is included in a **lease agreement**, it can help you avoid unnecessary disagreements or expenditures during or after your lease is over.

Contents of a lease agreement:

The lease agreement specifies the legal rights and obligations of the lessor and the lessee. It typically contains terms relating to the following:

1. Description of the lessor, the lessee, and the equipment.
2. Amount, time and place of lease rentals payments.
3. Time and place of equipment delivery.
4. Lessee's responsibility for taking delivery and possession of the leased

equipment.

5. Lessee's responsibility for maintenance, repairs, registration, etc. and the lessor's right in case of default by the lessee.

6. Lessee's right to enjoy the benefits of the warranties provided by the equipment manufacturer/supplier.

7. Insurance to be taken by the lessee on behalf of the lessor.

8. Variation in lease rentals if there is a change in certain external factors like bank interest rates, depreciation rates, and fiscal incentives.

9. Options of lease renewal for the lessee.

10. Return of equipment on expiry of the lease period.

11. Arbitration procedure in the event of dispute.

***1.* Contents of a Lease Agreement**

The **lease agreement** outlines and details the obligations and responsibilities of the landlord (lessor) and the tenant (lessee). It explains what the landlord and tenant have agreed upon in regards to length of the lease, how much the monthly rent will be, and who will be responsible for upkeep of the property. It is important for tenants to understand that a lease agreement can be altered prior to being signed. If there is something that you do not understand or agree to, or if there is a provision that needs to be altered, discuss it with the landlord prior to signing the lease.

***2.* A Legal, Binding Document**

Once your lease agreement is signed, it governs what the landlord and the tenant can and cannot do during the term of the lease. The **lease agreement**acts as a legal, binding contract between the landlord and tenant and will be used as such by the court if any legal proceedings arise between the two parties. If there is more than one tenant responsible for the lease, a landlord can enforce the lease against all the tenants should the need arise, so

it is important for everyone involved to understand what their responsibilities are under the terms of the lease.

3. Verbal Lease Agreements

While most lease agreements are written, there are verbal lease agreements that can be enforced as oral contracts; however, it is important to note that not all states allow verbal residential lease agreements, and verbal commercial agreements are prohibited in every state. Tenants with verbal residential lease agreements are protected by tenants-rights laws that exist in each state. The complexity of commercial leases makes it nearly impossible to substantiate verbal agreements in court and that is why they are not allowed.

1.8 Evaluating lease proposals

The basic commercial term in a finance lease is the 'firm term' rental payable during the primary lease period. In a short-term hiring agreement, rental represents simply the amount charged by the owner for the use of the equipment during a specific period of hire. However, in the case of a finance lease, rental, although nominally related to a period of use (the primary period), is usually calculated as being the amount which over the primary lease period will recover for the owner the capital cost of the equipment together with his or her outgoings, principally interest, and profit margin, taking into account any tax charges and allowances that may apply.

On occasions rental is likened to an annuity or equalised mortgage repayment made to a building society or other lender. From this perspective, the rentals or loan repayments comprise a capital element and an interest element and the early instalments comprise a smaller amount of principal and a larger proportion of interest than later repayments, because of the reducing amount of outstanding

capital on which the interest is computed.

This "loan" analogy may be useful in understanding the general nature of lease rentals under a "full payout" finance lease, but it can be misleading when lease quotations are being evaluated. In a loan quotation the main considerations are simply interest rates and repayment provisions, but with a lease many additional factors influence the evaluation, several of which arise from the impact of taxation on a lease transaction. Unlike a loan, where only the interest element of the repayments is subject to tax, the whole of a lease rental is treated as income in the books of the lessor, and the rental is allowable in full against the lessee's taxable profits. This is not true in all countries but is still a basic consideration in many jurisdictions.

Although these additional factors tend to complicate the lease evaluation, they can enable leasing companies to provide terms that are designed to fit the needs of a particular customer and the circumstance of a particular transaction.

Full-payout finance leases

In the calculation and evaluation of finance lease rates, any secondary period rentals or renewal rentals that may be payable are normally ignored. The equipment is regarded as being fully paid for over the primary lease period. After the end of the primary period the lease is usually terminable by the lessee at any time, and hence it would be imprudent for a lessor to rely on any secondary period income in evaluating the overall return.

In evaluating a "full payout" or finance lease, a leasing company will seek to recover out of the rentals payable during the primary lease period the whole of the capital cost of leased equipment plus a margin. However, in certain cases, a

lessor may place a residual value on the equipment and, thereby, reduce the amount of each rental. This situation can arise if, for example:

(a) the lessor has agreed to sell, or has an option to sell, the equipment to a third party, perhaps the manufacturer or distributor of the equipment, at the end of the primary period at a prearranged price; or

(b) the lease provides for a period or periods of compulsory extension, or extension at the lessor's (rather than, normally, the lessee's) option, which effectively extends the primary lease period to include some or all of the secondary period.

In both cases, the action contemplated to recover the unamortised cost at the end of the primary period prevents the lessor from granting the lessee an option to extend the lease at a much reduced secondary period rental, which is a commercial term commonplace in financial leasing in many countries.

Any under-recovery of capital cost which is acceptable to the lessor will, naturally, significantly reduce the primary period rentals payable.

Primary lease period

The length of the primary period is an important factor in evaluating a leasing proposal. A lessee's choice of the most suitable available period will depend on a number of factors, including the anticipated period of use of the asset and the possible need to match cash inflows(earning capacity of the assets) with outflows (lease rentals).

The length of the primary lease period is normally related to the useful life of

the equipment. A primary period of around 75 per cent of the useful life may be regarded as typical, although both the percentage and individual estimates of the length of the useful life of the equipment vary widely. A general pattern of primary periods, ranging from three years upwards, has emerged for most types of equipment. Five years is the most common period for many types of equipment, including plant, machinery and agricultural and transportation items.

For larger items of plant and assets, such as aircraft and ships, longer periods are appropriate and leases of 10 years and more are not uncommon. There is no recognised maximum primary period. Railway rolling stock has a long useful life and has in the past been regarded as suitable for 20, or even 30 year periods, although it is unlikely that a leasing company would be willing to consider a lease of that length under current economic conditions. Aircraft and ships have been leased for periods of 15 years or more.

It is important to determine the length of the period over which the primary period rentals are payable. An extension of only three months in the primary period results in an appreciable reduction in each primary period rental but increases the total rentals payable during the primary lease period.

In most financial leases, there will be an opportunity to extend the term of the lease beyond the agreed primary period. This and other options normally open to a lessee are discussed later.

Rental payment patterns

The variety of rental payment patterns is an area where financial leasing shows its natural flexibility. There are several sets of possibilities.

Advance or Arrears

Leasing companies have gradually moved towards requiring rentals in advance, principally for security reasons. This trend has also been reflected in the procedure – used by Governments in the past to control consumer spending – of specifying the number of monthly rentals to be paid in advance of supply on certain types of consumer equipment. Currently, rentals are often payable in advance, although there appears to be no longer a statutory requirement in most countries.

Frequency

Prior to the 1980s, most rentals were payable monthly. Over the years there has been a gradual move towards less frequent payments, partly to reduce the lessor's administration costs and partly to increase the amount paid in advance without an initial requirement for more than one rental to be paid.

Quarterly rentals are the most common today (although monthly rentals remain the most appropriate for smaller lease). Semi-annual and annual payments are also in general use for large facilities.

The total primary lease period rentals payable for different rental frequencies reflect the reduced or additional interest, depending on whether rentals are payable in advance or in arrears, respectively, arising from the lengthening of the payment interval.

"Tailored" Rentals

In addition to the various payment patterns with level or equal rentals, there are

a variety of ways in which rentals can be structured to meet the special requirements, usually based on anticipated cash flows, of individual lessees. Schemes can be designed to meet most sets of circumstances provided the final terms are both commercial and acceptable in credit terms from the lessor's point of view. The most common are described below.

1. Seasonal. Inclusive tour airlines and hotels may have leased aircraft, catering and other equipment with higher rentals payable in the summer months and lower rentals in the winter. Agricultural equipment is also frequently subject to these type of arrangements.

2. Stepped. The leasing arrangement may recognize the likely revenue increase, for inflationary or other reasons, expected to be generated by the equipment over the primary period. This is often required by a company who is installing new technology where the anticipated income flows from the equipment is likely to increase as the customers demand increases.

3. Deferred. Certain types of equipment do not generate revenue until some time after they are installed, or may not produce immediate cost savings. In such cases, a lessee may wish to have the cash flow benefit of a rent free period until such time as the equipment is fully integrated into the company's operations. A rental moratorium significantly increases the total interest payable during the primary lease period.

4. Ballooned. On occasions, one of the parties may wish to limit the length of the primary lease period to less than might be regarded as usual, taking into account the useful life of the equipment; but it is considered acceptable for rentals payable during the primary period to be based on the recovery of less than the whole capital cost. In these circumstances, it is possible to have a lump

sum balloon rental payable on the expiry of the primary period; there is an opportunity to review the arrangements at that time with a view to a possible rephasing of the lump sum rental over a secondary period.

Commitment Fees

A lessor, in entering into a lease, agrees to provide lease finance for a specific item of equipment or a group of items, selected by the lessee. There will be occasions, when a lessee decides not to proceed with the acquisition of an item of equipment (because, for example, of an unforeseen reduction in demand for the goods produced by the equipment concerned) and wishes to cancel the arrangements rather than proceed with the lease. Alternatively, a lessee may have arranged a 'shopping basket facility to be utilised by a set date for an agreed total value of equipment but because of delivery delays, may no longer need the full amount of the facility.

In these circumstances the lessor will have allocated certain resources, funds and taxable capacity or capital to support a committed facility for the lessee's use and may require compensation for the cancellation of the facility; particularly if it is not possible to redeploy the resources elsewhere. There are two main ways of providing for such compensation.

Firstly, the leasing terms can include a commitment fee payable at the time of setting up the facility, which is non-refundable. In this case the lessor receives just the same cash return if the facility is drawn down in full or not drawn down as he retains the initial fee in compensation. The amount of the commitment fee may be reflected either in a corresponding reduction in the amount of the first rental or treated simply as an additional payment, the subsequent rentals being reduced accordingly.

Alternatively, a fixed commitment fee pay be payable either at the time of cancellation or on expiry of the facility, in addition to the normal rentals payable.

Renewal options

Finance leasing agreements in many countries do not include an option for the lessee to acquire title to the leased equipment either at a nominal price or at an agreed reduced purchase price, although such options are a normal feature of financing arrangements in some countries and are still referred to as leases.

Where a lessee has an option to extend the lease beyond the end of the agreed primary lease period at a much reduced rental, which is fixed at the time of the original negotiations on the lease agreement this is referred to as a 'renewal option'.

In some cases the 'renewal' is referred to as a 'secondary period' and is usually for an agreed number of years, although it may be an indefinite period. There may be an option providing for the extension of the lease for a given secondary period or the secondary period may run on a year-by-year basis, or indefinitely until the giving of a pre-arranged notice period by the lessee. In large- ticket leases, there may be more than one renewal period, the secondary period being followed by a tertiary period with yet lower rentals, and so on.

If a lessee no longer wishes to continue to use the leased asset in his or her business on or after the expiry of the primary period, the equipment may be returned to the lessor to be sold, re-leased, or scrapped. Alternatively, it may be sold, in some countries by the lessee acting as he selling agent of the lessor, without the equipment physically passing into the possession of the lessor.

There is unlikely to be any additional rent payable when a lease is terminated during a secondary period; however, on the other hand, it is unusual for there to be a specific refund of rent paid in advance for a year's renewal when a lease is terminated during the course of a year.

Provided that a lessee has fulfilled all the obligations under a leasing agreement, the majority of leasing companies will pass on to the lessee the major part of any sale proceeds in the form of either a rebate of rentals or, less commonly, a commission for handing the disposal of the equipment.

Where the lessor is prepared to renew the lease at a less than economic rent and/or rebate a proportion of the sale proceeds, he or she is foregoing the opportunity to use a major part of the value of the equipment as a source of profit after the end of the primary period. The initial leasing arrangement is being regarded as a financing activity which is expected to last the whole or most of the useful life of the equipment. The leasing company sees its reward as principally the excess of primary period rentals over the capital cost of the equipment, interest and expenses (taking into account tax allowances and charges). Renewal rentals and the lessor's share of the residual value may be considered as the additional consideration necessary for the lessor to provide finance by way of a leasing facility and to take the inherent risks of ownership for the whole of the lease period.

If a lessor is prepared to grant one of these favourable options, there is no particular reason why a lessee should not enjoy residual value benefits, provided that there are no adverse tax consequences.

These renewal terms give the lessee economic, as opposed to legal, ownership of the equipment; the lessee has the opportunity to use the equipment for most

of its useful life, and can share substantially in its residual value. This is important to lessors as well as to lessees. The lessee has a much greater incentive to maintain the equipment in good repair if he or she is to receive a share of the proceeds, thereby enhancing the lessor's security interest in the equipment during the primary period, and perhaps, reducing any risk arising through the use of the equipment while defective.

Timing differences

So far we have illustrated the flexibility of lease periods, and primary rental payment patterns with reference to the inherent flexibility of a lease. These examples serve the purpose well enough, but it is necessary now to take account of the factors which relate to the tax influences on lease evaluation. In considering the effect of varying these factors we must recognise that, strictly speaking, it is the maintenance of the lessor's "after tax rate of return" on the transaction, rather than the nominal interest rate, which is essential to the lessor's evaluation. In a number of cases the difference between rentals required to maintain the nominal rate and to maintain the after-tax return will be insignificant, and for simplicity's sake, therefore, reference will continue to be made to the maintenance of the nominal rate where the difference is immaterial.

This difference between nominal rate and the after tax rate of return is important only in those countries which have substantial tax incentives for new capital equipment investment and where the lessor is a profitable and substantial local business. In these circumstances the date of the acquisition of equipment, or, more precisely, the date the expenditure on the equipment is incurred, may influence the rental a lessor is prepared to quote. Leasing companies in these circumstances may quote different rentals for expenditure taking place at different times during their financial year. The reason for the timing difference

is the variation in the length of time before a lessor obtains tax relief on the expenditure and the time when he starts paying tax on the incoming rental stream. The difference can be significant to a lessor's return

Variation clauses

Depending upon the jurisdiction the lessor may find that the parameters used in the calculation of the rentals, such as tax or the cost of money may have significant effect on the rate of return if changed during the course of the agreement. Some of these variations are covered by including a variation clause into the agreement – in these cases the rental can be changed to reflect the effect of changes to the lessors rate of return.

Agreements may also provide for adjustment to the amount of the rental for several other factors, including the following:

Entitlement to tax relief on new equipment purchase. Rentals may be arrived at on the assumption that the lessor is entitled to tax relief on any expenditure on leased equipment. This assumption may prove to be invalid because of a change in the system of allowances, the tax rate or because the expenditure is regarded as ineligible for one reason or another. The effect of such a clause is complex to calculate and administer for a portfolio of small leases, and the uncertainty involved would be commercially unacceptable both for lessor and lessee. With a large lease, however, a variation clause of this type is not unusual.

Taxation System A change in the basis of taxation may materially affect a leasing company's return. A provision in a lease agreement requiring an adjustment to rentals for any such change may be included by a lessor in

contemplation of a change in the whole structure of the corporation tax system. A lessor may also wish to limit the risk of a loss arising from other, less extensive, taxation changes, such as changes in the due dates for payment of tax.

Exchange Rates A lease may include an arrangement for the rental to be adjusted to reflect any gain or loss on exchange in cases where a lessor intends to finance the acquisition of a specific, normally large-valued item of equipment by way of borrowing in a foreign currency.

Cash Flow Profile For large-value leases, rentals are frequently calculated on a provisional basis by reference to a preliminary set of assumptions agreed by the lessor and lessee. Once the actual figures are known, an adjustment is made (either on a lump sum basis or to future rentals) for any of the assumptions that are not fulfilled. The range of assumptions will vary between individual leasing facilities, but may include the dates of progress payments, the maximum expenditure in any one financial year , the amount of interest incurred in the pre-delivery period or the start date of the lease. In making an adjustment to rentals for a change in any of the assumptions initially used in their computation, a lessor is effectively putting a lessee in the position of being the purchaser of the equipment when the consequences of a change in taxation or other factor would fall directly on the lessee. It is not possible to specify in a leasing agreement the amount by which rentals would vary for any general change in the basis of taxation or for changes in some of the other assumptions described above. In such circumstances, the lease terms will generally require that the rentals are increased, or reduced, by such amount as is appropriate in order to maintain the rate of return on the lessor's investment at the same level as it would have been, had the change not occurred. The difficulty for lessees lies in the number of possible methods by which a lessor can measure the rate of

return on an individual lease. Many leasing companies are not prepared to divulge the details of the basis of their calculation, but some leases include a provision whereby the accuracy of any rental adjustment is certified by a firm of chartered accountants, usually the lessor's auditors.

Interest Variation Leasing companies use several bases for calculating interest adjustments, apart from the broad approach of maintaining the rate of return.

1. Rentals may be fixed in relation to a specified lending rate at the date of expenditure on the leased equipment. Once determined, rentals would remain at the same level throughout the lease period. Lending rates prescribed include London Inter-Bank Offered Rate (related to a specific loan period for funds such a one year) and the base rate of a bank specified by the lessor. A lease including provisions of this type is generally described as "variable up to drawdown".

2. The facility may provide for a specifically calculated period adjustment for the difference between the actual lending rate and the rate of interest initially assumed for the purpose of calculating rentals. Such adjustments are usually made quarterly, semi-annually or annually in arrears either by applying:

(a) the average difference in interest rates over that period, or

(b) the difference in interest rates on the first day of each quarterly, six monthly or annual period (depending usually on rental frequency).

to the amount of the lessor's cash investment in the lease from time to time.

3. There may be a formula setting out the amount by which the rentals are to vary for each 1 per cent change in the average lending rate over the primary lease period. In some cases, the amount of the percentage adjustment is fixed throughout the term; in most cases however it varies year by year, reflecting the lessor's reducing cash investment over the primary period of the lease.

In conjunction with any of these methods, the lease may stipulate either a range of interest rates inside which there is to be no rental adjustment or a maximum and/minimum lending rate above or below which rentals are not to be adjusted. The possible permutations demonstrate the different ways in which both lessors and lessees appraise leasing arrangements, and the different funding arrangements available to the lessor.

Ignoring taxation allowances and a lessor's overheads, an interest variation at the start date of the lease would increase or decrease, as the case may be, the effective interest rate of a rental by the same amount as the change in the prescribed lending rate. Subsequent changes would have a proportionately similar impact. However, to the extent that tax timing differences (allowances claimed and rentals charged) are taken into account in calculating the lease rentals, the effect of interest variation clauses will not necessarily alter the nominal interest rate of the lease by 1 per cent for every 1 per cent change in interest costs.

Once the lessor's cash investment has been reduced to nil at some point during the primary lease period the cost of money is no longer directly relevant and interest variation clauses based on maintaining the lessor's return cease to be operative. In theory, the adjustment during the remainder of the lease period, the reinvestment or cash surplus stage, should be in reverse. Any increase in interest rates in this period over that assumed for the purpose of calculating the

rentals increases a lessor's earnings from the lease – the leasing company receives more interest on its cash surplus. Similarly, a reduction in interest rates decreases a lessor's earnings.

Tax Variation To take account of changes in the rate of corporation tax, lease agreements provide for rentals to be adjusted either by stating that the lessor's rate of return is to be maintained, or by reference to a formula. The formula shows the amount of increase or decrease for each 1 per cent change in the rate of corporation tax applicable to each fiscal year, part or all of which falls within the primary lease period. Some leasing companies make the adjustment by applying a specified factor to a

Index Linking One form of rental variation that has not yet appeared in financial leases is index linking. It is found in several types of operating leasing, such as computers, with rentals being fixed annually either directly or implicitly by reference to a suitable index, such as the replacement cost of the type of equipment being leased. For finance leasing, the introduction of index linking of rentals may depend on developments in the indexing of interest rates.

Progress Payments The acquisition of equipment can involve progress payments to the manufacturer or supplier. In some cases, the pre-delivery period is a few months, but in others, particularly for large valued items such as ships and aircraft, the construction period of the asset may stretch over several financial years. There are a number of possible methods of arranging progress payments.

1. Sale and lease-back before use. The prospective lessee places the order for the equipment, makes the progress payments, and sells his or her interest in the equipment to the lessor immediately before the asset is brought into use.

2. Pre-delivery rentals. The lessor places the order and makes the progress payments. The lessee pays periodic pre-delivery rentals related to the interest incurred by the lessor during the pre-delivery period. The primary period rentals, commencing on the date of delivery of the equipment, are calculated in relation to the capital cost of the equipment.

3. Capitalising interest. The pre-delivery interest is "rolled-up" or capitalised by the lessor. (This is sometimes described as "rentalised). As in "Pre-delivery rentals", the lessor makes the progress payments and a sum equal to the total interest incurred by the lessor on the progress payments up to the date of delivery of the equipment is added to the cost of the equipment for the purpose of calculating primary period rentals.

Lessor's Outgoings

A leasing company often incurs out-of-pocket expenses in setting up a leasing facility, particularly in relation to large-value leases. Such costs may include fees for legal, taxation and accountancy advice, insurance premiums, survey and valuation charges, and commitment fees and other expenses in connection with any loan being arranged by the lessor, such as under the ship mortgage or export finance schemes. A lessor may also pay a commission to a broker for the introduction of business, although often an introductory or consultancy fee is settled directly between the lessee and the broker or adviser.

There are three ways in which a lessor generally recovers outgoings:

1. The lessee makes a separate payment to the lessor for any expenses incurred.

2. The lessor "capitalises" the expenses for rental purposes by adding them to

the cost of the equipment to arrive at the principal amount on which the rentals are to be calculated.

3. The lessor quotes rentals which include an element for any outgoings. Under this arrangement any over-or underestimate of expenses is for the lessor's account.

Early Termination

Lessors and lessees enter into finance lease agreements with the intention of continuing the leasing of the equipment for the whole of the primary lease period. A finance lease is normally unlikely to be attractive to a lessee contemplating termination soon after the start date, and leases do not generally contain specific provisions for voluntary early termination, although provision is made for termination due to a total loss of the goods or following default by a lessee. However, leasing companies are normally prepared to agree to a voluntary early termination during the course of the primary period.

There are various ways of calculating the amount of the terminal payment to be made by the lessee on a voluntary termination, or following a total loss of the equipment. In some cases, the basis is the same as that stipulated in the lease for a termination following a default by the lessee. Although there is no necessity for the provisions to be similar, it is unusual for prescribed voluntary termination arrangements to be significantly more favourable to a lessee because of the possible implication that the payments required to be made on default constitute a penalty in law.

The most common method of calculating the termination payment is to discount future rentals from their due dates back to the proposed date of

payment. The rate at which rentals are to be discounted for calculating the terminal payment varies, but is frequently around 4-5 per cent per annum..

An alternative, more often found in facilities for large-valued items, is for the leasing company to compute a series of termination payments for each month or quarter of the primary lease period using a computer programme and taking into account the main lease terms, the required rate of return and the assumed sale proceeds of the leased equipment. These amounts, expressed as a percentage of the cost of the equipment and sometimes called "stipulated loss values" are then set out in an appendix to the lease agreement. If the lease includes a rental variation clause, the amounts of the termination payments are normally also subject to adjustment for the same factors as the rentals. The appendix may also be subject to variation depending on the actual sale proceeds realised on disposal of the equipment.

The Package

The lessee's choice of the most suitable of the various terms described in the previous sections depends on their availability, cash flow and other requirements. A leasing company is not necessarily prepared to offer prospective customers all the various alternatives and may insist on adhering to its standard terms. It is not difficult to separate a lessor's leasing quotation into its component parts – rate of primary period rental, length of primary period renewal options, variation clauses, etc. Individual lessees will assess the relative importance of the various financial terms differently on the basis of their own requirements, and the equipment or project concerned. Although in certain cases one or more of the terms may be crucial, it is generally the acceptability to both lessor and lessee of the combination of all the terms as a package that matters for the conclusion of a satisfactory transaction

Accounting and Reporting by Lessee

A lessee uses the leased asset and makes regular payments to the lessor. The accounting and reporting of different leases is done as following:

ACCOUNTING FOR FINANCE LEASE BY LESSEE

The finance lease is reported by lessee as follows on different financial statements:

- **Balance Sheet:** Both leased asset and lease payable (liability) is reported. The value reported is lower of the present value of the lease payments in future or the leased asset's fair market value.
- **Income Statement:** The interest expense on the lease payable is reported. It is calculated on the lease payable at the beginning using the implied interest rate in the lease. Generally, the interest rate used is lower of the borrowing rate of a lessee and the implicit rate of a lessor. If the leased asset is depreciable, then a depreciation expense is also reported as with any other asset.
- **Cash Flow Statement:** Under U.S.GAAP, the interest component of the lease payment is reported as an operating cash outflow. And the principal repayment component that reduces the lease payable is reported as a financing cash outflow. Under IFRS, the interest expense can be reported either an operating cash outflow or a financing.

ACCOUNTING FOR OPERATING LEASE BY LESSEE

The operating lease is reported by lessee as follows on different financial statements:

- **Balance Sheet:** Neither an asset nor a liability is reported.
- **Income Statement:** The asset's rent is expensed which is same as the lease payment.
- **Cash Flow Statement:** The complete lease payment or the rent expense

is reported as operating cash outflow.

IMPACT OF LEASE ACCOUNTING ON LESSEE'S FINANCIAL STATEMENTS

The difference in accounting in both the leases – finance and operating impacts the various elements of the financial statements as below**:**

- Assets, liabilities, net income in later years, operating income (EBIT) and cash flow from operations are higher in finance lease as compared to that in operating lease.
- Net income in early years and cash flow from financing are lower in finance lease as compared to that in operating lease.
- Though total income and total cash flow remain same in both the leases.

IMPACT OF LEASE ACCOUNTING ON LESSEE'S FINANCIAL RATIOS

As with financial statements, financial ratios are also impacted by the different leases:

- Current ratio, working capital, asset turnover ratio, fixed asset turnover ratio, return on as sets in early years and return on equity in early years is lower in finance lease.
- Return on assets in later years, return on equity in later years, debt to assets ratio and debt to equity ratio is higher in finance lease.

Accounting and Reporting by Lessor

ACCOUNTING FOR FINANCE LEASE BY LESSOR

For the lessor, the finance lease is of two types under U.S.GAAP. If the present value of all the lease payments is same as the carrying value of the leased asset, such lease is called direct financing lease. If the present value of the lease payments is more than the carrying value of the leased asset, it is called sales type lease. Both these types of finance lease are reported by lessor as follows on different financial statements:

Balance Sheet: The lease receivable is reported. The value is derived from the present value of lease payments in future. Also, the assets are reduced by the book value of the leased asset.

- **Income Statement:** The interest revenue is reported. It is calculated on the lease receivable at the beginning using the interest rate in the lease.
- **Cash Flow Statement:** The interest component of the lease revenue is reported as an operating cash inflow and the principal component of the payment is reported as an investing cash inflow.

ACCOUNTING FOR OPERATING LEASE BY LESSOR

The operating lease is reported by the lessor as follows on different financial statements:

- **Balance Sheet:** The leased asset is reported as always.
- **Income Statement:** The interest revenue is reported as well as the depreciation related to the asset is reported.
- **Cash Flow Statement:** The periodic lease payment is categorized as an operating cash inflow.

IMPACT OF LEASE ACCOUNTING ON LESSOR'S FINANCIAL STATEMENTS

The financial statements of the lessor is impacted by the difference in both the leases in the following ways:

- The lease revenue and the total cash flow is similar under both the leases.
- Income in the early years is higher in finance lease than that of operating lease.
- Income in the later years is lower in finance lease than that of operating lease.

- The operating cash flow is lower in finance lease than operating lease.
- The amount of taxes in early years is higher in finance lease than operating lease.

Conclusion: The accounting and reporting of a lease differ from the perspective of a lessor and a lessee. It also further differs depending on the type of lease – finance or operating. Thus, it is imperative that the lease is properly categorized and reported as it has numerous implications on financial statements and financial ratios.

Summary:

- a lease is contractual arrangement in which the owner of the asset (lessor) grants the right to use that asset to the user(lessee) for an agreed period of the time in return for periodic payment retail on the expiry of the lease period , the asset reverts back to the owner.
- Essential element of leasing:

1) Parties to the lease agreement are lessor & lessee

2) The property or equipment to be leased is the subject manner of the lease

3) Ownership is separated from the economic use of the leased asset

4) Lease rentals are payable by the lessee

5) The lease is terminated at the end of the lease period in various ways

- **Classification**

1) Finance lease and operating lease

2) Sale and lease back & direct lease

3) Single investor lease & lever aged lease

4) Domestic lease & international lease

- **Contents of the lease agreement:** classes contains the lease agreement specifies. Nature of the lease, description of the leased equipment's, delivery & redelivery of the equipment's, lease, lease rentals payable but the lease, lawful use of the equipment , responsibility for repair & maintenance insurance of

leased asset , that alteration may be made without written consent of the lesser, applications etc.

- **Advantages of leasing:**

1) leasing gives advantages both to the lessor & lessees.
2) Flexibility
3) User orientation
4) Tax benefits
5) Convenience
6) Expeditious disbursement of funds
7) Hundred percentage financing
8) Better utilization of own funds for alternatively purpose.

- **Limitations of leasing:**

1) Restriction on use of leased asset
2) Loss of residual value to the lessee
3) Understatement of lessees and so on

- **Players in leasing:** In India are independent companies , other finance & investment company , manufactures lessors, developments finance institutions house lessor and commercial banks.

- **Product profile**

1) finance lease is popular.
2) Rentals are structured to suit lessee's requirements
3) Rentals recovers the entire investment during the primary lease period
4) Most of the lease transaction are direct lease.
5) Sale and lease back types are rare
6) Cross border lease are not popular

- **Problems of leasing**:

1) leasing in India still in nascent stage .
2) experts in leasing are not adequate
3) lesser tax shelters lessee tax burden
4) a heavy stamp duty is levied on lease documents.

- An immediate solution for this problem is called for if leasing industry in India is to prosper.
- Leasing agreements:

A lease agreement is simply a contract between a landlord and a tenant that states what the tenant will pay monthly for rent and for how long.

2.1 What is a 'Hire Purchase'

A hire purchase is a method of buying goods through making installment payments over time. The term "hire purchase" originated in the United Kingdom and is similar to rent-to-own arrangements in the United States. Under a hire purchase contract, the buyer is leasing the goods and does not obtain ownership until the full amount of the contract is paid.

Difference between Hire Purchase vs. Installment Purchase

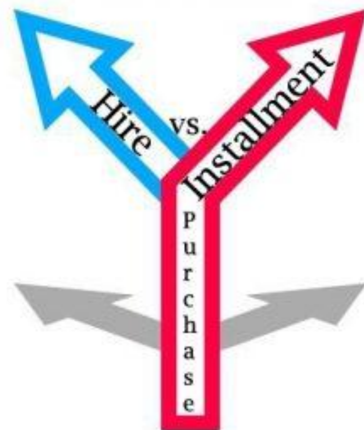
Both hire purchase and installment sale are popular methods of financing goods. These methods are different to each other in terms of their option to purchase, a right of termination, and transfer of ownership.Hire purchase is defined as an arrangement between hirer (buyer or User) and seller of an asset whereby the seller allows the hirer to use the asset for a regular payment of installment for the purchase price. The buyer also has the option to purchase the goods on payment of all the installments. Whereas installment purchase is defined as another method of financing the capital goods / assets whereby the goods are purchased by the buyer but the payment is made in smaller installments.

HIRE PURCHASE VS. INSTALLMENT PURCHASE

Both hire purchase and installment purchase may look similar as both are a method of finance and payment in both the cases is made in smaller parts. In that impression, it is interesting to know the differences between the two. Following are the points of differences in these two methods of financing.

TIME OF PURCHASE AND OWNERSHIP

In the case of hire purchase, the act of purchasing takes place only when whole payment is made to the financing company. It means after making payment of the last hire charges / installment only, the goods are considered purchased or if the buyer or hirer prepays in a lump sum in between the agreed period for purchasing the goods. In the case of installment purchase, the purchase happens as soon as the agreement between the buyer



and financing company is entered into. In hire purchase, both ownership and purchase is delayed till the complete payment whereas in installment purchase, purchase and ownership take place before the complete payment.

OPTION / RIGHT TO TERMINATE

The hirer, in the case of hire purchase agreement, has an option / right to terminate the agreement and return the goods whereas there is no such right or option available to the buyer in case of installment purchase. This is because the purchase has not taken place in case of hire purchase but it takes place at the beginning only.

INSTALLMENT/HIRE CHARGES

The monthly or period payment in installment purchase is termed as installment whereas, in hire purchase arrangement, it is called hire charges. Installment derives its value from the length of time, the sale value of an asset, and interest rate whereas the hire charges is a function of two additional factors viz. option of termination and repairs and

maintenance. Ideally, the installment should be less than the hire charges for the same asset. Therefore, hire purchase is an expensive system compared to installment purchase.

RISK, REPAIR AND MAINTENANCE RELATED TO ASSET

In hire purchase, all the risks are born by the financing company till the last payment by hirer because it is the official owner of the asset till that time. In installment purchase, the risks are borne by the buyer from day one. Similarly, repair and maintenance is the headache of financier in the case of hire purchase and buyer in case of installment purchase.

RIGHT TO SELL OR TRANSFER

The right to sell or transfer is always exercised by the owner of the assets. In the case of hire purchase, this right lies with the financing company or seller as the case may be because they are the owners of the asset. In the case of installment purchase, it is with the buyer because he becomes the owner on the day he signs the agreement.

THE DEFAULT OF INSTALLMENT/HIRE CHARGES

When a hirer defaults in the payment of hire charges, the financier has the right to forfeit the money paid till that date and take back the possession of the goods. Whereas in installment purchase, the installment paid are not forfeited and the financier is liable to receive the remaining dues.

HIRE PURCHASING FINANCE

MEANING:

Hiring purchasing is a method of financing the price of goods to be sold on a future data. the goods are led on hire. The purchase paid in installments. The hirer is allowed to option to purchase the goods by paying all installments.

A hire purchase agreement as defined as a transaction in which the goods are led on hire with an option to the hirer to purchase .the following conditions are

1) Payment to made installments over a specified period
2) The position is deliver to the hirer at the time of signing the contact
3) The property in the goods causes to the hirer on payment of last installments
4) Each installments are treated as hire charges . the difficult is made in payment of any installments the seller can take back the goods
5) The hirer is free to return the goods without being required to pay any further installments due after the returns

Difference between the hirer purchase & payments

Sl no	Hirer purchase	Installment payments
1	It is a transaction in which the goods are let on hire with an option to the hirer to purchase them. Price is paid in installments	The contract of the side is entered into the goods are delivered & ownership is delivered & the ownership is transferred to the buyer. Price is paid in installments
2	The hirer has the option to purchase the goods at the time during the term of agreement. The hirer can terminate the agreements at any time before the payment of the last installments.	The buyer is committed to pay the full price.
3	Ownership is transferred to the hirer only when he exercises the option are an payment of the last installments	The ownership is the goods passes on to purchaser simultaneously with the payment of the initial payment
4	Goods can be repossessed on the default of the hirer in payment of installments	The seller has no right to repossess the goods. He has only the right to sure the buyer for the amount due to him.

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HIRE PURCHASE ACT 1946

INTERPRETATION:

1.—In this Act, unless the context otherwise requires—

the words "action", "buyer", "delivery", "goods", "property", "sale", "seller" and "warranty" have the meanings respectively assigned to them by theSale of Goods Act, 1893 ;

the expression "hire-purchase agreement" means an agreement for the bailment of goods under which the bailee may buy the goods or under which the property in the goods will or may pass to the bailee, and where by virtue of two or more agreements, none of which by itself constitutes a hire-purchase agreement, there is a bailment of goods and either the bailee may buy the goods, or the property therein will or may pass to the bailee, the agreements shall be treated for the purposes of this Act as a single agreement made at the time when the last of the

agreements was made;

the expression “credit-sale agreement” means an agreement for the sale of goods under which the purchase price is payable by five or more instalments.

The expression “hire-purchase price” means the total sum payable by the hirer under a hire-purchase agreement in order to complete the purchase of the goods to which the agreement relates, exclusive of any sum payable as a penalty or as compensation or damages for a breach of the agreement;

the word “owner” means the person who lets or has let goods to a hirer under a hire-purchase agreement and includes a person to whom the owner's property in the goods or any of the owner's rights or liabilities under the agreement has passed by assignment or by operation of law;

The word “hirer” means the person who takes or has taken goods from an owner under a hire-purchase agreement and includes a person to whom the hirer's rights or liabilities under the agreement have passed by assignment or by operation of law;

The expression “contract of guarantee” means, in relation to any hire-purchase agreement or credit-sale agreement, a contract, made at the request express or implied of the hirer or buyer, to guarantee the performance of the hirer's or buyer's obligations under the hire-purchase agreement or credit-sale agreement, and the expression “guarantor” shall be construed accordingly;

The expression “total purchase price” means the total sum payable by the buyer under a credit-sale agreement, exclusive of any sum payable as a penalty or as compensation or damages for a breach of the agreement.

(2) Where an owner has agreed that any part of the hire-purchase price may be discharged otherwise than by the payment of money, any such discharge shall for the purposes of sections 5 , 7 , 12 , 13 , 14 , 15 and 16 of this Act, be deemed to be a payment of that part of the hire-purchase price.

2.APPLICATION OF THIS ACT—This Act shall apply in relation to every hire-purchase or credit-sale agreement not being—

(*a*) an agreement relating to livestock, or

(*b*) an agreement between ComhlachasIascaighMharana h-Éireann, Teoranta (The Irish Sea Fisheries Association, Limited), and any of its members,

and the expressions "hire-purchase agreement" and "credit-sale agreement" shall be construed accordingly.

3. REQUIREMENTS RELATING HIRE PURCHASE AGREEMENTS —(1) Before any hire-purchase agreement is entered into in respect of any goods, the owner shall state in writing to the prospective hirer, otherwise than in the note or memorandum of the agreement, a price at which the goods may be purchased by him for cash (in this section referred to as the cash price):

Provided that this subsection shall be deemed to have been sufficiently complied with—

(*a*) if the hirer has inspected the goods or like goods and at the time of his inspection tickets or labels were attached to or displayed with the goods clearly stating the cash price, either of the goods as a whole or of all the different articles or sets of articles

comprised therein, or

(*b*) if the hirer has selected the goods by reference to a catalogue, price list, or advertisement, which clearly stated the cash price either of the goods as a whole or of all the different articles or sets of articles comprised therein.

(2) An owner shall not be entitled to enforce a hire-purchase agreement or any contract of guarantee relating thereto or any right to recover the goods from the hirer, and no security given by the hirer in respect of money payable under the hire-purchase agreement or given by a guarantor in respect of money payable under such a contract of guarantee as aforesaid shall be enforceable against the hirer or guarantor by any holder thereof, unless the requirement specified in the foregoing subsection has been complied with, and—

(*a*) a note or memorandum of the agreement is made and signed by the hirer and by or on behalf of all other parties to the agreement, and

(*b*) the note or memorandum contains a statement of the hire-purchase price and of the cash price of the goods to which the agreement relates and of the amount of each of the instalments by which the hire-purchase price is to be paid and of the date, or the mode of determining the date, upon which each instalment is payable, and contains a list of the goods to which the agreement relates sufficient to identify them, and

(*c*) the note or memorandum contains a notice, which is at least as prominent as the rest of the contents of the note or memorandum, in the terms prescribed in the Schedule to this Act, and

(*d*) a copy of the note or memorandum is delivered or sent to the hirer within seven days of the making of the agreement:

Provided that if the Court is satisfied in any action that a failure to comply with the requirements specified in the foregoing sub-section or any requirement specified in paragraph (*b*), (*c*) or (*d*) of this subsection has not prejudiced the hirer, and that it would be just and equitable to dispense with the requirement, the Court may, subject to any conditions that it thinks fit to impose, dispense with that requirement for the purposes of the action.

4. REQUIREMENTS RELATED TO CREDIR SALE AGREEMENTS—(1) Before making any credit-sale agreement under which the total purchase price exceeds five pounds, the seller shall state in writing to the prospective buyer, otherwise than in the note or memorandum of the agreement, a price at which the goods may be purchased by him for cash (in this section referred to as the cash price):

Provided that this subsection shall be deemed to have been sufficiently complied with—

(*a*) if the buyer has inspected the goods or like goods and at the time of his inspection tickets or labels were attached to or displayed with the goods clearly stating the cash price, either of the goods as a whole or of all the different articles or sets of articles comprised therein, or

(*b*) if the buyer has selected the goods by reference to a catalogue, price list or advertisement, which clearly stated the cash price either of the goods as a whole or of all the different articles or sets of articles comprised therein.

(2) A person who has sold goods by a credit-sale agreement under which the total purchase price exceeds five pounds shall not be entitled to enforce the agreement or any contract of guarantee relating thereto, and no security given by the buyer in respect of

money payable under the credit-sale agreement or given by a guarantor in respect of money payable under such a contract of guarantee as aforesaid shall be enforceable against the buyer or guarantor by any holder thereof, unless the requirement specified in the foregoing subsection has been complied with, and

(*a*) a note or memorandum of the agreement is made and signed by the buyer and by or on behalf of all other parties to the agreement, and

(*b*) the note or memorandum contains a statement of the total purchase price and of the cash price of the goods to which the agreement relates and of the amount of each of the instalments by which the total purchase price is to be paid and of the date, or the mode of determining the date, upon which each instalment is payable, and contains a list of the goods to which the agreement relates sufficient to identify them, and

(*c*) a copy of the note or memorandum is delivered or sent to the buyer within seven days of the making of the agreement:

Provided that, if the court is satisfied in any action that a failure to comply with the requirement specified in the foregoing subsection or any requirement specified in paragraph (*b*) or (*c*) of this subsection has not prejudiced the buyer, and that it would be just and-equitable to dispense with the requirement, the court may, subject to any conditions that it thinks fit to impose, dispense with that requirement for the purposes of the action.

5. RIGHTS OF THE HIRER IN HIRE PURCHASE AGREEMENT(1) A hirer shall, at any time before the final payment under a hire-purchase agreement falls due, be entitled to determine the agreement by giving notice of termination in writing to any person entitled or authorised to receive the sums payable

under the agreement, and shall, on determining the agreement under this section, be liable, without prejudice to any liability which has accrued before the termination, to pay the amount, if any, by which one-half of the hire-purchase price exceeds the total of the sums paid and the sums due in respect of the hire-purchase price immediately before the termination, or such less amount as may be specified in the agreement.

(2) Where a hire-purchase agreement has been determined under this section, the hirer shall, if he has failed to take reasonable care of the goods, be liable to pay damages for the failure.

(3) Where a hirer, having determined a hire-purchase agreement under this section, wrongfully retains possession of the goods, then, in any action brought by the owner to recover possession of the goods from the hirer, the court shall, unless it is satisfied that having regard to the circumstances it would not be just and equitable so to do, order the goods to be delivered to the owner, without giving the hirer an option to pay the value of the goods.

(4) Nothing in this section shall prejudice any right of a hirer to determine a hire-purchase agreement otherwise than by virtue of this section.

6. AVOIDANCE OF CERTAIN PROVISIONS: Any provision in any agreement—

(*a*) whereby an owner or any person acting on his behalf is authorised to enter upon any premises for the purpose of taking possession of goods which have been let under a hire-purchase agreement, or is relieved from liability for any such entry, or

(*b*) whereby the right conferred on a hirer by this Act to determine the hire-purchase agreement is excluded or restricted, or whereby any liability in addition to the liability imposed by this Act is

imposed on a hirer by reason of the termination of the hire-purchase agreement by him under this Act, or

(*c*) whereby a hirer, after the determination of the hire-purchase agreement or the bailment in any manner whatsoever, is subject to a liability which exceeds the liability to which he would have been subject if the agreement had been determined by him under this Act, or

(*d*) whereby any person acting on behalf of an owner or seller in connection with the formation or conclusion of a hire-purchase or credit-sale agreement is treated as or deemed to be the agent of the hirer or the buyer, or

(*e*) whereby an owner or seller is relieved from liability for the acts or defaults of any person acting on his behalf in connection with the formation or conclusion of a hire-purchase agreement or credit-sale agreement,

shall be void.

7. DUTY OF OWNERS AND SELLERS TO SUPPLY DOCUMENTS AND INFORMATION(1) At any time before the final payment has been made under a hire-purchase agreement or credit-sale agreement, any person entitled to enforce the agreement against the hirer or buyer shall, within four days after he has received a request in writing from the hirer or buyer and the hirer or buyer has tendered to him the sum of one shilling for expenses, supply to the hirer or buyer a copy of any memorandum or note of the agreement, together with a statement signed by the said person or his agent showing—

(*a*) the amount paid by or on behalf of the hirer or buyer,

(*b*) the amount which has become due under the agreement but remains unpaid, and the date upon which each unpaid instalment

became due, and the amount of each such instalment, and

(*c*) the amount which is to become payable under the agreement, and the date or the mode of determining the date upon which each future instalment is to become payable, and the amount of each such instalment.

(2) In the event of a failure without reasonable cause to comply with the last foregoing subsection, then, while the default continues—

(*a*) no person shall be entitled to enforce the agreement against the hirer or buyer or to enforce any contract of guarantee relating to the agreement, and, in the case of a hire-purchase agreement, the owner shall not be entitled to enforce any right to recover the goods from the hirer, and

(*b*) no security given by the hirer or buyer in respect of money payable under the agreement or given by a guarantor in respect of money payable under such a contract of guarantee as aforesaid shall be enforceable against the hirer or buyer or the guarantor by any holder thereof,

7. APPROPRIATION OF PAYMENTS MADE IN RESPECT OF HIRE PURCHASE AGREEMENTS: A hirer who is liable to make payments in respect of two or more hire-purchase agreements to the same owner shall, notwithstanding any agreement to the contrary, be entitled, on making any payment in respect of the agreements which is not sufficient to discharge the total amount then due under all the agreements, to appropriate the sum so paid by him in or towards the satisfaction of the sum due under any one of the agreements, or in or towards the satisfaction of the sums due

under any two or more of the agreements in such proportions as he thinks fit, and, if he fails to make any such appropriation as aforesaid, the payment shall by virtue of this section be appropriated towards the satisfaction of the sums due under the respective hire-purchase agreements in the proportions which those sums bear to one another.

Illustration :1(when rate of interest is not given)

Mr. X purchased a machine on hire purchase system of Rs. 3000 being paid on delivery and the balance in five installments of Rs 6000 each, payable annually on 31stdecembeer. The cash price of the machine was Rs 30,000. Calculate the amount of interest for each year.

Solution:

1st year = Amount outstanding for interest after down payment Rs. 30,000

2nd year = Amount outstanding for interest after 1st installment Rs. 24,000

3rd year = Amount outstanding for interest after 2nd installment Rs. 18,000

4th year = Amount outstanding for interest after 3rdinstallment Rs. 12,000

5th year = Amount outstanding for interest after 4th installment Rs. 6,000

Ratio of outstanding amounts = 5:4:3:2:1

Hire purchase price = Total of all installments

Total interest = hire purchase price - cash price

= 33000 – 30000 = 3000

Interest = Rs. 3,000

installments	No of outstanding Installments	Ratio of interest	Interest in Rs
1st installment	5	5/15	3000 x 5/15 = 1000
2nd installment	4	4/15	3000x 4/15 =800

3rd installment	3	3/15	3000x3/15 =600
4th installment	2	2/15	3000x2 /15 = 400
5th installment	1	1/15	3000 x 1/15 = 200
Total	15		

Illustration :2 (When the rate of interest, cash price, and installments are given)

On 1.1.86 X purchased machinery on hire purchase system. The payment is to be made of Rs. 4000 down (on signing of the contract) and Rs 4000 annually for three years. The cash price of the machinery is Rs. 14,900 and the rate of interest is 5%. Calculate the interest in each year installment.

Solution; Table showing calculation of interest

Particulars	Total cash price (Rs)	Installment paid (Rs)	Interest paid (Rs)	Cash price paid (Rs)
Cash price Down payment	14,900 4000	4000	——	4000
	10,900			
1st installment	3,455	4000	545	3,455
	7445			
2nd installment	3627.75	4000	372.25	3,627.75
	3817.25			
3rd installment	3817.25	4000	182.75	3,817.25
	Nil	16,000	1,100	14,900

2.2FACTORING & FORFEITING

MEANING:

Factoring is the method of were by a company sells is its trade debts at a discount to the financial institution.

The factoring is the continuing agreements between the financial institutions / bankers (factors) & company (client) .Selling goods on providing services on credit. The factor purchases the client trade debts. The client is immediately paid 80-85% of uncollected paid debts. The remaining sum is paid as & when collected from trade customers.

Definition: factoring involves the outright sale of receivable at a discount factor to obtain a funds-*M.Y.KHAN.*

TYPES OF FACTORING

1) Recourse & non-recourse factoring
2) Advantage & maturity factoring
3) Full factoring
4) Disclosed & un disclosed factoring
5) Domestic & international factoring

1. Recourse and Non-Recourse Factoring:

In a recourse factoring arrangement, the factor has recourse to the client (selling firm) if the receivables purchased turn out to be bad, i.e., the risk of bad debts is to be borne by the client and the factor does not assume the risks of default associated with receivables. The difference between recourse and non-recourse factoring is mainly on account of risk factor.

Whereas, in case of non-recourse factoring, the risk or loss on account of non-payment by the customers of the client is to be borne by the factor and he cannot claim this amount from the selling firm. Since the factor bears the risk of non-payment, commission or fees charged for the services in case of non-recourse factoring is higher than under the recourse factoring.

The additional fee charged by the factor for bearing the risk of bad debts/non-payment on maturity is called del crederecommission.

2. Advance and Maturity Factoring:

Under advance factoring arrangement, certain percentage of receivables is paid in advance to the client, the balance being paid on the guaranteed payment date.

But, in case of maturity factoring, no advance is paid to the client and the payment is made to the client only on collection of receivables or the guaranteed payment date as may be agreed between the parties. Thus, maturity factoring consists of the sale of accounts receivables to a factor with no payment of advance funds at the time of sale.

3. Conventional or Full Factoring:

In conventional or full factoring, the factor performs almost all the services of factoring including non-recourse and advance factoring. It is also known as old Line Factoring.

4. Domestic and Export Factoring:

The basic difference between the domestic and export factoring is on account of the number of parties involved. In domestic factoring three parties are involved, namely, the selling firms (client), the factor and the customer of the client (buyer).

In contrast, four parties are involved in case of export or cross-border factoring. Namely, the exporter (selling firm or client), the importer or the customer, the export factor and the import factor. Since, two factors are involved in the export factoring; it is also called two-factor system of factoring.

LEGAL ASPECTS OF FACTORING:

1) **A** client undertake to sell and the factor agrees to purchase receivables, subject to terms & conditions specified to the agreements

2) The client warrants that a receivable are valid , enforceable, undisputed & recoverable. He undertakes to settle disputes , damages & detection relating to bills assigned to the factor

3) The client agrees that the bills purchased by the factor non resources basic well arise only from transaction approved by the factor those calling within the credit limits authority by the factors.

2.3 FORFAITING

Forfaiting is a form of financing of receivables in international trades. It is a purchase of trade bills, promissory notes by a bank or financial institution to the seller. The purchase is through discount the documents the entire risk of non-payment in collection.

The purchaser assumes all risk and the responsibility for the collection .he pays cash to the seller after discounting the bills are notes.

DEFINITION: the non-recourse purchase by the bank in all any other financial institution of receivable arising from an export of goods & services.

FEATURES:

1. As per the commercial contract between the exporter & importer, the exporter sells & delivers the goods to the importer on a deferred payment basis.
2. The importer accepts the series of bills drawn on him by the exporter. The promissory notes & bills are graduated by the banks.
3. The guaranteed by the bank is known as *aval.*
4. *AVAL* is defined as an endorsement by a bank guarantying payment by a buyer(importer).
5. Forfaiter pays to the exporter the face value of the bill or note less discount.
6. Forfaiter may hold these notes or bills till maturity for payment by the importers bank.

FACTORING Vs FORFAITING

SL NO	**FORFAITING**	**FACTORING**
1	It is ideal for medium term financing at a fixed rate of interest. It finances notes or bills arising out of deferred credit transaction spread over 3 or 5 years.	It is used for short term financing
2	It is used in export business.	It is used to finance both domestic & export business.
3	It discount the entire value of the note or bills.	It only the partial ranging between 80-85%. The balance is rented by the factor as a factor reserve which is paid after maturity.
4	In this arrangement the availing bank provides an unconditional and irrevocable guarantee. The	In a factoring of a non-resource type the export factor credits decision is based on the standing of the exporter participate decision credit extension

	forfaiter provides finance depending upon the finance standing of the availing bank	& credit protection process.
5	Forfaiting is the pure financing arrangement	Apart from financing & factoring includes legal administration collection & so on.
6	It charges premium for guarding against exchange rate fluctuations	A factor does not guard against exchange rate fluctuation.
7	It is done without recourse to the client.	Factoring is with or without recourse to the client.

2.4 Factoring in India:

Factoring owns its existence to the recommendation to the *kalyanasundaram* study group appointed by RBI in 1989. On the basis of the recommendation , RBI issued guidelines for factoring services in1990.the first factoring company , namely SBI factors , commercials factors ltd…commends its operations in 1990

Recommendations of kalyanasundaram committee

1) Initially the organization may be promoted on a zonal basis
2) The services of export factor would largely availed on the export fund.
3) Factors should of the services the sectors in the company.
4) The introduction of export factoring services would provide an additional facility to exporters.
5) Factors should offer their services to all industries and all sector in the company
6) The central government and RBI should set up the specialized agencies for credit investigations.
7) Small industries development bank of India in association with one or more commercials bank may undertake factoring activities.
8) Support of computers quick & dependable means of communications are needed for the effective discharge factoring services.

9) Only promoter institution or group of individuals with good track record in financial services should be allowed entry into this field.

10) The subsidiaries or associates of bank are ideally suited for undertaking factoring services

11) Bank branches should educate the business community about the nature and scope of the services & the benefits accruing therefrom.

12) Suppliers can obtain financial services for both banks and factors. So it is required to provide for proper linkage between bank & factoring organizations.

Accounts Receivable Management

Accounts receivable refers to the outstanding invoices a company has or the money the company is owed from its clients. ... Receivables essentially represent a line of credit extended by a company and due within a relatively short time period, ranging from a few days to a year.

An account receivable clerk is an accounting professional who ensures organizations receive payment for services offered or goods sold to clients. This typically involves sending bill reminders and statements to clients, posting financial transaction to an accounting system and making bank d**eposits.**

BREAKING DOWN 'Accounts Receivable - AR'

On a public company's balance sheet, accounts receivable is often recorded as an asset, because there is a legal obligation for the customer to remit cash for the debt. If a company has receivables, this means it has made a sale but has yet to collect the money from the purchaser. Essentially, the company has accepted an IOU from its client.

Why Do Businesses Have Accounts Receivable?

Most companies operate by allowing some portion of their sales to be on credit. In some cases, business offer this type of credit to frequent or special customers who are invoiced periodically. The practice allows customers to avoid the hassle of physically making payments as each transaction occurs. In other cases, businesses routinely offer all of their clients the ability to pay after receiving the service. For example, electric companies typically bill their clients after the clients have received the electricity. While the electricity company waits for its customers to pay their bills, the unpaid invoices are considered accounts receivable.

What Happens When a Company Cannot Collect Its Accounts Receivable?

If a company cannot collect its accounts receivable, it may decide to take the debtor to court over the unpaid debt, or it may outsource the debt collection activity to a third-party bill collector. These companies typically charge a set fee or a percentage of the amount they collect. In other cases, businesses sell their accounts receivable for pennies on the dollar to a factoring company that then collects the debt. Factoring companies often offer some cash up front, making them an attractive option for companies that need a boost to their working capital.

If a business has reported an account receivable as income and it does not receive payment, it has a bad debt. The Internal Revenue Service (IRS) allows businesses to subtract bad debts from their gross income on their income tax returns, as long as they reported the debt as income on a previous return.

DATA SECURITISATION:

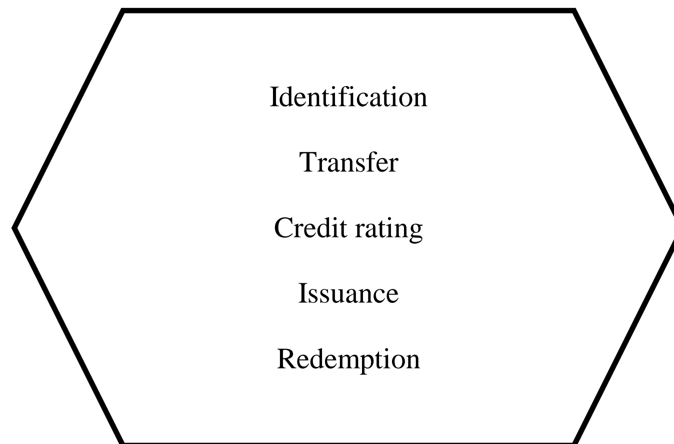
Asset specification is an innovative financial technique in the name of financial services. Banks & finance companies with the backing of underlying asset (higher purchase & property receivables) offer securitization packages.

Banks & financial institutions give loans for the purchases of assets such as cars, houses, trucks, machinery etc.

They hold a pool of individual loans and receivable that generates cash flows. Security that creates again then, which are sold to investors.

Definition: "asset securitization is a process of separating certain assets from the balance sheet & using them as collateral from the issuances of securities".

The securitisation-process in nutshell.



Summary:

- Factoring is the fund based financial services
- It finance receivables & facilities the collection of receivables.it involves the outright sale of receivables at a discount to a factor to obtain funds.

- The functions of factors are maintenance & administration of sales ledger, collection facility, financing facility, assumption of credit risk & provision of advisory services.
- The factor varies in its form and content .There are 1) recourse and non-recourse factoring 2) Advantage & maturity factoring 3) Full factoring 4) Disclosed & un disclosed factoring 5) Domestic & international factoring.
- The legal relationship between the factor & client is governed by the provisions of the factoring contract
- Factoring gives the several advantages 1) off-balance sheet financing 2) reduction in current liabilities 3) improvements in current ratio 4) reduction of cost 5)additional source of funds 6) higher credit of standing.
- In India still in nascent stage. Factoring owns its existence to the recommendation to the *kalyanasundaram* study group appointed by RBI in 1989. On the basis of the recommendation , RBI issued guidelines for factoring services in1990.the namely SBI factors , commercials factors ltd
- Factoring in India encounters series obstacles, lack of specialized credit information agency, stamp duty on assignment of debt, legal hassles, funding limitations & limited coverage. If factoring is to grow these problems to be solved.

Securitisation is an innovative financial service. It is the process of separating separate asset from the balanced sheet using them as collateral for the issues of the security.

Parties of securitisation include:

1. **Originator:** the seller identifies a pool of loans and receivables from asset port folio
2. **SPV:** the originator transvers assets to SPV. The SPV converts these assets into securitized instruments. it receives security to investors
3. **Rating agency:** an independent expending expert evaluates the assets backing and gives certification on these.
4. **Trustee:** the investors representative safeguards the interest of investors
5. **Investors:** holders of securitized instruments redeem them on maturity.

Debt securitisation benefits originators, investors and borrowers. Lower cost of capital, easy access to capital market, risk transfer, improvement in balanced sheet statics etc.The some important benefits available to originators. Investors get higher return on securitized instruments.

3.1 CREDIT RATING:

Definition: “rating are designed exclusively for the purpose of grading bonds according to the investments qualities”- *moodies.*

“Credit rating is an unbiased & independent opinion as to issuer’s capacity to meet its financial obligations. It does not constitute a recommendation or buy or sell or hold a particular security”- *crisil.*

The above definition reveals the some important features of credit ratings

1) Credit rating indicates the current opinion of the independent professional agency on the relative ability of the issuer of a debt security to meet the debt service obligation.

2) Rating is expressed in term of symbols & code numbers which are easily understandable to investors.

3) Credit rating thus not amount to any recommendation by hold or sell an instrument

4) Credit rating is specific to a debt or a financial instrument intended to grade instruments in term of the credit risks associated with the instruments.

5) Credit rating is neither the general purpose evaluation of a corporate entity nor overall assessments of the credit risks likely to be involved in all the debts contracted by the issuers.

6) Credit rating minimized the role of names recognition even lesser known companies can approach the market on the basic of the ratings .

Who can promote credit rating agency:

1) Public financial institution, defined as the section 4-A of the companies act.

2) Scheduled bank

3) Foreign bank operated in India with RBI approval.

4) Foreign credit rating agency having at least 5 years' experience in rating security.

5) Any company in corporate under the company act having a continuous net worth.

3.2 RATING PROCESS

1) Specify the rating process; file a copy of the save with the SEBI for record.

2) Have a professional rating committee compromising members who are adequately qualified & knowledgeable to assign a rating

3) Be satisfied by analyzed qualified to carry out a rating assignment

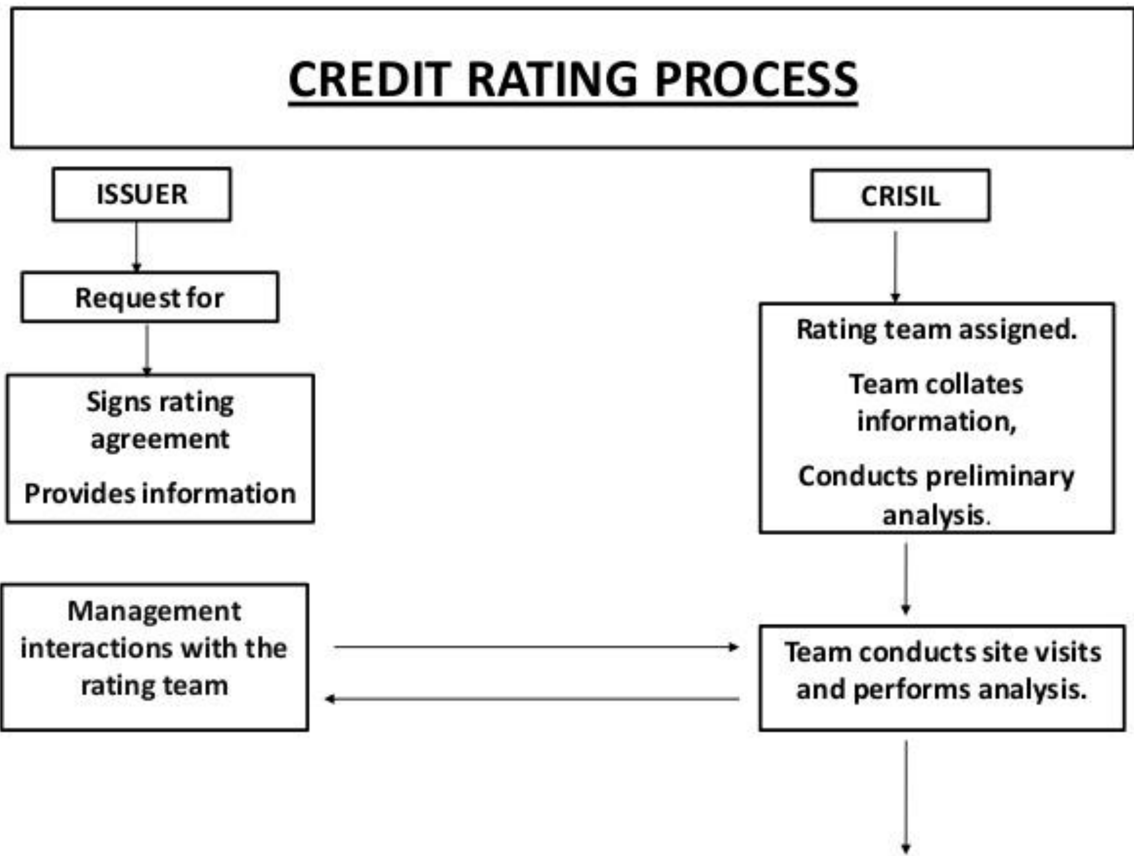
4) Inform the SEBI about new rating instruments are symbols introduced by it.

5) Exercise to diligence in order to ensure that the rating given is fair & appropriate

6) Not to rate security issued by it.

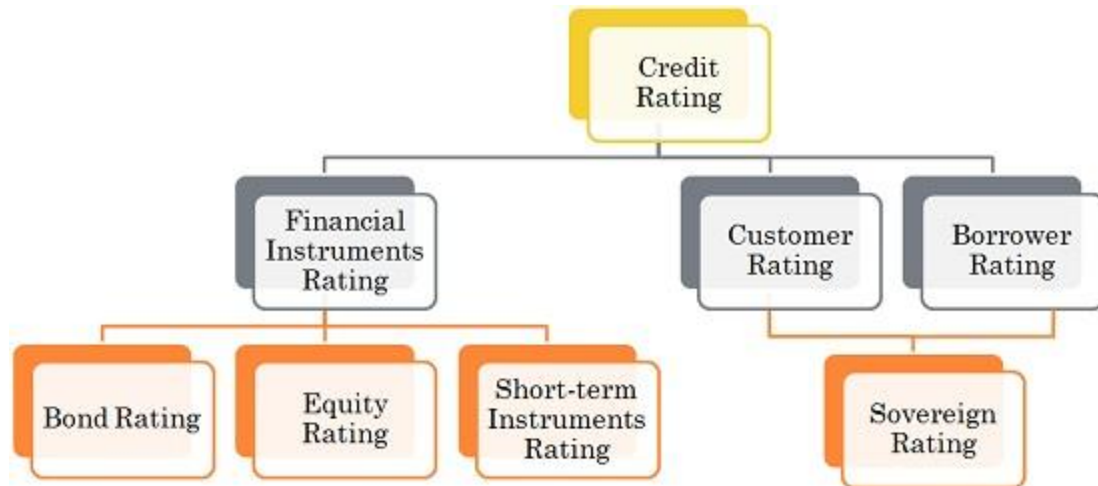
7) Not to change the definition of rating without prior information to the SEBI

8) Disclose to the stock exchange concerned, the rating assigned to the security of a client including changes in ratings.



Credit rating is instrument specific and is meant to grade various commercial instruments, with respect to the credit risk and the obligator's ability to make good the debt obligations, as per the terms of the agreement. The different types of credit ratings

are depicted in the figure below:



- **Request from issuer and analysis**: The first step to credit rating is that the enterprise applies to the rating agency for the rating of a particular instrument. Thereafter, an expert team interacts with the firm's those charged with governance and acquires relevant data. Factors which are considered includes:
  - Historical performance
  - Financial Policies
  - Business Risk profile
  - Competitive Position, etc.
- **Rating Committee**: Based on the information gathered and evaluation performance, the presentation of the report is made by the expert's team to the Rating Committee, in which the issuer is not permitted to take part.
- **Communication to management and appeal**: The decision of the rating is shared with the issuer and if he/she does not agree with the decision, then an opportunity of being heard is given. The issuer is required to provide material information, so as to appeal against the decision. The decision is reviewed by the committee, but that does not make any change in the ratings.
- **Pronouncement of the rating**: When the issuer agrees to the rating decision, the agency make a public announcement, of the rating.

- **Monitoring of the assigned rating**: The agency which rates the issue, overlooks the performance of the issuer and the business environment in which it operates.
- **Rating Watch**: On the basis of continuous critical observation undertaken by the rating agency, it may place a rated security on Rating Watch.
- **Rating Coverage**: Credit Ratings are not confined to particular debt instruments, but also covers public utilities, transport, infrastructure, energy projects, Special Purpose Vehicles etc
- **Rating Scores**: Rating scores are given by the credit rating agencies like CRISIL, ICRA, CARE, FITCH.

Credit Rating is of great help, not just in investors protection but to the entire industry, as it directly mobilizes savings of the individuals.

3.3 What is a 'Sovereign Credit Rating'

A sovereign credit rating is the credit rating of a country or sovereign entity. Sovereign credit ratings give investors insight into the level of risk associated with investing in a particular country and also include political risks. At the request of the country, a credit rating agency will evaluate the country's economic and political environment to determine a representative credit rating. Obtaining a good sovereign credit rating is usually essential for developing countries in order to access funding in international bond markets.

The Effects of Sovereign Ratings

Sovereign ratings have many effects on countries around the world. Several studies have shown that better sovereign ratings are associated with lower credit spreads. In turn, these lower spreads equate to lower financing costs for countries issuing bonds.

The effects of these higher spreads and financing costs can include:

- **Inflation Risk**. Central banks that print more currency to cover current and future debts risk causing inflation, which itself can lead to a number of economic problems.
- **Political Instability**. Countries that are unwilling or unable to print more currency may undergo austerity measures to cut their costs, which can result in civil unrest.
- **Fewer Options**. Central banks facing high borrowing costs may not find it as economical to provide stimulus packages or other growth incentives during difficult times.

But in either case, sovereign ratings represent a useful tool for international investors to determine a country's investment quality.

- Sovereign credit ratings have become increasingly popular as countries seek to tap the bond markets and investors look for opportunities.
- These ratings are calculated by companies like Standard and Poor's or Moody's based on a number of different criteria.
- Better sovereign ratings can reduce inflation risk, ensure political stability, and make it cheaper to borrow money when needed

Venture Capital Definition

A venture capital can be defined as a temporary equity or quasi-equity investment in a growth-oriented small or medium business managed by a highly motivated entrepreneur. The investment is combined with managerial assistance.

3.4 Venture capital finance

In the conventional method, investment is undertaken by companies through stock market. Companies normally get their finance through promoters or shareholders and later when they become highly profitable, they go for commercial borrowings.

After reaching a particular stage, companies expand their capital structure through the stock exchanges. It is very difficult for an entrepreneur to raise capital in traditional way even though he possess good knowledge.

Hence a new method of financing long term capital to medium and small scale sectors is adopted through institutional mechanism which gave birth to Venture capital finance.
Before going in for venture capital finance, the venture capital institution will have to assess the potentiality of the borrowing concern by a proper appraisal. This appraisal will be similar to the project appraisal undertaken by commercial banks.

Features of Venture capital

The following are the features of venture capital

1. It is basically **financing of new companies** which are finding it difficult to go to the capital market at their early stage of existence.
2. This **finance can also be loan-based or in-convertible debentures** so that they carry a fixed yield for the providers of venture capital.
3. Those who provide venture capital **aim at capital gain due to the success achieved by the concern** that borrows.
4. It is a **long-term investment** and made in companies which have high growth potential. The provision of venture capital will bring rapid growth for the business.
5. The venture capital provider will also **take part in the business of borrowing concern** whereby, the venture capital financier not merely confines to finance, but also provide managerial skill.
6. Not all the capitalists will experience high risk. But venture capital financing **contains risks**. But the risk is compensated with a higher return.
7. Not much of technology is involved in venture capital, it **involves financing mainly small and medium size firms**, which are in their early stages. With the assistance of venture capital, these firms will stabilize and later can go in for traditional finance.

3.5 Types of Venture Capital funding

The various types of venture capital are classified as per their applications at various stages of a business. The three principal types of venture capital are early stage financing, expansion financing and acquisition/buyout financing.

The venture capital funding procedure gets complete in six stages of financing corresponding to the periods of a company's development

- *Seed money: Low level financing for proving and fructifying a new idea*
- *Start-up: New firms needing funds for expenses related with marketingand product development*
- *First-Round: Manufacturing and early sales funding*
- *Second-Round: Operational capital given for early stage companies which are selling products, but not returning a profit*
- *Third-Round: Also known as Mezzanine financing, this is the money for expanding a newly beneficial company*
- *Fourth-Round: Also calledbridge financing, 4th round is proposed for financing the "going public" process*

A) Early Stage Financing:

Early stage financing has three sub divisions seed financing, start up financing and first stage financing.

- Seed financing is defined as a small amount that an entrepreneur receives for the purpose of being eligible for a start up loan.
- Start up financing is given to companies for the purpose of finishing the development of products and services.
- First Stage financing: Companies that have spent all their starting capital and need finance for beginning business activities at the full-scale are the major beneficiaries of the First Stage Financing.

B) Expansion Financing:

Expansion financing may be categorized into second-stage financing, bridge financing and third stage financing or mezzanine financing.

Second-stage financing is provided to companies for the purpose of beginning their expansion. It is also known as mezzanine financing. It is provided for the purpose of assisting a particular company to expand in a major way. Bridge financing may be provided as a short term interest only finance option as well as a form of monetary assistance to companies that employ the Initial Public Offers as a major business strategy.

C) Acquisition or Buyout Financing:

Acquisition or buyout financing is categorized into acquisition finance and management or leveraged buyout financing. Acquisition financing assists a company to acquire certain parts or an entire company. Management or leveraged buyout financing helps a particular management group to obtain a particular product of another company.

Advantages of Venture Capital

- They bring wealth and expertise to the company
- Large sum of equity finance can be provided
- The business does not stand the obligation to repay the money
- In addition to capital, it provides valuable information, resources, technical assistance to make a business successful

Disadvantages of Venture Capital

- As the investors become part owners, the autonomy and control of the founder is lost
- It is a lengthy and complex process
- It is an uncertain form of financing
- Benefit from such financing can be realized in long run only.

3.6 Investment banking

Investment banking is the process where an institution or organisation, known as the investment bank, which helps a person or organisation to raise capital. The procedure may involve the institution to underwrite or act as the client's agent for the purpose.
There may be a few other purposes of investment banking such as:
Market making.
Buy or sell derivatives.
Foreign exchange etc.
Investments banking and commercial banking differs in a few ways. The investment banking does not involve any deposits. There are a few other minor differences but this is the major difference between these two types of banking.

Types of Investment Banking:

Investment banking has two main branches. One of them involves the exchange of securities with cash. Securities may also be exchanged with securities. This branch may also involve promoting some securities. The other branch mainly works with different kinds of funds, pension, hedge, mutual etc. these two are the sell and buy sides of the investment banking. Some investment banks specialises in the buying side while others specialise in the selling side. Some firms specialises in both the components of investment banking.

Parts of Investment Banking:

Investment banks are divided into a few parts. The various activities of an investment bank are divided into three offices, front, back and middle. The jobs of these three parts are further divided into some sub parts.
The front office mainly consists of three activities that include the main work of investment. It also includes research work like writing reviews and reports. And then there is the actual trading.
The middle office mainly works with the strategising and management part of the institution. They strategise new plans, and manage risk, treasury etc.

The back office is mainly a checking facility. It takes on the work of data checking and whether or not the rules and regulations issued are followed.

Why Investment Banking:

This is a common question that may arise in any bodies mind before going for investment banking. Well first of all if you practise investment banking, there is a financial security that comes with it. There are many financial aids also offered by the firms. Moreover you can get expert advice in your investment. And most importantly, investment banking can work for both sides, the one issuing securities as well as the one buying them. These are some of the reasons why one should be interested in investment banking when it comes to buying and selling of securities.

Thus to conclude, we can say that investment banking is a financial market that deals with capitals and securities. They are an institution that, although has been criticised in the recent past for overpaying the people in the industry and also conflict of interest of both the parties involved, that try to help both the issuer and buyer of an financial asset. There means of working has already been discussed and it proves that investment banking is very efficient in solving the aforesaid problems.

Unit 4

4.1 INSURANCE

Insurance is a contract, represented by a policy, in which an individual or entity receives financial protection or reimbursement against losses from an insurance company. The company pools clients' risks to make payments more affordable for the insured.

Insurance policies are used to hedge against the risk of financial losses, both big and small, that may result from damage to the insured or her property, or from liability for damage or injury caused to a third party.

There are a multitude of different types of insurance policies available, and virtually any individuals or businesses can find an insurance company willing to insure them, for a price. The most common types of personal insurance policies are auto, health, homeowners and life insurance policies. Most individuals in the United States have at least one of these types of insurance.

Do you need insurance?

There are lots of different types of insurance – you can cover almost anything, from your wedding to your pets.

Some insurance is compulsory – you can’t drive a car without at least basic car insurance, and you can’t get a mortgage on your house without buildings insurance.

After compulsory insurances, the most important thing is to protect yourself and your family.

The types of insurance that you need will depend on what you need to protect.

Insurance helps you protect yourself against risks like a house fire, car accident or burglary. You can also get insurance that pays you money if you get too ill to work or to provide for your family if you die.

Insurance is a means of protection from financial loss. It is a form of risk management primarily used to hedge against the risk of a contingent, uncertain loss.

An entity which provides insurance is known as an insurer, insurance company, or insurance carrier. A person or entity who buys insurance is known as an insured or policyholder. The insurance transaction involves the insured assuming a guaranteed and known relatively small loss in the form of payment to the insurer in exchange for the insurer's promise to compensate the insured in the event of a covered loss. The loss may or may not be financial, but it must be reducible to financial terms, and must involve something in which the insured has an insurable interest established by ownership, possession, or preexisting relationship.

The insured receives a contract, called the insurance policy, which details the conditions and circumstances under which the insured will be financially compensated. The amount of money charged by the insurer to the insured for the coverage set forth in the insurance policy is called the premium. If the insured experiences a loss which is potentially covered by the insurance policy, the insured submits a claim to the insurer for processing by a claims adjuster.

4.2 Life insurance

Life insurance (or **life assurance**, especially in the Commonwealth of Nations), is a contract between an**insurance** policy holder and an insurer or assurer, where the insurer promises to pay a designated beneficiary a sum of money (the benefit) in exchange for a premium, upon the death of an **insured** person

BASIC PRINCIPLES OF LIFE INSURANCE

Insurance can be defined in many different ways, from many different points of view. For example, from an economic viewpoint, insurance is a system for reducing financial risk by transferring it from a policyowner to an insurer. The social aspect of insurance involves the collective bearing of losses through contributions by all members of a group to pay for losses suffered by some group members. From a business viewpoint, insurance achieves the sharing of risk by transferring risks from individuals and businesses to financial institutions specializing in risk. The insurer is not in fact paying for the loss. The insurer writes the claim check, but is actually transferring funds from individuals

who as part of a pool, paid premiums that created the fund from which the claims are paid. Lastly, from a legal standpoint, an insurance contract (policy) transfers a risk, for a premium (consideration), from one party (the policyowner) to another party (the insurer). It is a contractual arrangement in which the insurer agrees to pay a predetermined sum to a beneficiary in the event of the insured's death. By virtue of a legally binding contract, the possibility of an unknown large financial loss is exchanged for a comparatively small certain payment. This contract is not a guarantee against a loss occurring, but a method of ensuring that payment is made for a loss that does occur. Risk Management Life entails risk, which is the possibility of loss. People generally seek security and avoid uncertainty. The risk of death is unavoidable, and is especially an economic threat if premature, when an individual may be exposed to heavy financial responsibilities, yet has not had the time to accumulate wealth to offset the financial needs of survivors. Life insurance provides a tool for risk management, a process for dealing with the risk of loss of life. risk management Insurance substitutes certainty for uncertainty, through the pooling of groups of people who share the risks to which they are exposed.

Uncertain

Insurance substitutes certainty for uncertainty, through the pooling of groups of people who share the risks to which they are exposed. Uncertain risks of individuals are combined, making the possible loss more certain, and providing a financial solution to the problems created by the loss. Small, certain periodic contributions (premiums) by the individuals in the group provide a fund from which those who suffer a loss are compensated. The certainty of losing the premium replaces the uncertainty of a larger loss. Life insurance thus manages the uncertainty of one party through the transfer of a particular risk (death) to another party (the insurer) who offers a restoration, at least in part, of relatively large economic losses suffered by the insured individual. indemnity The essence of insurance is the principle of indemnity, that the person who suffers a financial loss is placed in the same financial position after the loss as before the loss occurred. He neither profits nor is disadvantaged by the loss. In practice, this is much more difficult to achieve in life insurance than in property insurance. No life insurance company would provide insurance in an amount clearly exceeding the estimated

economic value of the covered life. Limiting the amount of life insurance sold to reflect economic value gives recognition to the rule of indemnity. Additionally, only persons exposed to the potential loss may legitimately own the insurance covering the insured's life.

Risk Pooling

Life insurance is based on a mechanism called risk pooling, or a group sharing of losses. People exposed to a risk agree to share losses on an equitable basis. They transfer the economic risk of loss to an insurance company. Insurance collects and pools the premiums of thousands of people, spreading the risk of losses across the entire pool. By carefully calculating the probability of losses that will be sustained by the members of the pool, insurance companies can equitably (fairly) spread the cost of the losses to all the members. The risk of loss is transferred from one to many and shared by all insureds in the pool. Each person pays a premium that is measured to be fair to them and to all based on the risk they impose on the company and the pool (each class of policies should pay its own costs). If all insureds contribute a fair amount to the mortality fund held by the insurance company, there will be sufficient dollars in the fund to pay the death benefits of those insureds that die in the coming year. Individually, we do not know when we will die, but statistically, the insurer can predict with great accuracy the number of individuals that will die in a large group of individuals. The insurance company has taken an uncertainty on any individual's part, and turned it into a certainty on their part.

4.3 Life Insurance Corporation of India (**LIC**) is an Indian state-owned insurance group and investment companyheadquartered in Mumbai. It is the largest insurance company in India with an estimated asset value of ₹1,560,482 crore .As of 2013 it had total life fund of Rs.1433103.14 crore with total value of policies sold of 367.82 lakh that year.

The Life Insurance Corporation of India was founded in 1956 when the Parliament of India passed the Life Insurance of India Act that nationalised the private insurance industry in India. Over 245 insurance companies and provident societies were merged to create the state owned Life Insurance Corporation.

Founding organisations

The Oriental Life Insurance Company, the first company in India offering life insurance coverage, was established in Kolkata in 1818 by "Anita Bhavsar" and others. Its primary target market was the Europeans based in India, and it charged Indians heftier premiums.Surendranath Tagore had founded Hindusthan Insurance Society, which later became Life Insurance Corporation.

The Bombay Mutual Life Assurance Society, formed in 1870, was the first native insurance provider. Other insurance companies established in the pre-independence era included

- Postal Life Insurance (PLI) was introduced on 1 February 1884
- Bharat Insurance Company (1896)
- United India (1906)
- National Indian (1906)
- National Insurance (1906)
- Co-operative Assurance (1906)
- Hindustan Co-operatives (1907)
- Indian Mercantile
- General Assurance
- Swadeshi Life (later Bombay Life)
- Sahyadri Insurance (Merged into LIC, 1986)

The first 150 years were marked mostly by turbulent economic conditions. It witnessed India's First War of Independence, adverse effects of the World War I and World War II on the economy of India, and in between them the period of worldwide economic crises triggered by the Great depression. The first half of the 20th century saw a heightened struggle for India's independence. The aggregate effect of these

events led to a high rate of and liquidationof life insurance companies in India. This had adversely affected the faith of the general public in the utility of obtaining life cover.

Nationalisation in 1956

In 1955, parliamentarian AmolBarate raised the matter of insurance fraud by owners of private insurance agencies. In the ensuing investigations, one of India's wealthiest businessmen, RamkrishnaDalmia, owner of the *Times of India*newspaper, was sent to prison for two years.

The Parliament of India passed the Life Insurance of India Act on 19 June 1956 creating the Life Insurance Corporation of India, which started operating in September of that year. It consolidated the business of 245 private life insurers and other entities offering life insurance services; this consisted of 154 life insurance companies, 16 foreign companies and 75 provident companies. The nationalisation of the life insurance business in India was a result of the Industrial Policy Resolution of 1956, which had created a policy framework for extending state control over at least 17 sectors of the economy, including life insurance.

Growth as a monopoly

From its creation, the Life Insurance Corporation of India, which commanded a monopoly of soliciting and selling life insurance in India, created huge surpluses and by 2006 was contributing around 7% of India's GDP.

The corporation, which started its business with around 300 offices, 5.7 million policies and a corpus of INR 45.9 crores (US$92 million as per the 1959 exchange rate of roughly ₹5 for US$1), had grown to 25,000 servicing around 350 million policies and a corpus of over ₹800,000 crore (US$120 billion) by the end of the 20th century.

Liberalisation post 2000s

In August 2000, the Indian Government embarked on a program to liberalise the insurance sector and opened it up for the private sector. LIC emerged as a beneficiary from this process with robust performance, albeit on a base substantially higher than the private sector.

In 2013 the first year premium compound annual growth rate (CAGR) was 24.53% while total life premium CAGR was 19.28% matching the growth of the life insurance industry and outperforming general economic growth.[7]

OPERATION

Today LIC functions with 2048 fully computerized branch offices, 8 zonal offices, around 113 divisional offices, 2,048 branches and 1381 satellite offices and corporate offices;[1] it also has 54 customer zones and 25 metro-area service hubs located in different cities and towns of India. It also has a network of 1,337,064 individual agents, 242 Corporate Agents, 89 Referral Agents, 98 Brokers and 42 Banks for soliciting life insurance business from the public.

SLOGAN

LIC's slogan *yogakshemamvahamyaha* is in Sanskrit language which translates in English as "Your welfare is our responsibility". This is derived from ancient Hindu text, the Bhagavad Gita's 9th chapter, 22nd verse.The slogan can be seen in the logo, written in Devanagari script.

AWARDS AND RECOGNITION

- Economic Times Brand Equity Survey 2012 rated LIC as the No. 6 Most Trusted Service Brand of India.
- From the year 2006, LIC has been continuously winning the Readers' Digest Trusted brand award.
- Voted India's Most Trusted brand in the BFSI category according to the Brand Trust Report for 4 continuous years - 2011-2014 according to the Brand Trust Report.

EMPLOYEES AND AGENTS

As on 31 March 2014, LIC had 1,20,388 employees, out of which 24,867 were women (20.65%).

4.4 General insurance

General insurance or non-life **insurance** policies, including automobile and homeowners policies, provide payments depending on the loss from a particular financial event. **General insurance** is typically defined as any **insurance** that is not determined to be life **insurance**.

Life is full of risks. That's what makes it so interesting and exciting. But some unexpected events can really set you back.

General insurance helps us protect ourselves and the things we value, such as our homes, our cars and our valuables, from the financial impact of risks, big and small – from fire, flood, storm and earthquake, to theft, car accidents, travel mishaps – and even from the costs of legal action against us. And we can choose the types of risks we wish to cover by choosing the right kind of policy with the features we need.

In general, insurance works by spreading the cost of unexpected risks among a large number of people in the same region who share similar risks.

When you take out an insurance policy, you pay a monthly or annual premium. That money joins the premiums of many thousands of other policyholders and goes into a big pool of funds.

If things go wrong, your insurer may either repair or replace the items that have been lost or damaged, depending on the terms of your policy. You may also have the choice of receiving a cash settlement for the amount of money agreed in your policy.

The term insurance can be understood as an arrangement, in which the insurer commits to provide compensation for loss, damage, death, caused to the insured in return for the payment of the premium. There are two types of contract, life insurance, and general insurance. The insurance plan which covers the life-risk of the insured is called **life insurance**. On the other hand, the insurance plan which covers any risk other than the life-risk of an individual is called **general insurance**.

Life insurance is also known as assurance, whereby the sum assured is paid to the insured, while the general insurance policies are called as insurance.

Comparison Chart

BASIS FOR COMPARISON	LIFE INSURANCE	GENERAL INSURANCE
Meaning	Life insurance can be understood as the insurance contract, in which the life risk of an individual is covered.	General insurance refers to the insurance, which are not covered under life insurance and includes various types of insurance, i.e. fire, marine, motor, etc.
What is it?	It is a form of investment.	It is a contract of indemnity.
Term of contract	Long term	Short term
Claim payment	Insurable amount is paid, either on the occurrence of the event, or on maturity.	Loss is reimbursed, or liability incurred will be repaid on the occurrence of uncertain event.
Premium	Premium has to be paid over the years.	Premium should be paid in lump sum.
Insurable interest	Must be present at the time of contract.	Must be present, both at the time

BASIS FOR COMPARISON	LIFE INSURANCE	GENERAL INSURANCE
		of contract and at the time of loss.
Policy value	It can be done for any value based on the premium the policy holder willing to pay.	The amount payable under non-life insurance is confined to the actual loss suffered or liability uncured, irrespective of the policy amount.
Savings	Life insurance place has a component in savings.	General insurance has no such savings component.

The term life insurance implies the type of insurance, that covers the risk of life and provides a guarantee to compensate by paying the specified sum, either on the death of the insured or after the specified period.

In life insurance, the amount is payable on the happening of the uncertain event. Moreover, there are certain plans, wherein the payment of the policy amount is made at the maturity. These are long term contracts which require the payment of premium throughout its life till it matures and the sum assured is paid on maturity. It can be surrendered, after some years, wherein the policyholder will get a proportion of premiums paid, called as surrender value.

There are three types of life insurance, discussed as under:

- **Whole life assurance**: In whole life assurance, the amount of the policy is paid only on the death of the insured, to the nominee or the legal heir of the insured.**Whole life insurance** is a contract with premiums that includes **insurance** and investment components. The **insurance** component pays a predetermined amount when the insured individual dies. The investment component builds an accumulated cash value the insured individual can borrow against or withdraw.
- **Term life assurance**: In term life assurance, the policy amount is paid to the nominee, if the insured passes away before the expiry of the specified term, or to the insured himself, on the maturity of the term.A type of **life insurance** with a limited coverage period. Once that period or "**term**" is up, it is up to the policy owner to decide whether to renew or to let the coverage end. This type of **insurance** policy contrasts with permanent **life insurance**, which is intended to provide**life**-long protection
- **Annuity**: When the term of the policy expires, the payment of the policy amount is paid to the holder periodically, as long as the insured is alive.An **insurance** product that features a predetermined periodic payout amount until the death of the annuitant. These products are most frequently used to help retirees budget their money after retirement. Typically, the annuitant pays into the **annuity** on a periodic basis when he or she is still working.

Definition of General Insurance

General insurance or otherwise known as non-life insurance or property and casualty insurance, is a contract that covers any risk apart from the risk of life. The insurance is to safeguard us and our property, such as home, car, and other valuables from fire, theft, flood, storm, accident, earthquake and so on.

These are the contract of indemnity, wherein the insurer promises to make good, the loss occurred to the insured. So, irrespective of the amount of policy, the insurance company will reimburse the loss suffered by the insured. They are short term in nature, generally one year and so renewal is required every year. The types of general insurance are:

- **Fire insurance**: The insurance covers the risk of loss to the property due to fire.**Fire insurance** covers damage or loss to a property because of**fire**. It is a specific form of **insurance** in addition to homeowner's or property **insurance**, and it covers the cost of replacement and repair or reconstruction above what the property **insurance** policy covers. Personal property. ... Homeowners **insurance** typically helps protect personal belongings, from specific risks (described in most policies as "perils"), such as **fire**and lightning strikes. If your belongings are damaged or destroyed in a **fire**, homeowners **insurance** may help **cover** the loss.
- **Marine insurance**: The insurance covers the risk associated with loss due to a marine adventure, like sinking, stranding and collision of the ship, caused to the ship or cargo owner.**Marine insurance** covers the loss or damage of ships, cargo, terminals, and any transport or cargo by which property is transferred, acquired, or held between the points of origin and final destination. The **Marine Insurance Act 1906** (8 Edw. 7 c.41) is a UK **Act** of Parliament regulating**marine insurance**. The **Act** applies both to "ship & cargo" **marine insurance**, and to P&I cover. The **Act** was drafted by Sir Mackenzie Dalzell Chalmers, who had earlier drafted the Sale of Goods **Act** 1893.
- **Health insurance**: It covers the risk of the health of the policyholder or his/her family members from accident or disease.**Health insurance** is a type of **insurance** coverage that pays for medical and surgical expenses incurred by the insured. **Health insurance** can reimburse the insured for expenses incurred from illness or injury, or pay the care provider directly.
- **Home insurance**: The insurance of home and its contents from any uncertainty.**Homeowners insurance** is a package policy. This means that it covers both damage to your property and your liability or legal responsibility for any injuries and property damage you or members of your family cause to other people. This includes damage caused by household pets.
- **Motor insurance**: The insurance of vehicles is covered under motor insurance, which is divided into two heads, i.e. two-wheeler insurance and four-wheeler insurance. A **motor insurance** policy is a mandatory policy issued by an **insurance** company as part of prevention of public liability to protect the general

public from any accident that might take place on the road. The law mandates that every owner of a **motor vehicle**must have one **motor insurance** policy.

Key Differences Between Life Insurance and General Insurance

The difference between life insurance and general insurance can be drawn clearly on the following grounds:

1. The insurance contract, in which the life risk of an individual is covered, is known as life insurance. As opposed, the insurance, which is not covered under life insurance and includes various types of insurance, i.e. fire, marine, motor, etc. is general insurance.

2. Life insurance is nothing but an investment avenue. On the contrary, general insurance is a contract of indemnity.

3. Life insurance is a long-term contract, which runs over a number of years. Conversely, general insurance is a short term contract, which needs to be renewed every year.

4. In life insurance, the sum assured is paid, either on the happening of the event or the on the maturity of the term. As against this, in general insurance, the amount of actual loss is reimbursed, or liability incurred will be repaid on the happening of an uncertain event.

5. In life insurance, the premium is paid throughout the life of the term. In contrast, in general insurance, one shot payment of premium is made.

6. In life insurance, the insurable interest must be present only at the time of the contract, but in general insurance, the insurable interest must be present, both at the time of contract and at the time of loss.

7. Life insurance can be done for any value based on the premium the policyholder willing to pay. Unlike, general insurance the sum payable is confined to the amount of loss suffered, regardless of the policy amount.

8. The component of saving is normally present in life insurance but not in general insurance.

In life insurance, the actuaries estimate the liability under the current policy at regular intervals. On the other hand, in general insurance, a part of the premium is taken forward to make provision of the unexpired liability and the remaining amount i.e. the net of claims and expenses is taken as the profit of loss.

Premium

An **insurance premium** is the amount of money that an individual or business must pay for an **insurance** policy. The **insurance premium** is considered income by the**insurance** company once it is earned, and also represents a liability in that the insurer must provide **coverage** for claims being made against the policy. Financial cost of obtaining an insurance cover, paid as a lump sum or in installments during the duration of the policy. A failure to pay premium when due automatically cancels the insurance policy which, upon payment of the outstanding amount within a certain period, may be restored.

The premium rate your firm pays for workers' compensation insurance is based on the risk classifications assigned to your business and your firm's experience factor. The premium rates you pay, usually per hour worked, are determined by the following formula:

Premium Rate =

Firm's Experience Factor ×

(Class Accident Fund Base Rate + Class Medical Aid Fund Base Rate + Class Stay At Work Base Rate)

+ Supplemental Pension Fund Base Rate.

Risk and return

Low levels of uncertainty or risk are associated with low potential returns,whereas**high** levels of uncertainty or risk are associated with **high** potential returns. According to the risk-return **tradeoff**, invested money can render higher profits only if the investor is willing to accept the possibility of losses.

Returns are the monies received from incurring a certain level of risk. In our industry, we'll call returns premiums. As a result, there's a direct correlation between risk and return. For a higher level of risk, we expect a high return or our customers to pay a higher premium.

In purchasing an insurance product, the customer has transferred the risk to an insurance company. This strategy is called risk transfer. There are also two other risk management strategies: risk assumption and avoidance.

Todd continues, 'Now for the rest of this seminar, we'll explore the risk and return concept as well as discuss the three risk management strategies.'

Risk and Return

Insurance companies are in business to accept risks -- risk that an automobile accident may occur, a house may burn down, or a business may flood. Insurance companies restore the property to its original state before the loss occurred.

However, insurance companies require a return, or **premium**. That premium is based on the risk. The higher the probability the loss will occur, the higher the premium.

4.5 MUTUAL FUNDS:

A mutual fund is at its core a managed portfolio of stocks and/or bonds. You can think of a mutual fund as a company that brings together a large group of people and invests their money on their behalf in this portfolio. Each investor owns shares of the mutual fund, which represent a portion of its holdings.

Investing in a share of a mutual fund is different from investing in shares of stock. Unlike stock, mutual fund shares do not give its holders any voting rights. A share of a mutual fund represents investments in many different stocks (or other securities) instead of just one holding.

Investors typically earn a return from a mutual fund in three ways:

1. Income is earned from dividends on stocks and interest on bonds held in the fund's portfolio. A fund pays out nearly all of the Income it receives over the year to fund owners in the form of a distribution. Funds often give investors a choice either to receive a check for distributions or to reinvest the earnings and get more shares
2. If the fund sells securities that have increased in price, the fund has a capital gain. Most funds also pass on these gains to investors in a distribution.
3. If fund holdings increase in price but are not sold by the fund manager, the fund's shares increase in price. You can then sell your mutual fund shares for a profit in the market.

Mutual funds have some clear advantages for investors, but also some limitations and drawbacks. Here is an overview of the pros and cons:

Advantages of Mutual Funds

• **Professional Management** – The primary advantage of funds is not having to pick stocks and manage investments. Instead, a professional investment manager takes care of all of this using careful research and skillful trading. Investors purchase funds because they often do not have the time or the expertise to manage their own portfolios, or they don't have access to the same kind of information that a professional fund has. A mutual fund is a relatively inexpensive way for a small investor to get a full-time manager to make and monitor investments.

• **Diversification** – By owning shares in a mutual fund instead of owning individual stocks or bonds, your risk is spread out across many different holdings. The idea behind diversification is not to put all of your eggs in one basket – instead, spread

investments across a large number of diverse assets so that a loss in any particular investment is minimized by gains in others. In other words, the more stocks and bonds you own, the less any one of them can seriously hurt your finances. Large mutual funds typically own hundreds of different stocks in many different industries. It wouldn't be practical for an investor to build this kind of a portfolio with a small amount of money.

Economies of Scale – Because a mutual fund buys and sells large amounts of securities at a time, its transaction costs are lower than what an individual would pay for securities transactions. Moreover, a mutual fund, since it pools money from many smaller investors can invest in certain assets or take larger positions than a smaller investor could. For example, the fund may have access to IPO placements or certain structured products only available to institutional investors.

- **Simplicity** – Buying a mutual fund is fairly straightforward. Many banks or brokerage firms have their own line of in-house mutual funds, and the minimum investment is often small. Most companies also have automatic purchase plans whereby as little as $100 can be invested on a monthly basis. Brokers can also purchase any other listed mutual fund on behalf of clients.

- **Variety** – Mutual funds today exist with any number of various asset classes or strategies. This allows investors to gain exposure to not only stocks and bonds but also commodities, foreign assets, and real estate through specialized mutual funds. Some mutual funds are even structured to profit from a falling market (known as bear funds). Mutual funds provide opportunities for foreign and domestic investment that may not otherwise be directly accessible to ordinary investors.

- **Transparency** – Mutual funds are subject to industry regulation that ensures accountability and fairness to investors.

Disadvantages of Mutual Funds

- **Active Management** – Many investors debate whether or not the professionals are any better than you or I at picking stocks. Management is by no means infallible, and, even if the fund loses money, the manager still gets paid. Actively managed funds incur higher fees, but increasingly passive index funds have gained popularity. These funds track an index such as the S&P 500 and are much less costly to hold.

- **Costs and Fees** – Creating, distributing, and running a mutual fund is an expensive undertaking. Everything from the portfolio manager's salary to the investors' quarterly statements cost money. Those expenses are passed on to the investors. Since fees vary widely from fund to fund, failing to pay attention to the fees can have negative long-term consequences. Actively managed funds incur transaction costs that accumulate over each year. Remember, every dollar spent on fees is a dollar that is not invested to grow over time.

- **Dilution** – It's possible to have poor returns due to too much diversification. Because mutual funds can have small holdings in many different companies, high returns from a few investments often don't make much difference on the overall return. Dilution is also the result of a successful fund growing too big. When new money pours into funds that have had strong track records, the manager often has trouble finding suitable investments for all the new capital to be put to good use.

- **Liquidity** – A mutual fund allows you to request that your shares be converted into cash at any time, however, unlike stock that trades throughout the day, many mutual fund redemptions take place only at the end of each trading day.

- **Taxes** – When a fund manager sells a security, a capital-gains tax is triggered. Investors who are concerned about the impact of taxes need to keep those concerns in mind when investing in mutual funds. Taxes can be mitigated by investing in tax-sensitive funds or by holding non-tax sensitive mutual fund in a tax-deferred account, such as a 401(k) or IRA.

- **Cash Drag** – Mutual funds require a significant amount of their portfolios to be held in cash in order to satisfy share redemptions each day. To maintain liquidity and the

capacity to accommodate withdrawals, funds typically have to keep a larger portion of their portfolio as cash than a typical investor might. Because cash earns no return, it is often referred to as a "cash drag."

Types of mutual funds:

Money Market Funds

The money market consists of safe (risk-free) short-term debt instruments, mostly government Treasury bills. This is a safe place to park your money. You won't get substantial returns, but you won't have to worry about losing your principal. A typical return is a little more than the amount you would earn in a regular checking or savings account and a little less than the average certificate of deposit (CD). While money market funds invest in ultra-safe assets, during the 2008 financial crisis, some money market funds did experience losses after the share price of these funds, typically pegged at $1, fell below that level and broke the buck.

Income Funds

Income funds are named for their purpose: to provide current income on a steady basis. These funds invest primarily in government and high-quality corporate debt, holding these bonds until maturity in order to provide interest streams. While fund holdings may appreciate in value, the primary objective of these funds is to provide a steady cash flow to investors. As such, the audience for these funds consists of conservative investors and retires. Because they produce regular income, tax conscious investors may want to avoid these funds.

Bond Funds

Bond funds invest and actively trade in various types of bonds. Bond funds are often actively managed and seek to buy relatively undervalued bonds in order to sell them at a profit. These mutual funds are likely to pay higher returns than certificates of deposit and money market investments, but bond funds aren't without risk. Because there are

many different types of bonds, bond funds can vary dramatically depending on where they invest. For example, a fund specializing in high-yield junk bonds is much more risky than a fund that invests in government securities. Furthermore, nearly all bond funds are subject to interest rate risk, which means that if rates go up the value of the fund goes down.

Balanced Funds

The objective of these funds is to provide a balanced mixture of safety, income and capital appreciation. The strategy of balanced funds is to invest in a portfolio of both fixed income and equities. A typical balanced fund will have a weighting of 60% equity and 40% fixed income. The weighting might also be restricted to a specified maximum or minimum for each asset class, so that if stock values increase much more than bonds, the portfolio manager will automatically rebalance the portfolio back to 60/40.

A similar type of fund is known as an asset allocation fund. Objectives are similar to those of a balanced fund, but these kinds of funds typically do not have to hold a specified percentage of any asset class. The portfolio manager is therefore given freedom to switch the ratio of asset classes as the economy moves through the business cycle.

Equity Funds

Funds that invest primarily in stocks represent the largest category of mutual funds. Generally, the investment objective of this class of funds is long-term capital growth. There are, however, many different types of equity funds because there are many different types of equities. A great way to understand the universe of equity funds is to use a style box, an example of which is below.

Investment Style

Size	Value	Blend	Growth
Large			
Mid			
Small			

The idea here is to classify funds based on both the size of the companies invested in (their market caps) and the growth prospects of the invested stocks. The term value fund refers to a style of investing that looks for high quality, low growth companies that are out of favor with the market. These companies are characterized by low price-to-earning (P/E), low price-to-book (P/B) ratios, and high dividend yields. On the other side of the style spectrum are growth funds, which look to companies that have had (and are expected to have) strong growth in earnings, sales, and cash flows. These companies typically have high P/E ratios and do not pay dividends. A compromise between strict value and growth investment is a "blend," which simply refers to companies that are neither value nor growth stocks and are classified as being somewhere in the middle.

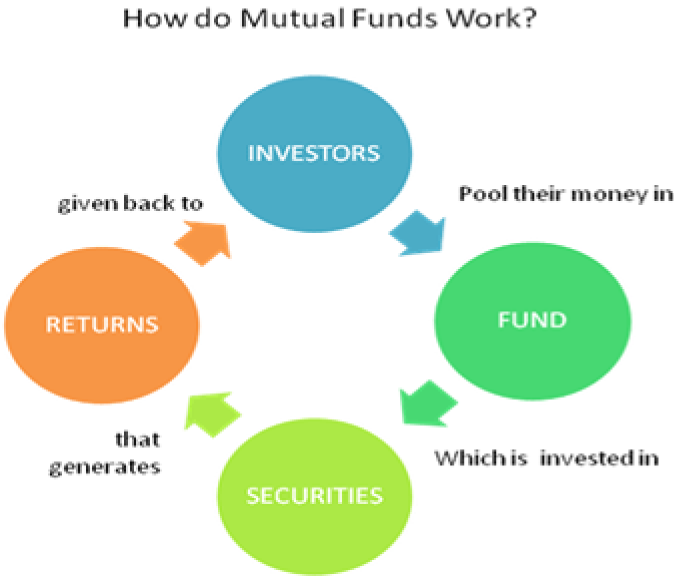
The other dimension of the style box has to do with the size of the companies that a mutual fund invests in. Large-cap companies have high market capitalizations, with values over $5 billion. Market cap is derived by multiplying the share price by the number of shares outstanding. Large-cap stocks are typically blue chip firms that are often recognizable by name. Small-cap stocks refer to those stocks with a market cap ranging from $200 million to $2 billion. These smaller companies tend to be newer, riskier investments. Mid-cap stocks fill in the gap between small- and large-cap.

A mutual fund may blend its strategy between investment style and company size. For example, a large-cap value fund would look to large-cap companies that are in strong financial shape but have recently seen their share prices fall, and would be placed in the upper left quadrant of the style box (large and value). The opposite of this would be a fund that invests in startup technology companies with excellent growth prospects: small-

cap growth. Such a mutual fund would reside in the bottom right quadrant (small and growth).

Global/International Funds

An international fund (or foreign fund) invests only in assets located outside your home country. Global funds, meanwhile, can invest anywhere around the world, including within your home country. It's tough to classify these funds as either riskier or safer than domestic investments, but they have tended to be more volatile and have unique country and political risks. On the flip side, they can, as part of a well-balanced portfolio, actually reduce risk by increasing diversification since the returns in foreign countries may be uncorrelated with returns at home. Although the world's economies are becoming more interrelated, it is still likely that another economy somewhere is outperforming the economy of your home country.



History

The first structure of Mutual fund was the one adopted by UTI in 1963. This was followed by SEBI MF guidelines in 1993. These guidelines were later replaced by comprehensive set of SEBI MF regulations 1996.

1. **Unit trust of India** – The first Mutual fund of India was a Unit Trust of India. It was formed as a body corporate under an act of Parliament. Different provisions of the UTI Act laid down the structure of management, scope of business, powers and functions of the Trust as well as accounting, disclosures and regulatory requirements for the Trust. However, it was different from the present day mutual funds in more than one ways. It was a trust, custodian, and investment manager all in one. It was capable of buying property and borrows/lending money for project finance."The management structure of UTI is thus distinct from the remaining mutual funds in more than one way. First, unlike other mutual funds, it is a statutory body corporate and not a Trust under the Indian Trusts Act. Second, there is no separate asset management company with a separate Board of directors of AMC to manage the schemes. The functions of the Board of directors of AMC, and Trustees are combined in the Executive Committee and Board of UTI. The Sponsors exist in the form of Government and IDBI, though they do not hold any equity in the Trustee Company or AMC for none exists. "

Organisation Structure of Mutual Funds of Public Sector Banks – In 1987, the public sector banks were allowed to set up mutual fund. State Bank of India was the first one to set up mutual fund. It preferred to adopt the Trust route and set up the mutual fund as a Trust under the Indian Trust Act 1882. Later, other mutual funds followed the same and thus Trusts set up under the Indian Trusts Act became the adopted legal form of mutual funds in India. These mutual funds combined the role of Trustee, fund manager and custodian in the sponsoring bank. However there was little demarcation in the role and responsibilities and the structure was open to conflict of interests.

2. **SEBI MF Regulations 1996** – Securities and Exchange Board of India (SEBI) was formed in 1992 and was given the regulatory responsibility of Capital markets and Mutual Funds. SEBI formed Mutual Funds regulations in 1993 which were later replaced by new regulations in 1996. "SEBI, while framing the Mutual Fund Regulations, gave a lot of consideration to two major factors, one, that mutual funds garner large moneys from the pubic for investment in a dynamic market place which require specialisation on

the part of persons performing these functions. Secondly, there could arise potential conflicts of interest which were to be avoided by ensuring arm's length relationship between various functionaries. Such stipulation of arm's length relationship ensures that the person who performs a function is answerable to another and does not assess or judge his own performance." This is the structure which is followed by all the existing mutual funds in India.

2. Structure of Mutual Funds

The Mutual Funds in India are regulated by SEBI MF Regulations, 1996. Under the regulations mutual fund is formed as a Public Trust under the Indian Trusts Act, 1882. These regulations stipulate a three tiered structure of entities – sponsor (creation), trustees, and Asset Management Company (fund management) – for carrying out different functions of a mutual fund, but place the primary responsibility on the trustees.

1. **The Fund Sponsor** – SEBI regulations define Sponsor as any person who either itself or in association with another body corporate establishes a mutual fund. Sponsor sets up a mutual fund to earn money by doing fund management through its subsidiary company which acts as Investment manager of the fund. Largely, a sponsor can be compared with a promoter of a company. Sponsors activities include setting up a Public Trust under Indian Trust Act, 1882 (the mutual fund), appointing trustees to manage the trust with the approval of SEBI, creating an Asset Management Company under Companies Act, 1956 (the Investment Manager) and getting the trust registered with SEBI.

1. **Eligibility of Sponsor** – Mutual funds involve managing retail investor's money and hence, it becomes important to ensure that it is run by entities with capabilities and professional merits. SEBI (Mutual fund) Regulations, 1996 specifies the following eligibility criteria in this regard: (i) Sponsor is required to have financial services business experience of at least 5 years and a positive Net worth in all the preceding five years. (ii) Sponsors' Net worth in the immediately preceding year is required to be more than the capital contribution to AMC. (iii) Sponsor is required to be profit making in at least three out of the last five years including the last year.

(iv)Sponsor must contribute at least 40% of the Net worth of the Asset Management Company. Any entity, which contributes at least 40% to the Net worth of an AMC, is deemed sponsor and therefore is required to fulfil all the requirements given in 1 to 4.

2. **Trustees** – The trust is created through a document called the trust deed which is executed by the fund sponsor in favour of the trustees. Trustees manage the trust and are responsible to the investors in the mutual funds. They are the primary guardians of the unit-holders funds and assets. Trustees can be formed in either of the following two ways -Board of Trustees, or a Trustee Company. The provisions of Indian Trust Act, 1882, govern board of trustees or the Trustee Company. A trustee company is also subject to provisions of Companies Act, 1956.

1. **Obligations of trustees** – Trustees ensure that the activities of the mutual fund are in accordance with SEBI (mutual fund) regulations, 1996. They check that the AMC has proper systems and procedures in place. Trustees also make sure that all the other fund constituents are appointed and that proper due diligence is exercised by the AMC in the appointment of constituents and business associates. All schemes floated by the AMC have to be approved by the trustees. Trustees review and ensure that the net worth of the AMC is as per the regulatory norms. They furnish to SEBI, on a half-yearly basis, a report on the activities of AMC.

2. **Regulation regarding appointment of trustees** – Sponsor with prior approval of SEBI appoints trustees. There should be at least four members in the board of trustees with at least 2/3rd independent. A trustee of one mutual fund cannot be trustee of another mutual fund, unless he is an independent trustee in both cases and has the approval of both the boards. The trustees are appointed by executing and registering a trust deed under the provisions of Indian registration Act. This trust deed is also registered with SEBI.

3. **Responsibilities of trustees** – The Trustees are required to fulfill several duties and obligations in accordance with SEBI (Mutual Funds) Regulations, 1996 and the Trust Deed constituting the Mutual Fund. These include 1. The Trustee and the Asset Management Company enter into an Investment Management Agreement (IMA) with the approval from SEBI. 2. The Investment Management Agreement shall contain such clauses as are mentioned in the Fourth Schedule of the SEBI (MFs) Regulations, 1996

and other such clauses as are necessary for making investments. 3. The Trustees shall have a right to obtain from the Asset Management Company such information as is considered necessary by the Trustees. 4. The Trustee shall ensure before the launch of any scheme that the Asset Management Company possesses/has done the following: a. Systems in place for its back office, dealing room and accounting; b. Appointed all key personnel including fund manager(s) for the Scheme(s) and submitted their bio-data which shall contain the educational qualifications, past experience in the securities market to SEBI, within 15 days of their appointment; c. Appointed Auditors to audit its accounts; d. Appointed a Compliance Officer to comply with regulatory requirement and to redress investor grievances; e. Appointed Registrars and laid down parameters for their supervision; f. Prepared a compliance manual and designed internal control mechanisms including internal audit systems; and g. Specified norms for empanelment of brokers and marketing agents

3. **Asset Management Company** – The Asset Management Company (AMC) is the investment Manager of the Trust. The sponsor, or the trustees is so authorized by the trust deed, appoints the AMC as the "Investment Manager" of the trust (Mutual Fund) via an agreement called as 'Investment Management Agreement'. An asset management company is a company registered under the Companies Act, 1956. Sponsor creates the asset management company and this is the entity, which manages the funds of the mutual fund (trust). The mutual fund pays a small fee to the AMC for management of its fund. The AMC acts under the supervision of Trustees and is subject to the regulations of SEBI too.

1. **Role of AMC** – The AMC is an operational arm of the mutual fund .AMC is responsible for all carrying out all functions related to management of the assets of the trust. The AMC structures various schemes, launches the scheme and mobilizes initial amount, manages the funds and give services to the investors .In fact, AMC is the first major constituent appointed .Later on AMC solicits the services of other constituents like Registrar, Bankers, Brokers, Auditors, Lawyers etc and works in close co-ordination with them.

2. **Restrictions on business activities of the Asset Management** Company – In India, regulator has ensured that an AMC focuses just on its core business and that

the activities of AMC's are not in conflict of each other. These are ensured through the following restrictions on the business activities of an AMC. a. An AMC shall not undertake any business activity except in the nature of portfolio management services, management and advisory services to offshore funds etc, provided these activities are not in conflict with the activities of the mutual fund. b. An AMC cannot invest in any of its own schemes unless full disclosure of its intention to invest has been made in the offer document c. An AMC shall not act as a trustee of any mutual fund

4. **Custodian** – Though the securities are bought and held in the name of trustees, they are not kept with them. The responsibility of safe keeping the securities is on the custodian. Securities, which are in material form, are kept in safe custody of a custodian and securities, which are in "De-Materialized" form, are kept with a Depository participant, who acts on the advice of custodian. Custodian performs a very important back office operation. They ensure that delivery has been taken of the securities, which are bought, and that they are transferred in the name of the mutual fund. They also ensure that funds are paid out when securities are bought. Custodians keep the investment account of the mutual fund. They collect and account for the dividends and interest receivables on mutual fund investments. They also keep track of various corporate actions like bonus issue, rights issue, and stock split; buy back offers, open offer etc and act on these as per instructions of the Investment manager. 3.4.1. Responsibility of custodian Following are the responsibilities of a custodian: (i) Provide post-trading and custodial services to the Mutual Fund; (ii) Keep securities and other instruments belonging to the Scheme in safe custody; (iii) Ensure smooth inflow/outflow of securities and such other instruments as and when necessary, in the best interests of the unit holders; (iv) Ensure that the benefits due to the holdings of the Mutual Fund are recovered; and (v) Be responsible for loss of or damage to the securities due to negligence on its part or on the part of its approved agents. The Custodian normally charge portfolio fee, transaction fee and out-of -pocket expenses in accordance with the terms of the Custody Agreement and as per any modification made thereof from time to time.

5. **Other constituents** – Regulation imposes responsibility on the trustees to ensure that the AMC has proper system and procedures in place and has appointed key personnel and other constituents like R&T agents, brokers etc.

1. **Registrar and transfer agent** – A mutual fund manages money of many unit-holders across cities and towns of the country. Investor servicing not only becomes important but challenging as well. This would typically include processing investors' application, recording the details of investors, sending them account statements and other reports on periodical basis, processing dividend payouts, making changes in investor details and keeping investor records updated by adding details of new investors and by removing details of investors who withdraw their funds from the mutual funds. It is very impractical and expensive for any mutual fund to have adequate workforce all over India for this purpose. Instead, they use entities called as Registrars and transfer agents, which generally provide services to many mutual funds. This ensures quality services across all location and keeps the costs lower for the unit-holders.

2. **Auditor** – Investor money is held by the trustees in trust. Regulation has ensured proper accounting norms to ensure fair and responsible record keeping of investor's money. Separate books of account are maintained for each scheme of the mutual fund and individual annual report is prepared. The books of accounts and the annual reports of the scheme are audited by auditors. The AMC is a company under companies act, 1956 and therefore is required to get its accounts audited as per the provisions of the companies act. In order to maintain high standards of integrity and transparency regulations stipulate that the auditor of the mutual fund schemes and the auditor of the AMC will have to be different.

3. **Brokers** – Brokers are registered members of the stock exchange whose services are utilized by AMCs to buy and sells securities on the stock exchanges. Many brokers also provide the Investment Manager (AMC) with research reports on the performance of various companies, sector and market outlook, investment recommendations etc. Regulations have imposes restrictions on the involvement of brokers in the investment process of any mutual fund in the following ways- a. If a broker is related to the sponsor or its associate, then the AMC shall not purchase or sell securities through that broker in excess of 5% of the aggregate of purchase and sale of

securities made by the mutual fund in all its schemes. b. For transactions through any other broker the AMC can exceed the limit of 5% provided it has recorded justification in writing and report of such exceeding has been sent to the trustee on a quarterly basis

3. **Regulation**

Securities and Exchange Board of India (SEBI) is the primary regulator of mutual funds in India. SEBI is also apex regulator of capital markets. Issuance and trading of capital market instruments and the regulation of capital market intermediaries is under the purview of SEBI. Apart from SEBI, mutual funds follow the regulations of other regulators in limited manner.

1. **RBI** – RBI acts as regulator of sponsors of bank-sponsored mutual funds, especially in case of funds offering guaranteed/assured returns. No mutual fund is allowed to bring out a guaranteed returns scheme without taking approval from RBI
2. **Companies Act, 1956** – Asset Management Company and Trustee Company will be subject to the provisions of the Companies Act, 1956.
3. **Stock Exchange** – Closed-end funds might list their units on a stock exchange. In such a case, the listings are subject to the listing regulation of stock exchanges. Mutual funds have to sign the listing agreement and abide by its provisions, which primarily deal with periodic notifications and disclosure of information that may impact the trading of listed units.
4. **Indian Trusts Act, 1882** – Recall that mutual funds are formed and registered as a public trusts under the Indian trusts Act, 1882. Hence, they have to follow the provisions of the Indian Trusts Act, 1882.
5. **Ministry of Finance (MoF)** – The finance ministry is the supervisor of both the RBI and SEBI. The MoF is also the appellate authority under SEBI regulations. Aggrieved parties can make appeals to the MoF on the SEBI rulings relating to mutual funds.

Functions

Think of mutual fund as buying a small slice from a large pizza. Every investor gets a proportionate share of the income, expenses, gains and losses of the purchased unit. The funds of the investors are managed by a team of qualified professionals who create an investment portfolio. The professional management team has the responsibility to choose where to invest the money of the mutual fund unit holders and monitor them. The investor is the owner of the purchased unit only and has no rights on individual securities. The risk factor is low in mutual funds as the investments are diversified by creating a portfolio of investments in a large number of securities.

Objectives

If the objective of the mutual funds is equity or growth then it is to be understood that the company will invest in stocks only. If the objective is debt or income then they invest only in fixed income securities. The company will invest in short term money market instruments including government securities if its objective is money market. If the objective is balanced then we can say it will invest partly in stocks and partly in fixed income securities to maintain a balance between risk and returns.

As applied to mutual funds, you will learn the importance of the risk-return relationship in selecting quality mutual funds. In addition, we will explain the importance of understanding the concept of total return, which is the key component of a fund's investment performance.

UNIT 5

5.. Merchant banking:

A merchant banker is one who underwrites corporate security and advisors client on issues like corporate mergers. A bank, a company, a firm or even a proprietary concern can act as a merchant banker

Definition of Merchant banking:

There is no universal definition for Merchant banking. Some important definition for the sake of clarity are given below

1. A Merchant banking means any person who is engaged in the business of issue management by making arrangements for selling/buying /subscribing to securities or acting as managers/consultant or advisor or rendering of corporate advisory service in relation to such issue management.
2. Merchant banking may be defined as "an institution which covers a wide range of activities such as management of customer service, portfolio management credit syndication, acceptance of credit, counseling, endurance etc."
3. Merchant banking is basically service banking which provides non-financial service such as arranging for funds rather than providing them. The Merchant banker understand the requirements of business concerns and arranges finance with the help of financial institutions, banks, stocks exchanger & money market.
4. In the words of Skully" a Merchant bank could be best defined as a financial institutions conducting money market activities & lending, underwriting & rending financial advice & investment services whose organization is characterized by a high proportion of professional staff able to approach problems in an innovative manager &. to make an implement decision rapidly".
5. "Merchant banking essentially involves selling an issue for a company & handling related work".

5.1 MERCHANT BANKING IN INDIA

In India, the merchant banking sector has grown at a faster pace in the last two decades with the growth of the capital market and the money market. However, there have been ups and downs in the fortunes of this industry in the past. Over the years, the number of players in the merchant banking industry came down and currently we find only a few large firms surviving in the industry.

The first merchant banking activity in India started in 1969 by the Grindlays Bank by opening a merchant banking division. Initially they were issue mangers looking after the issue of shares and raising capital for the company. But subsequently they expanded their activities such as working capital management; syndication of project finance, global loans, mergers, capital restructuring, etc., initially the merchant banker in India was in the form of management of public issue and providing financial consultancy for foreign banks.

In 1973, SBI started the merchant banking and it was followed by ICICI. SBI capital market was set up in August 1986 as a full-fledged merchant banker. Between 1974 and 1985, the merchant banker has promoted lot of companies. However they were brought under the control of SEBI in 1992. Merchant banks were brought under the ambit of SEBI regulations and this lead to a disciplined growth of the industry. New checks and balances have been introduced in the functioning of merchant banks in India. Collaborative arrangements with the foreign merchant banks were also common

According to SEBI, “a merchant banker is one who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to the securities as manager, advisor or rendering corporate advisory services in relation to such issue management”.

Investment Banking Vs Merchant Banking

The term ‘merchant banking’ and ‘investment banking’ are often used interchangeable in the financial literature. However, we can make out a subtle distinction between these two.

The term ‘Investment Banking’ has the US origin whereas the term ‘merchant banking’ is in vogue in countries such as the UK and India.

The following list shows the selected investment banks, both domestic and global:

Domestic	Global
ICICI Securities	Goldman Sachs
Kotak Mahindra Capital Company	Morgan Stanley
Enam Financials	JP Morgan Chase
Karvy Investor Services	Rothschild
SBI Capital Markets	HSBC

5.2 RECENT DEVELOPMENTS AND CHALLENGES AHEAD

The recent developments in Merchant banking are due to certain contributory factors in India. They are the Merchant Banking was at its best during 1985-1992 being when there were many new issues. It is expected that 2010 that it is going to be party time for merchant banks, as many new issue are coming up.

The foreign investors both in the form of portfolio investment and through foreign direct investments are venturing in Indian Economy.

It is increasing the scope of merchant bankers in many ways. Disinvestment in the government sector in the country gives a big scope to the merchant banks to function as consultants. New financial instruments are introduced in the market time and again. This basically provides more and more opportunity to the merchant banks. The mergers and corporate restructuring along with MOU and MOA are giving immense opportunity to the merchant bankers for consultancy jobs.

The challenges faced by merchant bankers in India

• SEBI guideline has restricted their operations to Issue Management and Portfolio Management to some extent. So, the scope of work is limited

• In efficiency of the clients are often blamed on to the merchant banks, so they are into trouble without any fault of their own.

• The net worth requirement is very high in categories I and II specially, so many professionally experienced person/ organizations cannot come into the picture.

• Poor New issues market in India is drying up the business of the merchant bankers. Thus the merchant bankers are those financial intermediary involved with the activity of transferring capital funds to those borrowers who are interested in borrowing.

The activities of the merchant banking in India is very vast in the nature of

- The management of the customer's securities
- The management of the portfolio
- The management of projects and counseling as well as appraisal
- The management of underwriting of shares and debentures
- The circumvention of the syndication of loans
- Management of the interest and dividend etc.

INSTITUTIONAL STRUCTURE

In tracing the history of the merchant banking in India, the structure of merchant bankers appeared as follows at one point of time:

1. Merchant banking divisions of commercial banks, both Indian and Foreign.
2. Merchant banking divisions of financial institutions (e.g. IDBI, IFCI, etc.)
3. Merchant banking companies promoted by stock broking firms. (e.g. JM Financial, DSP)
4. Merchant banking services of NBFCs

However, the above structure has undergone a transformation now.

The merchant banking divisions of the commercial banks exist now as independent subsidiary companies of the parent firms. For example, the SBI Capital Markets Ltd is the subsidiary of SBI. The merchant banking activities of the NBFCs almost cease to exist.

5.3 FUNCTIONS OF MERCHANT BANK

A merchant banker is not merely an issue manager. The scope of his activities extends beyond issue management. He undertakes new responsibilities such as syndication of project financing, global fund raising, designing new financial instruments and deal making in corporate takeovers. From dealing in shares for major industrial houses to takeovers, the merchant bankers have come a long way in the spectrum of services that are offered. Their operations have considerably widened and have become more specialized.

The following are the functions of merchant bankers in India:

- Corporate Counseling
- Project Counseling
- Pre-investment Studies
- Capital Restructuring
- Credit Syndication and Project Finance
- Issue management and Underwriting
- Portfolio Management
- Working Capital Finance
- Acceptance Credit and Bill Discounting
- Mergers, Amalgamation and Takeovers
- Venture Capital
- Lease Financing
- Foreign Currency Finance
- Fixed Deposit Broking
- Mutual Funds
- Relief to Sick Industries
- Project Appraisal

Corporate Counseling: Corporate counseling is the beginning of the merchant banking services. Every industrial unit either new or existing needs it. The scope of corporate counseling is very vast. It covers a wide range of merchant banking activities and includes the services such as project counseling, project management, loan syndication, working

capital management, capital re-structuring, public issue management, fixed deposit, lease financing, etc.

Project Counseling: Project counseling has originated from corporate counseling. It relates to project finance and includes preparation of project reports, cost of the project and also arranging the financing pattern. The projects are appraised on the basis of the location, marketing and technical and financial viability of the project.

LEGAL AND REGULATORY FRAMEWORK

An application should be submitted to SEBI in Form A of the SEBI (Merchant Bankers) Regulations, 1992. SEBI shall consider the application and on being satisfied issue a certificate of registration in Form B of the SEBI (Merchant Bankers) Regulations, 1992. The registration fee payable to SEBI is Rs.5 lakhs which should be paid within 15 days of date of receipt of intimation regarding grant of certificate. The validity period of certificate of registration is Three years from the date of issue. Renewal, three months before the expiry period, an application should be submitted to SEBI in Form A of the SEBI (Merchant Bankers) Regulations, 1992. SEBI shall consider the application and on being satisfied renew certificate of registration for a

further period of 3 years. The renewal fee payable to SEBI is Rs.2.5 lakhs which should be paid within 15 days of date of receipt of intimation regarding renewal of certificate. The person whose registration is not current shall not carry on the activity as merchant banker from the date of expiry of validity period.

Categories of Merchant Bankers

Originally, as per SEBI regulations, merchant bankers were required to get authorization to act as an issue manager, underwriter or advisor. This authorization was granted by SEBI based on the net worth limits, professional competence, experience in the business, general reputation and the past performance record.

The categories for which registration may be granted are given below:

♣Category I – To carry on the activity of issue management and to act as adviser, consultant, manager, underwriter, portfolio manager.

♣Category II – To act as adviser, consultant, co-manager, underwriter, portfolio manager.

♣ Category III – To act as underwriter, adviser or consultant to an issue

♣ Category IV – To act only as adviser or consultant to an issue

Accordingly, four categories of merchant bankers should full fill the capital requirement as under:

- Category I Capital adequacy of Rs.5 crores
- Category II Capital adequacy of Rs.50 lakhs
- Category III Capital adequacy of Rs.20 lakhs
- Category IV No capital adequacy requirement

The functions rendered by these four categories were also stipulated by SEBI.

Category I merchant banker could act as an issue manager, underwriter, advisor, consultant and portfolio manager. Although the advisory or consultancy function could be performed by all the four categories, it will not possible for Categories III and IV merchant bankers to act as an issue manager or portfolio manager.

RELEVANT PROVISIONS OF COMPANIES ACT

The Companies Act, 1956 sets out the code of conduct for companies with regard to issue, allotment and transfers of securities. It provides for disclosure to be made in the prospectus about the project, means of financing, particulars of company management and the perceptions of management with regard to risk factors. The legal aspects concerning dividends, rights and bonus issues are covered in the Companies Act.

♣ Company means a company formed and registered under this Act or an existing company as defined in clause (ii);

♣ Existing company means a company formed and registered under any of the previous companies laws specified below: Any Act or Acts relating to companies in force before the Indian Companies Act, 1866 (10 of 1866) and repealed by the Act;

I. The Indian Companies Act, 1866
II. The Indian Companies Act, 1882
III. The Indian Companies Act, 1913
IV. The Registration of Transferred Companies Ordinance 1942

♣ Private company means a company which has a minimum paid-up capital of one lakh rupees or such higher paid-up capital as may be prescribed, and by its articles.

a) restricts the right to transfer its shares, if any;

b) limits the number of its members to fifty not including

c) persons who are in the employment of the company, and

d) persons who, having been formerly in the employment of the company, were members

e) of the company while in that employment and have continued to be members after the employment ceased; and

f) prohibits any invitation to the public to subscribe for any shares in, or debentures of, the company;

g) prohibits any invitation or acceptance of deposits from persons other than its members, directors or their relatives Provided that where two or more persons hold one or more shares in a company jointly, they shall, for the purposes of this definition, be treated as a single member;

♣ Public company means a company which

a) is not a private company;

b) has a minimum paid-up capital of five lakh rupees or such higher paid-up capital, may be prescribed

c) is a private company which is a subsidiary of a company which is not a private company.

The various provisions and regulations of Companies Act, 1956 which govern the merchant bankers:

o Prospectus (Sec. 55 to 68A)

o Allotment (Sec. 55 to 75)

o Commissions and discounts (Sec. 76 & 77)

o Issue of shares at premium and at discount (Sec. 78 & 79)

o Issue and redemption of preference shares (Sec. 80 & 80A)

o Further issues of capital (Sec. 81) o Nature, numbering and certificate of shares (Sec. 82 to 84)

o Kinds of share capital and prohibition on issue of any other kind of shares (Sec. 85 & 86)

5.4 SEBI GUIDELINES

The SEBI Act, 1992 established SEBI as market regulator with all statutory powers. SEBI was established with the objective of protecting the interest of investors and for regulation and development of securities market in India. It has the powers to regulate all the market intermediaries. The SEBI grants registration to the market intermediaries and has powers to inspect, monitor and take penal actions on them in case of violations of any provisions of the Act or rules, Issues of securities, stock exchanges and other market intermediaries are subject to regulatory power of SEBI.

Merchant banking in India is governed by SEBI (Merchant Bankers) Regulations 1992. It provides for registration of merchant bankers, general obligations and responsibilities of merchant bankers, procedures for inspection and procedures for action in case of defaults. Besides these, the code of conduct for merchant bankers is also specified. To become a merchant banker the following are the pre-requisites:

• The applicant must be corporate body.

• The applicant should not carry on a business other than the securities market business.

• He should have the necessary infrastructure in terms of office space and experienced man-power.

• The associate company or the group company should not have been a registered merchant banker.

• The applicant should not have been involved in security scams.

• The minimum net worth of the applicant firm should be Rs.50million

Obligations and Responsibilities of Merchant Bankers

In the conduct of his business, a merchant banker is supposed to observe certain codes of conduct. SEBI has issued some guidelines for regulating the merchant banking
activities and the code of conduct for the merchant banks is specified in the Schedule III of the SEBI (Merchant Bankers) Regulations 1992.

1. High standards:
2. Due diligence:
3. Dealing with competing merchant bankers:
4. No tall claims:
5. Cost-effective service:
6. Confidentially:
7. Disclosure of information:
8. Avoid market manipulative practices:
9. Restrain on advisory role:

All public issues shall be managed by a merchant banker who acts as the lead merchant banker or the lead manager to the issue. The number of such lead managers is linked to the size of the public issue as given below. The regulations of SEBI specify certain responsibilities of the lead merchant banker. In a public issue, the responsibilities relate to the disclosure of information in the offer documents, allotment of securities and refund of application money.

Size of Public Issue and Number of Lead Managers

Issue Size	No.of Lead Managers
Less than Rs.50 crores	2
Rs.50 – 100 crores	3
Rs.100 – 200 crores	4
Rs.200 – 400 crores	5
Above 400 crores	5 or more

SEBI has pronounced the following guidelines for Merchant Bankers:

1. Submission of Offer Document:

2. Dispatch of issue material

3. Underwriting:

4. Compliance Obligations:

5) Redressed of investor grievances:

6) The concerned lead merchant banker

7) Issue of No objection Certificate (NOC):

8) Registration of Merchant Bankers:

9) Renewal of Registration:

10) Impositions of Penalty Points:

5.5 FEMA (Foreign Exchange Management Act)

The Foreign Exchange Management Act (FEMA) is a 1999 Indian Law "to consolidate and amend the law relating to foreign exchange with the objective of facilitating external trade and payments and for promoting the orderly development and maintenance of foreign exchange market in India".

FEMA was passed in the winter session of Parliament in 1999, replacing the Foreign Exchange Regulation Act (FERA). This act seeks to make offenses related to foreign exchange civil offenses. It extends to the whole of India, replacing FERA, which had become incompatible with the pro-liberalization policies of the Government of India. It enabled a new foreign exchange management regime consistent with the emerging framework of the World Trade Organization (WTO). It is another matter that the enactment of FEMA also brought with it the Prevention of Money Laundering Act of 2002, which came into effect from 1 July 2005.

Unlike other laws where everything is permitted unless specifically prohibited, under this act everything was prohibited unless specifically permitted. Hence the tenor and tone of the Act was very drastic. It required imprisonment even for minor offences. Under FERA a person was presumed guilty unless he proved himself innocent, whereas under other laws a person is presumed innocent unless he is proven guilty.

The main objective behind the Foreign Exchange Management Act (1999) is to consolidate and amend the law relating to foreign exchange with the objective of facilitating external trade and payments. It was also formulated to promote the orderly development and maintenance of foreign exchange market in India. FEMA is applicable to all parts of India. The act is also applicable to all branches, offices and agencies outside India owned or controlled by a person who is a resident of India.

The FEMA head-office, also known as Enforcement Directorate is situated in New Delhi and is headed by a Director. The Directorate is further divided into 5 zonal offices in Delhi, Mumbai, Kolkata, Chennai and Jalandhar and each office is headed by a Deputy Director. Each zone is further divided into 7 sub-zonal offices headed by the Assistant Directors and 5 field units headed by Chief Enforcement Officers.

Switch from FERA

FERA, in place since 1974, did not succeed in restricting activities such as the expansion of translational corporations (TNCs). The concessions made to FERA in 1991-1993 showed that FERA was on the verge of becoming redundant. After the amendment of FERA in 1993, it was decided that the act would become the FEMA. This was done in order to relax the controls on foreign exchange in India, as a result of economic liberalization. FEMA served to make transactions for external trade (exports and imports) easier – transactions involving current account for external trade no longer required RBI's permission. The deals in Foreign Exchange were to be 'managed' instead of 'regulated'. The switch to FEMA shows the change on the part of the government in terms of foreign capital.

Some Highlights of FEMA

FEMA is applicable in all over India and even branches, offices and agencies located outside India, if it belongs to a person who is a resident of India.

• It prohibits foreign exchange dealing undertaken other than an authorised person;

• It also makes it clear that if any person residing in India received any Forex payment (without there being a corresponding inward remittance from abroad) the concerned person shall be deemed to have received they payment from an unauthorized person.

• There are 7 types of current account transactions, which are totally prohibited, and therefore no transaction can be undertaken relating to them. These include transaction relating to lotteries, football pools, banned magazines and a few others.

• FEMA and the related rules give full freedom to Resident of India (ROI) to hold or own or transfer any foreign security or immovable property situated outside India. • Similar freedom is also given to a resident who inherits such security or immovable property from an ROI.

• An ROI is permitted to hold shares, securities and properties acquired by him while he was a Resident or inherited such properties from a Resident.

Leading indicators of sickness:

Just as diseases are identified by certain symptoms, industrial sickness can be identified by the following symptoms. These symptoms act as leading indicators of sickness, and if immediate remedial actions are not taken, the sickness will grow to the extent that the organization will find its natural death.

- ❖ Continuous reduction in turnover.
- ❖ Piling up of inventory.
- ❖ Continuous reduction of net profit to sales ratio.
- ❖ Short term borrowings at high interest rate.
- ❖ Continuous cash losses leading to erosion of tangible net worth.
- ❖ Default in payment of interest on borrowings and default in repayment of term loan instalments.
- ❖ The ‘sundry debtors’ as well as the ‘sundry creditors’ keep growing and reaching a disproportionately high level.
- ❖ Approaching the banker for temporary over draft at frequent intervals.
- ❖ High turnover of personnel, especially at senior levels.
- ❖ Change in accounting procedure with to view to window dressing.
- ❖ Delay in finalization of accounts.

Need for revival/rehabilitation programme: A project that has gone sick would have already swallowed huge scarce resources. In order to utilize the assets and infrastructure already created for the project, the project is to be revived from sickness. There is no doubt that the project would have had some weak areas which could have been the cause for the sickness. Inspite of this, rehabilitating the sick project is worth considering since the cost of setting up a new unit might be substantially higher as compared to the cost of rehabilitating a viable sick unit. Of course, having known the factors that were responsible for leading the unit to sickness, they can be properly addressed in the revival package. Revival of a sick unit may be necessitated or justified in view of the under lying socio-economic objectives such as the following.

(a) The project may be in a sector that is vital to the economy. Abandoning the project may lead to other socio-economic ill effects.

(b) Many ancillary units may be dependent on the unit that has gone sick. Unless the sick unit is revived, it will have a chain effect of all such dependent ancillary units becoming sick.

(c) Banks and financial institutions would have locked up their money in sick ventures. In order to get back the investment of banks and financial institutions, the project is to be revived and made to work again and generate surpluses. Though banks and financial institutions that support a revival programme for the sick unit may be required to fund the project again, they will be prepared to implement revival packages if they are convinced that they will, apart from getting back their present investment with interest, also get back their earlier investments that are locked up.

5.6 Services of merchant bank:

Merchant banks render diverse services & functions such as corporate counseling, project counseling, loan syndication, issue management, underwriting a public issue, acting as managers, consults are advisors to the issue portfolio management , advisory service related to mergers & takeovers , offshores finance & investment advisory service to NRI.

1. **Corporate counseling**: A merchant banker provides counseling services to companies. Corporate counseling convers project counseling, capital restructuring,

project management, public issue management, loan syndication , working capital, fixed deposit, lease financing, acceptance credit etc. suggestion & opinions are given to corporate units to solve their problems ensure better performance.

2. **Project counseling:** the new entrepreneur is advised on the conception of ideas of various projects, preparation of projects, feasibility reports, location of factory, obtaining funds, sanctions & approvals from state & central government departments. The project is appraised as to the location, technical, commercial & financial viability of the project. Applications are filled up with relevant data and information to obtain funds from financial institutions.

3. **Loan syndication:** Merchant bankers assists clients in getting term loans for projects. Such loans may be given by a single development finance institution or a syndicate or consortium. The choice of financial institution depends upon location of the unit & size of project cost. After making an appraisal of the project otsatisfyitsvialability, capital structure of the proposed entry is designed. Promoters contribution is arrived at. An approximate amount of term loan to be raised is finally arrived at. A preliminary meeting is fixed with financial institution. Application for term loan is submitted for perusal of banks.

4. **Issue management:** issue means offer for sale of securities by an body corporate to the public. Corporate securities include equity shares, preference shares and debentures or bands. Merchant bankers act as an intermediary for transfer of capital form the public or other person who owes it to the company making an issue. The issue function may be broadly divided into pre-issue management & post-issue management. The pre-issue management obligation of Merchant bankers relate to submission of various documents to SEBI, the appointment of intermediates, underwriting, making public the offer documents, dispatch of issue materials, mandatory collection centers, advertisement and abridged prospectus. The major post-issue obligations relate to association with allotment procedures, post issue monitoring reports, redressal of investors grievances co-ordination with intermediaries, post-issue advertisement, basic of allotment in over-subscribed issue etc.

5. **Underwriting of public issue:** underwriting is an agreement to the issue of securities in the event of failure of the issue to get full subscription from the public. The

issue underwriting by well-known institution command high premium from the public. By acting as an underwriter, Merchant bankers play a significant role in the development in the primary market from the corporate securities.

6. **Managers, consultants or advisors to the issue:** Merchant banker as managers to the issue assist in drafting of prospectus application form & completion of formalities under the company, appointment of registers for dealing with share application & transfer and listing of shares on the company on the stock exchange. Companies may appoint one or more agencies as managers to the issue. SEBI guidelines provide for management of issues by at least one authorized merchant bankers

7. **Portfolio management:** portfolio means a carefully blended asset combination which aims at minimizing risks & maximizing returns on investment in such assets. Instead of confining investment a single class of security, different kinds of security such as shares, debentures are bonds issued by different companies are chosen for investment. Portfolio management refers to maintaining an ideal combination of securities in a manner that they give maximum return with minimum risks. Investors by themselves may not be able to choose appropriate securities for want of expertise in the field of investments. Merchant bankers help the prospective investors in choosing write kind of securities.

8. **Advisory service relating to mergers to takeovers:** in merger two or more companies combined into a single company where one survives and other loss their corporate existence. Undertake over, one company occur controlling interest in the share capital of another existence company. Merchant bankers negotiate between the offeror and offeree. The merchant bankers appraise the merger or takeover proposals with regard to financial viability & technical feasibility. He negotiates purchase consideration & mode of payment. With the approval of the RBI or government, he drafts scheme of amalgamation and obtains approval from financial institution.

9. **Offshore finance:** the foreign investors are offered more services as they have less knowledge about domestic market. The merchant bankers help their kind on those dealings with involve foreign currency, long-term foreign currency loans, joint venture abroad, finance exports & imports & foreign collaboration arrangements.

In addition to above functions the merchant bankers perform functions relating to treasury management, stock broking, servicing of issues, small scale industry counseling, equity research, investment counseling, assistance to NRI investors, etc.

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