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MBA PPT

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Code: 110 Enhancing Business Communication Skills

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Module 1 Business Communication

Meaning; Process of communication; Channels of Communication - Concept, Medias; Barriers to communication; Guidelines to overcome communication barriers.

1.1 Objectives:

After studying this unit you should be able to understand

(1) Meaning of communication

(2) Types of communication

(3) Business communication

(4)Barriers to communication & Know how to overcome the Barriers and make Communication effective.

Chapter Outcome

Able To Understand Concept of communication Process of communication ,Channels of communication & Barrier's of communication & ways to overcome Barriers.

1.2 Introduction

Communication is an important aspect of human behavior. It stands for natural activity of all human beings to convey opinions, feelings, information, and ideas to others through words (written or spoken), body language, or signs. Communication is an integral part of life. From birth till death every living being is communicating in his or her own way, be it birds, animals, trees or human beings.

In the field of Business Management, communication plays a vital role. If we analyses the success story of many companies, we can find that a well-organized communication system is one of the root causes of its success story. As the forces of communication are becoming more and move modernized, it is necessary to make a study of it, to equip ourselves to be the managers of business. The field of business is very closely associated with the customers with whom we have to interact every day. The success of a business manager is directly proportionate to his success in communication, as a communicator as well as a receiver of communication.

Even in our daily life we find many failures and bungling just because the right communication does not reach the right person at the right time. A miscarriage in communication leads to untold sufferings to a number of people. All of us have the better experience of wasting time and physical pain just because the right communication did not reach us at the right time. The proverb "A stitch in time saves nine" can be altered in "A communication in time saves many things".

1.3 Definitions of Communication

Definitions: There are a number of definitions of the term communication. A few of them are being reproduced below:

"Communication is the sum of all things, one person does when he wants to create understanding in the minds of another. It involves a systematic and continuous process of telling, listening and understanding."

– Allen Louis

Communication has been defined "As the transfer of information from one person to another whether or not it elicits confidence."

– Koontz and O' Donell

"Communication is an exchange of facts, ideas, opinions or emotions by two or more persons."

– George Terry

Business Communication and its Scope for Management Communication is defined as "the process of passing information and understanding from one person to another, it is essentially a bridge of meaning between people. By using the bridge of meaning a person can safely cross the river of misunderstanding."

– Keith Davis

Effective communication is "purposive interchange, resulting in workable understanding and agreement between the sender and receiver of a message".

– George Vardman

"Communication is interchange of thoughts, opinions, or information, by speech, writing, or signs".

– Robert Anderson

Communication is the process by which information is passed between individuals and/ or organizations by means of previously agreed symbols.

– Peter Little

"Communication is an exchange of facts, ideas, opinions or emotions by two or more persons"
-- W. H. Newman & C. F. Gummer.

"Communication may be broadly defined as the process of meaningful, interaction among human beings. More especially, it is the process by meanings are perceived and understanding is reached among human beings"
-- D.E. Mcmefarland.

Communication is any behaviour that results in an exchange of meaning
-- The American Management Association.

"Communication is something so simple and difficult that we can never put it in simple words",
-T.S. Mathews.

– The American Management Association
Communication may be broadly defined as the process of meaningful interaction among human beings. More specifically, it is the process by which meanings are perceived and understandings are reached among human beings.

1.4 The Need for Communication

A normal human compulsorily needs some kind of communication with some other person or thing. If a person does not communicate anything to anybody he is an abnormal human being al counseling or treatment. Apart from this basic need, there are various other needs for communication.

(i) Need for Inclusion.

Everyman is a member in society, in a family, group…etc. He needs good relations with them, a sense of belonging. There is the need for social gathering, family or friends get together etc. We may belong to organizations, associations and there is the need to communicate.

(ii) Need for Control

With regard to power and influence there is a compulsion for communication. Without any communication, you cannot control anything in the world. Controlling people, workers, and friends also requires the right type of communication.

(iii) Human Need for Recognition, Affection

In business, recognition and affection take the shape of partnership, friendship and mutual help to tide over difficulties. It is very difficult not to control one's own self-expression.

1.5 Nature Of Communication

The analysis of the above definitions implies that communication has the following characteristics, which define the nature of Communication

1. ***It is process:*** The term process has been defined as an identifiable flow of interrelated events moving over time towards some goal or an end. Accordingly, communication is a process in which there are some identifiable inter-related events which starts with the sender. Then it moves by encoding messages, through some channel till the receiver receives the massage and ends with the feedback.
2. ***It is inevitable:*** Communication is essential physically, socially and psychologically. If an individual is provided all physical comforts but is not allowed to read, write, speak and listen, he will become mentally retarded.
3. ***Meaning Based:*** communication is meaning-based. As has been very succinctly said by a specialist, "The most immediate need for communication is to be able to refer to things in the real world, that is, to be able to name things, states, events, attributes, using words". In addition, we must be able to link words together so as to make meaningful sentences and language. Hence, there is a need to be clearheaded about what we want to say.
4. ***Communication is intentional as well as unintentional:*** While some communication is intended, that is, it is purposely done, much of the communicationmay be unintentional, that is, we might convey, in many ways, even what we don't wish to communicate.
5. ***Communication is systematic:*** Every component of Communication is affected by the other. The one who sends the message, the message itself as well as the receiver of the message; all are interrelated and affected by each other.
6. ***A two-way traffic:*** A significant aspect of communication is involvement of atleast two people, i.e., a sender and a receiver. In fact, one person cannot communicate to himself. A receiver is must to complete the communication act. There is no communication, until the massage sent by the sender is being received by the receiver. A personnel director may send

hundreds of memos and warning letters to employee, but communication is not complete unless it is received and read by them. Since communication is an exchange of views, opinions, directions etc., it is a two-way traffic. The “two way” can be understood in many ways. It is not just the sender is involved in communication, but the receiver, is also equally involved in the process. In another way, Communication is both ways, upward as well as downward, in an organization. Messages, directives, opinions, etc., are sent to lower levels in the hierarchy of management. Likewise, grievances, complaints, opinions feelings, points of view etc., are communicated upward along the line, i.e., from workers (lower level) to management (higher level).

George Terry has rightly remarked, “Simply talking or writing, without regard to the recipients’
response, is conducive to misunderstanding.”

Thus, communication should be both ways.

7. ***Communication is a social process:*** Human being is a social animal. He cannot live in isolation. Communication is a process which helps the human being to interact and socialize. Hence, it is a social process.

8. ***Dynamic Process:*** Dynamic means “ever changing”. Communication is not a constant, one time event. It is a dynamic process, which is changing all the time.

9. ***Continuous Process:*** Communication is a continuous process. More often than not, it is repeated to achieve the desired results. It is an ongoing process, in which one interaction is followed by the other.

10. ***Communication is both interaction and transaction:*** The participants of communication exchange ideas and information and also influence each other in the process. They share and exchange both thoughts and meanings.

11. ***It is spiraling process:*** Communication between the receiver and the sender usually does not start as the same level or grow at the same rate. It is due to difference at abilities of the sender as well as the receiver. Moreover, noise and time have an impact on it. As a result. Communication takes a spiral shape before it is completed and reaches the receiver the same level and space

12. ***It is contextual:*** Communication happens with reference to a context. The same words would mean different things if they are said in different contexts. Hence, meaning may differ in different situations.

13. ***Needs proper understanding:*** There may be numerous media of communication but the main purpose of conveying the message is to create a proper understanding of the message in the mind of the other party. For this purpose, it should be clearly and concisely worded.
14. ***Leads achievement of the organizational objective:*** Effective communication does this by creating the sense of object orientation in the organization.
15. ***Dispels misunderstanding:*** In this sense, it provides clear understanding between persons and thus builds a bridge of camaraderie among people.
16. ***It has four specific skills:*** Communication has four specific skills. They are reading, writing, speaking and listening. Their brief sketch is shown in the following Exhibit.
15. ***It is all pervasive:*** Irrespective of the type and size of the organization, communication is inevitable. It is important at all levels. It exists everywhere in an organization. With communication, it is possible to delegate authority, to coordinate activities, and to take managerial decisions.
16. ***It shares thoughts and ideas, which produce response:*** Thoughts and ideas, which do not produce response, do not come under the Preview of communication.
17. ***It is the lifeblood of the business:*** No business organization and no civilized society can exist, survive and grow without the existence of an effective communication network. Through communication, people working in an organization get activated and involved in performing variety of roles for achieving organizational goals. Various mode of communication are used for people outside the organization to know the existence, products, profit and progress of the organization.

Importance of Communication in Management

Communication skills constitute an important aspect of effective management. Managing is a complex process. In simple terms, it can be described as the organization of capital, labour, and material to achieve production and distribution of particular goods or services. First, the management fixes its objectives-what to do and form its policy on how to do it. Then there has to be a system through which the production and distribution processes can be guided, coordinated, and controlled to ensure that the management operations are led and coordinated and the results feed back. Managing is a unified, organized, and cooperative system committed to the achievement of common goals. The sense of unity of purpose and commitment to a single organisational goal can be developed only through the inspiring and persuasive power of communication. To be able to do so, a manager needs to have

communication skills of a high order to structure the information, according to its negative/ affirmative nature and to sue words and tones according to purpose of the communication. The manager should be able to create a desired relationship with audience/ workers to produce the needed response. For training and development programmes, communication also plays a vital role. For appraising employees, performance standard also require to be properly and clearly communicated so that employee understand what he needs to do, and subsequently employees also need feedback about their performance. In case the HR manager fails to properly communicate the performance outcome result, it will cause emotional problems, dissatisfaction, and low morale among employees. Communications is also essential for explaining disciplinary rules and procedures and their proper implementation. A human resources managers need to have good negotiation skills to arrive at an agreement during the collective bargaining process overcome obstacles, which may arise in the negotiation process. It is also required for fostering effective participative and collaborative work culture in the organization. Problems, suggestions opinions and recommendations of employees are transmitted through communication in an organization. Communication has direct link with motivation, morale, absenteeism and productivity of the employees. A leader's failure or success depends upon how well he communicates his plans, vision and ideas to his followers. Thus, a whole lot of strategies, verbal, of effective communication form an important part of management as a discipline. Some Important Functions of Managing The functions of managing which includes planning, organizing, instructing, coordinating and controlling requires the support/action of communication.

1. Forecasting and Planning: Each function depends on effective communication for its success. For example, if the management fails to communicate its objectives, polices, programmes, procedures, and budgetary provisions to the concerned people at the proper time, an organization would fail to run in an organized and targeted manner.

2. Organising: Organising, as a management function, determines the formal and informal relationships within the organization and outside it. These relationships are developed and maintained through inter-personal communication.

3. Instructing: The function of instructing wholly depends upon interpersonal exchange of information regarding products, processes, and targets for its success.

4. Coordinating: Coordinating as a manager's function is, perhaps, the most demanding of all functions. It requires excellent communication skills to ensure that all efforts are directed

toward the achievement of a single organisational goal. To see that diverse activities are unified into single whole, the manager should be able to relate with all people formally and socially.

5. Controlling: Finally for controlling, the manager should have competence to receive information and respond quickly Hence, an active communication system is vital for the good health of an organization. If there is a continuous sharing of ideas and interactive meetings between the management and workers, the overall atmosphere of understanding and goodwill would prevail in the workplace. If decision-making is transparent, employees would understand reasons for those decisions and accept and **implement them even if they affect them adversely**

Information to be Communicated in an Organisation

To reduce the chances of disinformation by the grapevine, an organisation keeps all its employees informed about a number of facts of the organization. The content of the information is generally a mixture of fact, opinion, attitudes, and interpretation. Broadly, all business communications can be divided into five types of information:

1. Statutory Information: The information, such as terms and conditions of service, is to be communicated to all employees as a statutory requirement.

2. Regular work-situation: The information regarding normal work situation has to be regularly communicated through routine formal briefing sessions or through informal chat sessions between the manager and the group members (his/her colleagues)

3. Major policy or operational change information: Any major change in the organisation policy or work, which is going to affect everyone or a large number of employees, has to be communicated to all be calling special meetings or by issuing notices to be read by all.

4. Information Bulletin: To keep people informed about events and happenings taking place in the organisation, periodic information in the form of a newsletter is communicated to all employees of the company. This information creates in employees a sense of involvement in the working of the organisation.

5. Communication by Expectancy: Information of critical changes should be carefully and gradually communicated to those who are going to be directly affected by the decision. Before the decision is taken and implemented, the people concerned must

SCOPE OF COMMUNICATION

Communication has unlimited scope. The scope of Communication can be understood under two headings:

1. External Dimension
2. Internal Dimension

External Dimension: External dimension regarding communication have a bigger arena .It includes building relations with external agencies and stakeholders. Effective communication can establish a healthy external organizational climate in which there is trust, cooperation, collaboration, innovation and commitment. Self involvement of people in various activities is inculcated to create vibrant and congenial atmosphere . Likewise, depending upon how an organization looks after its advertisements, publicity and public relations function, public image and goodwill of the organization is created through effective communication

Internal Dimension: A lot of communication takes place within the organization. In an organization, starting from formulating corporate vision, mission policy objectives, taking goals to their implementation, communication plays a significant role. For formulating policies, top management needs to obtain information and views of the middle and lower level management through various forms. Especially for the appropriate implementation of the top management policies and plans, it is only communication which facilitates proper understanding of the policies in the right spirit. Public relations, as a management function, solely depend on right communication. There are different functions to be performed by various functional departments to keep the organization running. Within each department and across different departments, functional heads have to communicate to their subordinates by giving job-related instructions, suggestions, advice and orders. For obtaining and giving cooperation to other departments, exchange of information plays a key role. When we look at each functional department, the scope of communication further becomes clear. For example, in the case of human resources department, the HR manager needs to take care of communication to avoid grievance, dissatisfaction, and industrial unrest in the entire organization. Communication skill is essential for manager to design right advertisement copies, conducting effective interviews, arranging better training programmers etc.

IMPORTANCE AND FUNCTIONS OF COMMUNICATION

Communication plays a vital role in every walk of life. According to Luthans, some estimates of the extent of its use to go up to about three –fourths of an active human being’s life, and even higher proportions of a typical manager’s time. The world is changing fast and with it,

every organization is becoming more and more sophisticated. So, communication has first of all to be given due recognition as an integral part of process change. Whenever a change in the direction of technology, structures or objectives takes place, it becomes easier with the help of communication. The importance of communication can be judged from the functions performed by it. Following are the important functions of communication:

1. Information Sharing: The main purpose of communication is to transmit information for a source to target individuals or groups. Various type of information is transmitted in the organisation: policies and rules, and changes and development in the organisation etc. There may be need for fast diffusion of some information in the organisation, e.g., special rewards and awards given, settlements with the union, and major changes in the organisation.

2. Feedback: There is a need to give feedback to the employees on their achievements, to the department on their performance, and to the higher management on the fulfillment of goals; and, difficulties encountered in the communication of feedback helps in taking corrective measures and making necessary adjustments, and it motivates people in developing challenging and realistic plans.

3. Influence: information is power. One purpose of communication is to influence people. The manager communicates to create a good environment, right attitudes, and congenial working relationship. All these are examples of influencing.

4. Problem-solving: In many cases communications aim to solving problems. Communication between the management and the unions on some issues (negotiation) is aimed at finding solutions for a problem and to evolve a consensus.

5. Assists in decision-making: The most important function of every manager is decision-making. In order to make accurate and appropriate decision, a manager needs to obtain information available in various channels of communication. Here the way decision is communicated will have an impact upon the outcomes of the organization in terms of cooperation and support of the people to achieve organizational goals. For arriving at a decision several kinds of communication are needed, e. g., exchange of information, views, and available alternative etc., communication helps a great deal in decision –making.

6. Facilitating change: The effectiveness of a change introduced in an organisation depends to a large extent on the clarity and spontaneity of the communication. Communication between the managers and employees helps in recognising the difficulties in the planned change, and in taking corrective action.

7. Group building: Communication helps in building relationships. If communication breaks down the group may disintegrate. Communication provides the necessary lubrication for the proper functioning of a group.

8. Gate keeping: Communication helps to build linkages of the organisation with the outside world. The organisation can use its environment to increase its effectiveness. 9. Conveying the right message: The main object of communication is to convey the right message to the right person, i.e., to the person for whom it is meant. The message conveyed should be well understood and accepted by the receiver in the right perspective. In other words, it should carry the same meaning which has been conveyed so that it may be translated in to action effectively.

10. Helps in Co-ordination of Effort: Communication is an effective tool for co-coordinating the activities of different persons engaged in running a business. Co-ordination without communication is a remote possibility. In organizations, there exist a lot of differences, which are many a times formally created by an organization through departments, divisions, delegation, decentralization, authority and power. Through various effective communication mechanisms like letters, circulars, meetings conferences, telephone, cellular phones etc., these differences are minimised and activities are properly coordinated to achieve organizational goals. The individuals or groups come to know what others are doing and what is expected from only through communication.

11. Good industrial Relations: communication develops good industrial relations as it conveys the feelings, ideas, opinions and viewpoints of one party two the other parties. The two parties –the management and the subordinates come closer through communication. They understand each other and dispel any misunderstanding. Thus, it promotes cooperation and good industrial relations.

12. Development of managerial skills: Communication helps managers to understand human behaviour at work. Communication of facts, ideas, opinions, information, feelings etc., add value to the knowledge of managers about various happenings, in the organization and behaviour of people. Thus, communication is a process of learning.

13. Ensuring Effectiveness of policies: The organisation formulates policies and programmes to guide the work force. This should be conveyed properly to those who are really responsible for the execution of work to achieve the organisation objectives. Only effective communication can translate the policies in to action. Effectiveness of the policies can be judged from the success which surely depends upon an effective communication system.

14. Motivating People: If people working in organizations are not regularly informed about their management's expectations, plans and policies with respect to their future career and growth, promotion and welfare measures, they feel frustrated 17 Business Communication and its Scope for Management and de-motivated. Through various communication devices, managers declare rewards and incentives to motivate employees.

15. Performance feedback: People working in an organization need to how well they are performing and what needs to be done to achieve and exceed the standards set by management? Through measures like letter of appreciation or suggestion, the subordinates are given a feedback about the performance status.

16. Job instruction: Managers need to communicate to their subordinates the job instructions in terms of requirements of the job from time to time. Failure on the part of managers in communicating these instructions may lead to confusion, wastage and inefficiency in an organization.

17. Controlling people: Every organization has its own rules, regulations and procedures framed by the management in order to perform various activities to regulate the behavior of people. Therefore an organization issues notices, circulars, letters etc. to communicate the existing or changed rules, regulations and procedures. The management information system is well –known as a control mechanism. Information is transmitted to ensure that plans are being carried out according to the original design. Communication helps in ensuring such control.

18. Useful as grapevine: Informal communication or grapevine in organizations, sometimes leading to rumours, is often used by employees to create misunderstanding. But sometimes management also takes the help of this route to assess the impact and reaction of employee before introducing proposed policy changes in the organization.

19. Emotive function: Communication facilitates the expression of feelings and satisfaction. It also enables the people to express their dissatisfaction and unhappiness through words or in writing to release their tension and frustration. That is why in organizations there exist grievance resolution machinery and often managers and supervisors are trained how to handle employees' emotional problems and grievances.

1.6 OBJECTIVES/PURPOSE OF COMMUNICATION

An objective is something that we want to attain or accomplish by our efforts; it is the purpose with which we undertake an activity. When we speak or write to our friends,

we may not have a specific purpose, except to keep in touch, to be friendly; when we chat with a group of friends, we simply want to socialize, be friendly, or express ourselves. But in an official or business situation, when we speak, listen or write to customers, or to our subordinates or our superiors, we have a specific purpose or objective; we want to accomplish something. Communication could have many objectives depending on the context and persons involved. Communication within a family, in a classroom, in a theatre, in a seminar, in a boardroom and in the organsation has different objectives. The objectives depend upon the purpose to be achieved.

The objectives of business communication would include the following:

To inform: This is the foremost objective of communication. Information is power. The information needs within and outside the organization can be met through communication

To persuade: Businesses work through persuation. It is important to persuade employees to work efficiently, to persuade customers to buy our product and so on. The objective of communication may be to persuade.

To educate: To disseminate knowledge and develop skills and attitudes among people working in the organization may be another objective of communication.

To train: Communication is an integral part of any training programme. Training is required to achieve proficiency in specific skills. Instruction, demonstration, practice and discussion during training require communication as an integral part.

To motivate: High level of morale and motivation are a must to ensure high levels of productivity and efficiency on a sustainable basis. Communication provides a means to keep motivation levels high.

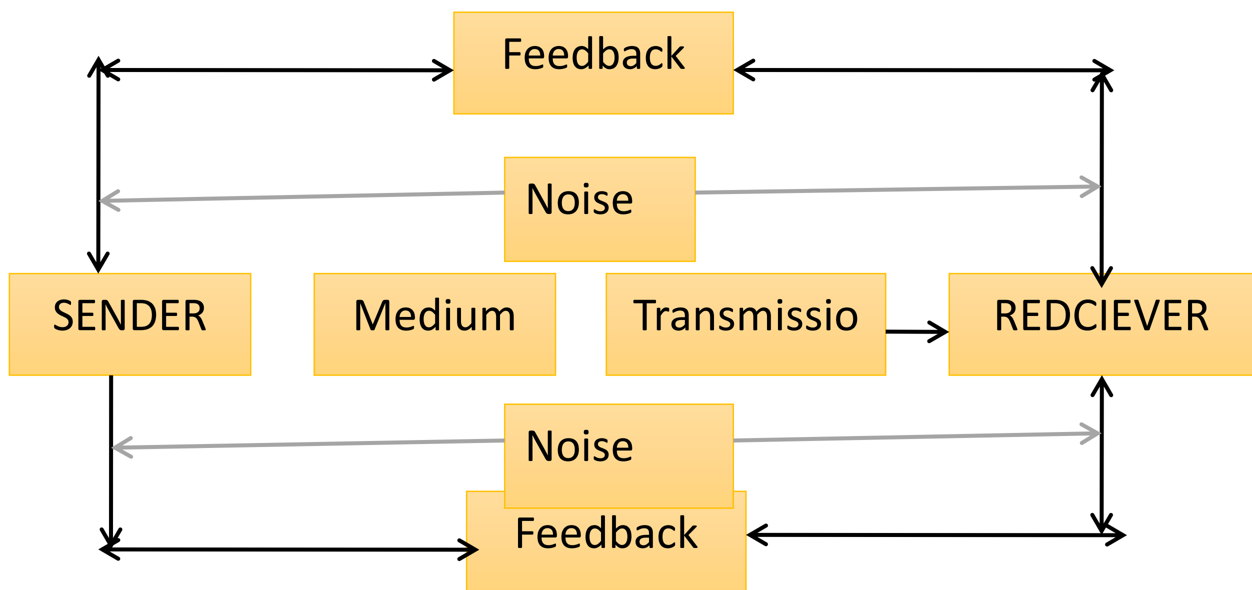
To integrate: Large business organizations have different business units, departments and territorial divisions, pursuing different targets. Communication provides the means for an integrated approach in pursuing organizational goals.

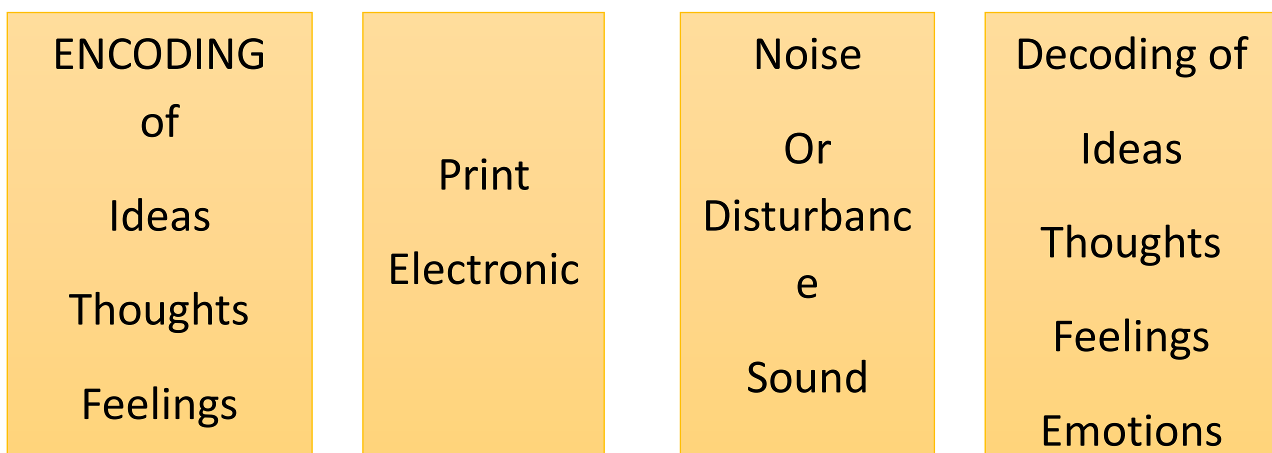
To relate: Good business relations are a must for the continued success of any business organsiation. Communication provides the means for building and nurturing mutually beneficial relationships.

To entertain: Whatever be the nature of business, there is always a time for entertainment. Communication facilitates social bonding and brings lighter moments that help in entertainment and relieving tension.

The objectives of communication are dynamic and ever-changing. Some of the common objectives of official communication are to get or give information, to ask for or give instructions or advice or suggestions, to make requests, to persuade other people to agree with us. Sometimes, we communicate with the intention of complaining, or warning; but unfortunately, we do this angrily and get into arguments. If we learn to complain and warn in an acceptable and constructive manner, our serious intention can be conveyed quite effectively without damaging relationships. In order to caution, counsel, clarify, apprise, evaluate, reprimand, organize and numerous such objectives, we make use of communication.

1.7 Communication process





Sender

The very foundation of communication process is laid by the person who transmits or sends the message. He is the sender of the message which may be a thought, idea, a picture, symbol, report or an order and postures and gestures, even a momentary smile. The sender is therefore the initiator of the message that need to be transmitted. After having generated the idea, information etc. the sender encodes it in such a manner that can be well-understood by the receiver.

Message

Message is referred to as the information conveyed by words as in speech and write-ups, signs, pictures or symbols depending upon the situation and the nature and importance of information desired to be sent. Message is the heart of communication. It is the content the sender wants to covey to the receiver. It can be verbal both written and spoken; or non-verbal i.e. pictorial or symbolic, etc.

Encoding

Encoding is putting the targeted message into appropriate medium which may be verbal or non-verbal depending upon the situation, time, space and nature of the message to be sent. The sender puts the message into a series of symbols, pictures or words which will be communicated to the intended receiver. Encoding is an important step in the communication process as wrong and inappropriate encoding may defeat the true intent of the communication process.

Channel / Transmission

Channel(s) refers to the way or mode the message flows or is transmitted through. The message is transmitted over a channel that links the sender with the receiver. The message may be oral or written and it may be transmitted through a memorandum, a computer, telephone, cell phone, apps or televisions.

Since each channel has its advantages and disadvantages, the choice of proper selection of the channel is paramount for effective communication.

Noise

Noise is anything that has a disturbing influence on the message. Since noise hinders communication, the sender should choose a channel that is free from noise. Noise may occur at the sender's end, during transmission, or at the receiver's end.

i. Ambiguous symbols that lead to faulty encoding

ii. A poor telephone connection

iii. An inattentive receiver

iv. Faulty decoding (attaching the wrong meaning to the message)

v. Prejudices obstructing the poor understanding of a message

vi. Gestures and postures that may distort the message

Receiver

Receiver is the person or group who the message is meant for. He may be a listener, a reader or a viewer. Any negligence on the part of the receiver may make the communication ineffective. The receiver needs to comprehend the message sent in the best possible manner such that the true intent of the communication is attained. The extent to which the receiver decodes the message depends on his/her knowledge of the subject matter of the message, experience, trust and relationship with the sender.

The receiver is as significant a factor in communication process as the sender is. It is the other end of the process. The receiver should be in fit condition to receive the message, that is, he/she should have channel of communication active and should not be preoccupied with other thoughts that might cause him/her to pay insufficient attention to the message.

Decoding

Decoding refers to interpreting or converting the sent message into intelligible language. It simply means comprehending the message. The receiver after receiving the message interprets it and tries to understand it in the best possible manner.

Feedback

Feedback is the ultimate aspect of communication process. It refers to the response of the receiver as to the message sent to him/her by the sender. Feedback is necessary to ensure that the message has been effectively encoded, sent, decoded and comprehended.

It is the final step of the communication process and establishes that the receiver has received the message in its letter and spirit. In other words, the receiver has correctly interpreted the message as it was intended by the sender. It is instrumental to make communication effective and purposeful.

Consider the following points related to the feedback involved in the process of communication −

- It enhances the effectiveness of the communication as it permits the sender to know the efficacy of his message.
- It enables the sender to know if his/her message has been properly comprehended.
- The analysis of feedbacks helps improve future messages. Feedback, like the message, can be verbal or nonverbal and transmitted through carefully chosen channel of communication.
- We can represent the above steps in a model as the model of communication process.

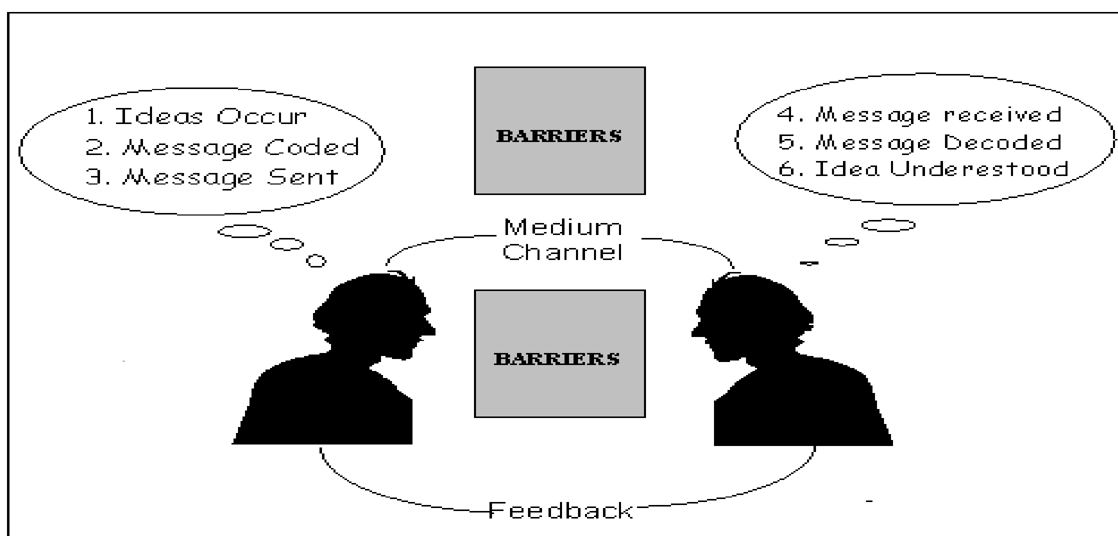
The process of communication, however, is not as smooth or barrier-free as it seems. From its transmission to receipt, the message may get interfered or disturbed with at any stage by many factors which are known as barriers to effective communication. One of the factors is poor choice of communication method. In addition to a poor choice of communication method, other barriers to effective communication include noise and other physical distractions, language problems, and failure to recognize nonverbal signals. We will discuss these barriers of communication in a subsequent chapter.

BARRIERS OF COMMUNICATION

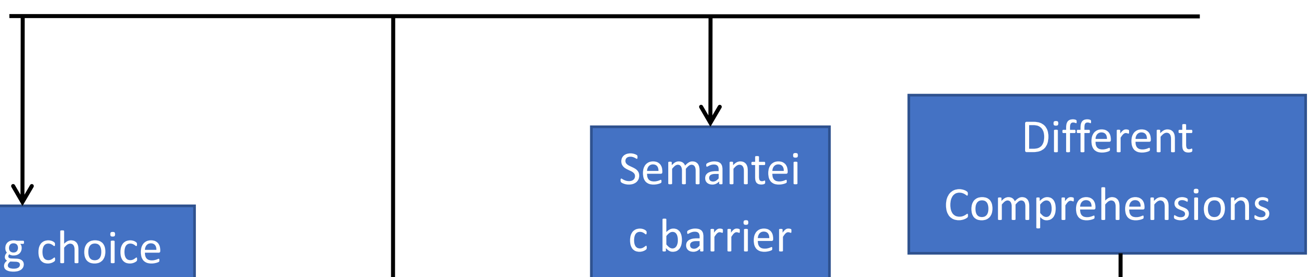
INTRODUCTION

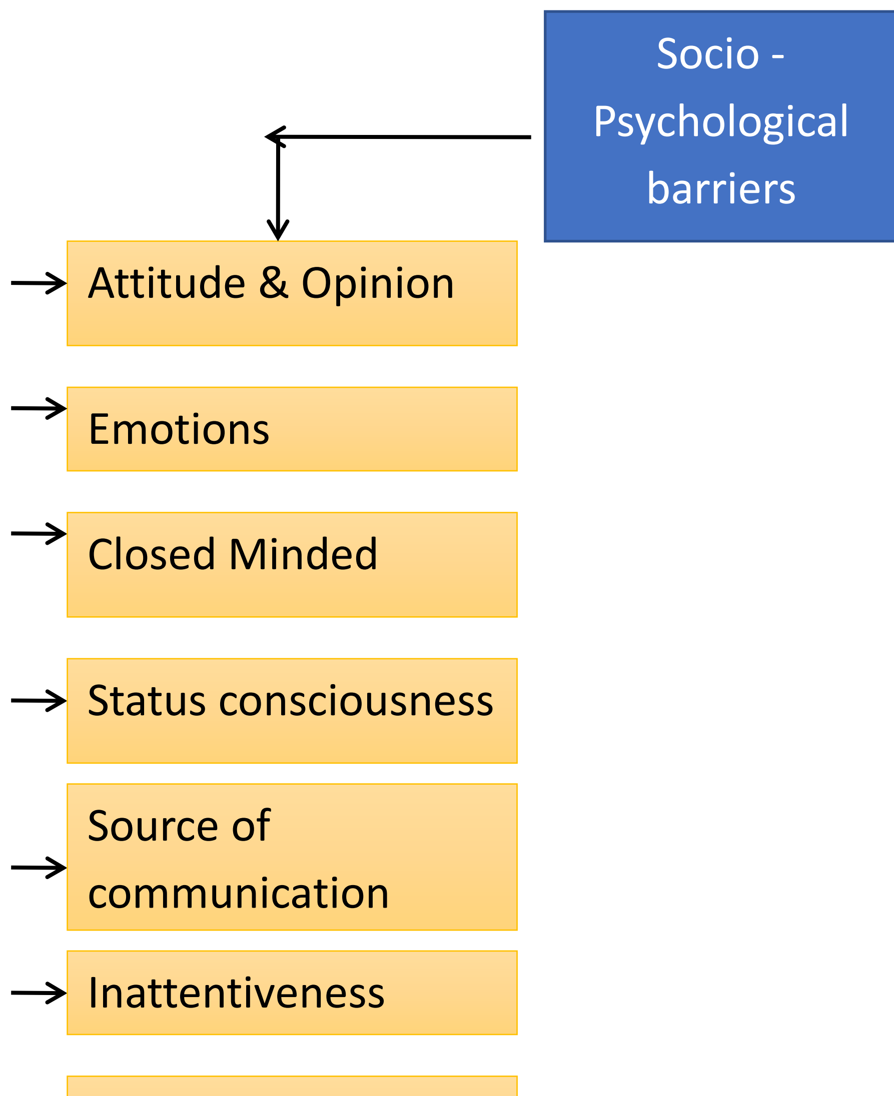
Communication is the process of transfer of ideas and expressions from one person to another. It is the way of self expression. The information to be communicated should be clear and accurate. If an individual sends the massage, and the other one receives it and interprets it in the same way as the sender had intended to express, the process of communication is said to be complete and successful. However, Communication is not always successful. Certain barriers in communication affect the clarity, accuracy and effectiveness of the message. These barriers hamper the growth of communication and relegate it to the status of a conversation where feedback is not expected. If either the speaker or the listener has problems in adjusting his frequency with the co-interactants, barriers would automatically be erected.

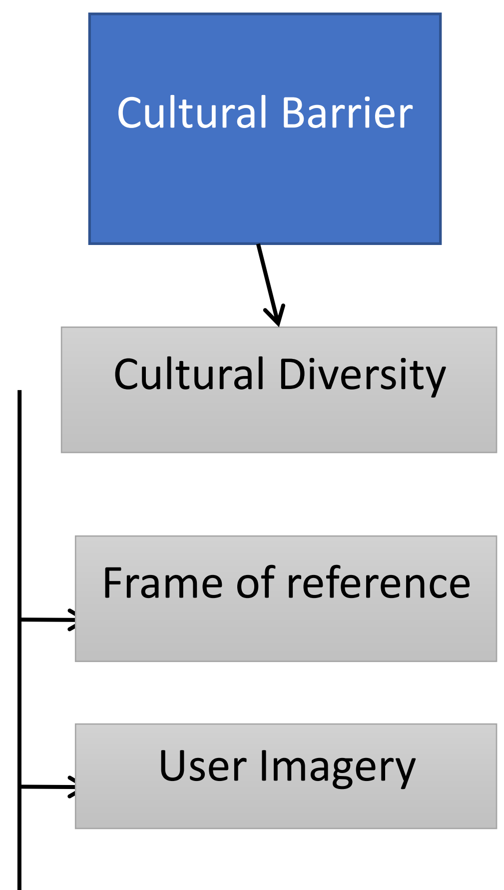
Several things can prevent the message from reaching the intended recipient or from having the desired effect on the recipient. There may be some fault in the communication system which may prevent the message from reaching. Some of these defects are in the mechanical devices used for transmitting, that is, the medium; some are in the tools we use for communicating, that is, language or other symbols used for encoding; Some are related to the sender or the receiver.



3.2 CATEGORISATION OF BARRIERS




Socio - Psychological barriers
Attitude & Opinion
Emotions
Closed Minded
Status consciousness
Source of communication
Inattentiveness


Cultural Barrier
Cultural Diversity
Frame of reference
User Imagery

The Barriers or negative forces may affect the effectiveness of communication by acting upon any or all of the basic elements of communication process and sender/receiver/ channel.

As the barriers to communication influence the major variables in the communication process, they may be categorized on various bases. Though the list of Barriers is exhaustive and there are many ways in which the Barriers can be categorized, one of the oldest categorization of barriers is stated below:

1. ***Semantic barriers:*** Different people assign different meanings to one specific message. This is due to the problems with meaning, significance, and the sending and reception of the meaning and content of the massage.

2. ***Organizational barriers:*** This type of barrier develops due to the problems with physical distance between members with respect to their functional specialization of tasks, power, authority and status relationship, values held, and ownership of information.

3. ***Interpersonal barriers:*** These barriers also develop in the process of communication. They are based upon the relationships, values held, and attitudes

of the participants in the process of communication.
4. ***Individual barriers:*** These are also called psycho-sociological barriers. The problem of this barrier arises due to differences in individual competencies to think and act, which would include physical aliments or handicaps. It is also because of individual skills in receiving and transmitting information, which would include poor listening and improper reading skills and adverse psychological conditions.
5. ***Cross Cultural (geographic) barriers:*** Culture is a shared set of values and attributes of a group. The communication barriers are also seen because of time, geographic locations, and the effects of time upon reception of the message and other cross cultural factors.

6. ***Physical Barriers/Channel and media barriers:*** The effectiveness and accuracy of communication is also affected by the physical barriers like distance, noise or channel and the media used in the process. In this category, problems that confront the media used in the process. In this category, problems that confront the issue of how best to communicate a message are included. (For example, it is best to transmit a massage face to face rather than in writing).
7. ***Technological barriers:*** They are barriers which arise due to technological advancements in the field of communication. Technology generates lot of information, which is beyond the capacity of the recipient. Further, the media advancements on account of technological process increase the barriers.
The ideas and massage have to reach from the transmitter to receive in the same sense. If it does not happen, it is on account of barriers in communication.
Some of these barriers can be explained as follows:

3.2.1 Semantic Barriers

"Semantics" is the science of meaning. It is contrasted with phonetics, the science of sounds. This barrier is related to the process of coding and decoding the message. There are various disruptions in understanding of the meanings of the words and information exchanged in the communication process. Various types of semantic gaps found in dayto-day use of people are as follows:
(a) ***Words having similar pronunciation but multiple meaning:*** Sometimes, in our conversation we use several words, which have the same pronunciation but are having many meanings. The words may be homophones and thus there may arise difficulty in getting to the right meaning of the message.

For example: sight, site, cite.
In verbal communication, a particular word may have a variety of meanings. For example, the English word 'round' has 110 different meanings. (As adjective 23, as noun 42, as verb 16, as preposition 13 and as adverb 13.)
(b) ***Badly expressed message:*** Lack of clarity and precision make the message badly expressed. Lack of coherence, awkward sentence structure, jargons etc. are common faults, which lead to such messages.
(c) ***Wrong interpretation:*** Whenever one interprets a symbol, his understanding may differ with others. The Hindi word 'kaka' means uncle in one part of the country but small boy in another part of the country. As inferences can give a wrong signal, more information may be sought to clarify doubts.
(d) ***Unqualified assumptions:*** Sometimes, the sender may send information is not clarified to the receiver, as he does not understand the assumptions clearly.
(e) ***Technical Language:*** When technical language is used in the communication process, it creates barriers in understanding the message in the same sense and in the same spirit. When technical jargons or specialist languages are used in the communication and conversation process, they create tension, confusion and misunderstanding between the sender and the receiver.
Example: Consider the new meanings given to ordinary words by computer technology; to people who are not familiar with computers, "mouse" is only an animal, where as in computer jargon, it is a device.

Organizational Barriers

Interference may arise from the relative status and power of the participants, the exercise of traditional roles, and incompatible needs and expectations. It may arise because of centralization or decentralization in an organization. It may originate in contradictory management policies, or too many levels of management or the clash between line and staff operations. The specialized nature of functions or even the special language of those functions may cause it. It may have its source in formal informal, or grapevine transactions. Following are the organizational barriers in communication:
(a) ***Organization culture and climate:*** In every organization, there exists a unique culture and climate. The climate and culture of an organization ultimately influence the freedom, thrust and interaction pattern among people in an organization. As people working over there take time to adapt themselves, bottlenecks in

communication are inevitable.

(b) ***Organizational rules and regulations:*** The rules and regulations of the organization vary widely from one organization to another. They may be so rigid that they may influence the flow of information in a wrong direction.

(c) ***Status relationships:*** The status, power and position relationship acts as the hurdle in the effectiveness of communications. Individuals may not be able to say what they wish to say because of their fear for the position and power of the other party in the communication process.

(d) ***Complexity in organizational structure:*** The complex hierarchical structure of the organization like too tall or too much of divisionalisation of the organization may not facilitate the free flow of communication.

(e) ***Inadequate facilities and opportunity:*** The organization may not have adequate communication facilities, equipment and mechanisms. Open door employment system, conferences, seminars and meetings being held in the organization also influence it.

(f) ***Lack of cooperation between superior and subordinate:*** There may not be proper cooperation between the superior and subordinate for various personal or organizational relationships, which may held to improper communication in an organization.

3.2.3 Interpersonal Barriers (Relating to Superior-subordinate)

Effectiveness of Communication depends a lot upon the interpersonal relationship between two people. If and when the sender and receiver are at the same economic, educational and status level and also have good rapport among each other, there is hardly any barrier arising in communication. But, in case of a difference at any level, there is a greater chance of Miscommunication. The most common example for this in an organization is the Barriers relating to Superior and Subordinate.

The subordinate must follow the order of the superior, carry out all work efficiently, and provide full information related to any matter, which arises in the organization or in any work. Moreover, the superior should have full confidence upon himself and the subordinate .In cash he wishes to gives some important message to the subordinate, the barriers existing between them in communication will be reduced. There are two type of superior subordinate barriers. They are barriers emanating from both superiors and subordinates:

1. ***Barriers emanating from superiors:*** Following are the barriers with respect to the superiors:

a) *Shortage of time for employees:* Superior may not devote enough time for their employees due to their busy schedule or other preoccupations. As a result, a gap is created between the superior and subordinates. In the later stage, it acts as a hurdle in the communication process.

b) *Lack of trust:* Sometimes, the supervisors may not trust their subordinates because of variety of reasons, which can act as a hurdle in the free flow of communication in a organization.

c) *Lack of consideration for employee's needs:* The employer may not devote enough time for the employees. As a result, they are enable to understand their needs and genuine problems. It may lead to miscommunication.

d) *Wish to capture authority:* The superior may hide the confidential and important information from employee in view of capturing and retaining their authority, which acts as the barrier to communication between the superior and subordinates in the organization.

e) *Fear of losing power of control:* The supervisor may have a fear of losing power of control if they freely express their ideas and view with their subordinate. Therefore, they may hide certain important information from their employees, which ultimately affect the communication process in the organization.

f) *Bypassing:* Bypassing also effects communication and acts as a barrier. Due to by passing. The inner feelings of employees are not freely expressed, which is essential for free exchange of information. The employer may not like by passing as an effective means of communication.

g) *Information overload:* Due to extra information provided to employees, they may miss certain important information, which ultimately acts as the barrier in communication.

2. ***Barriers emanating from subordinates:*** There can be communication barriers because of the subordinates. They may be facing certain problems like:

(a) *Lack of proper channel:* There may be complexity in the organizational structure, which may influence proper and effective communication from subordinate. They may not feel free to communicate because of pressure of position power and authority.

(b) *No interest to communicate:* There may not be any interest on the part of subordinates to have a dialogue, discussion and interaction with their superiors, which affect the communication process adversely.

3.2.4 Individual / Psycho-sociological Barriers

Individual or Psycho-sociological barriers are the prime barriers in interpersonal communication. People have different styles of communication. People also have personal feelings, desires, fears, hopes, likes, dislikes, attitudes, views and opinions. The meaning assigned to a message depends upon the emotional or psychological status of both the parties involved in the process of communication.

1. ***Style:*** Style, the manner in which a person communicates, involves many elements, though style overlaps with several of the other factors in analysis, it adds its own distinct flavour.

A few barriers related to style are as follows:

(a) Linguistic accent in oral exchanges are stylistic in nature. It often affects people. For example, the accent of Bengalis may create a reaction in North India.

(b) The form of expression (idiom) colours a transaction. Suppose you use an idiom familiar in Andhra Pradesh, but strange to some one from Shimla; the listener will be distracted by the style - the use of "strange" expressions.

(c) The level of drama greatly affects a situation. People do not react to highly dramatics situations as they do to subdued ones.

(d) Types of humour also play a part in style. People not only use varying styles of humour, they react differently to different kinds of jokes and sometimes fail to convey the proper massage which is intended to be conveyed.

(e) The choice of brevity as opposed to full detail in a presentation is also another element of style. Style can also be reflected through the use of a direct approach rather than an indirect one.

(f) The choice of discriminatory or non discriminatory communication modes is another element of style. Symbol can discriminate on the basis of sex, race, age, religion, handicap, or other characteristics. Many people react negatively to the discriminatory styles, whereas others, regrettably, practically try to insist one to join them in name calling and sirs.

(g) The qualities of credibility and charisma override many other aspects of style. Both the presence and the absence of these qualities can affect the flow of communication.

2. ***Selective perception:*** The receiver may make a world of his own around himself. He projects his interest and expectations as he decodes messages. He may only take that much piece of information, which may suit his world of thinking. As a result, the person acquires incomplete and inappropriate information, which influence the communication process.

Having a poor self-concept or self-understanding, or a poor understanding of other can cause perceptual distortions.

3. ***Halo effect:*** People do not listen carefully because of impressions based on earlier encounters. Even one of the parties having a halo effect will disrupt the flow of communication.

4. ***Status relationship:*** There may be status and power relationship, which may hinder the communication process and affect the effectiveness of communication. Status effects also hinder communication is as much as people occupying higher positions in the organization have a tendency to "tell a lot to subordinates but not to listen, effective communication is not possible.

5. ***Poor attention and Retention:*** About half of the information, if not properly retained, is lost. The sender may suffer from each a problem. It also said that about 30% of the information is lost in each oral transmission. Human memory may not always retain what it is told. This causes communication breakdown and necessitates the repetition of the message using several channels

6. ***Inattention:*** The preoccupied mind of the receiver and the reluctant non-listening is one of the major psychologies barriers. It is because of it that people do not react to ideas/massages received in communication.

7. ***Undue importance of written words:*** The undue importance given to the written words may lead to loss of information. The successive information is not accurate and right. Written communication often tells what is to be done but not why it should be done. It takes the persuasive quality.

8. ***Defensiveness:*** If one feels threatened by a message, one becomes defensive andresponds in such ways that reduce the understanding. Such defensive behavior prevents understanding.

9. ***Closed Mind:*** Limited intellectual background, limited reading and narrow interests can cause a person's mind to be narrow. This limits the ability to take in new ideas. People with closed minds do not take in any new information or suggestions to change.

10. ***State of Health:*** Physical condition can affect the efficiency in all communication skills. In case of poor health condition, the communicating ability is reduced as the mind is not alert and perception is low.

11. ***Filtering:*** Filtering is the process of reducing the details or aspects of a message. Each person who receives the message reduces it according to his or her understanding of the situation. In this process, much of the important information may be lost or misinterpreted and the sender will fail to convey what he wants to convey.

3.2.5 Cross - Cultural/ Geographic Barriers

Culture is a shared set of values and attributes of a group; it is the sum total of the ways of living built up by a group and transmitted from one generation to another. Culture is so much a part of an individual's manner of talking, behaving and thinking, that communication style and competence are influenced by it.

Some of the significant differences between cultures are:

(a) National Character/ Basic Personality.

(b) Language

(c) Values and norms of behaviour

(d) Social relationships

(e) Concepts of time

(f) Concepts of space

(g) Non verbal communication

(h) Perception

Words, colours and symbols have different meanings in different cultures.

For example:

(i) In England, an invitation for dinner 8 pm would see most guests arriving at about 8.15; in Germany punctually is king; in Greece, 9 to 9.30 might be the norm; in India even later- if at all.

(j) In most parts of the world nodding your head means agreement, shaking your head means no-except in some parts of India, where the reverse is true.

(k) When the Japanese say "Yes", they mean, "Yes, I am listening". The Americans may take it to mean, "Yes, I agree".

(l) For some cultures, "Time is money", while in other cultures, it may be subordinate to relationships.

(m) Wearing white colour on marriage may be forbidden in some cultures, where as, in other cultures, the main wedding dress is white in colour.

Communication can be very difficult at times due to these cross cultural barriers.

3.2.6 Physical Barriers/ Channel and Media Barriers

Physical distractions cause a lot of noise, often literally: insufficiently insulated rooms with car noises filtering through, poor lighting, and such things as frequent movement of bodies postures, with a pen in the hand, even the arrival of coffee at a critical stage on

the communication process are the causes of communication barriers in organizations. Constant telephone interruptions are one of the commonest physical distractions. These obstacles prevent a message from reaching the intended recipient.

The following obstacles are considered under this category:

1. ***Noise:*** Noise is any disturbance which occurs in the transmission process. In face to face conversation without a microphone, the air may be disturbed by noise in the environment such as traffic, factory work, a typewriter clattering away in a nearby office and people talking, and so on. Wider connotation of noise includes many other factors that are likely to hinder communication. Sometimes, the inner chatting going on in the mind of the listener, which distracts the message received, is also termed as Noise.

2. ***Environment:*** Interferences may also arise from external transreceivers, number of links in the chain and circumstantial factors:

(a) *External transreceivers:* people often delegate to others such acts as typewriting, drawing, photographing, listening, reading, and taping. When one does so, he still remains responsible for controlling such external process.

Evaluation has to be done which has been transmitted or received by someone else. Reliable people and equipment should be selected to accomplish the communication-related tasks.

(b) *Number of links in the chain:* The major barriers to effective communication lie in the number of links in the chain between the sender and the ultimate receiver. Larger the chain less is the accuracy of message towards to end of the chain. For example, when one person whispers, the whispered "chaining" continues until the massage moves from one to another through all people in the circle. The last person to receive the massage states it aloud, and the originator orally compares the final received message with the original massage. The final massage usually bears little resemblance to the serious for purposive communication endeavors. Thus, efforts are made to reduce the number of intermediate links. With each added station, the chances of a massage accomplishing its purpose diminish significantly.

(c) *Circumstantial Factors:* The same sort of differentiation in circumstances counts for the channels within each of the levels and in broader terms for the oral, written, and non-verbal communication. For example, a speech delivered before a small dinner gathering will be different from the same speech delivered before an auditorium full of people. Everyone is markedly different while

sitting to watch cricket match rather than a legal hearing. Still another circumstantial feature a listener who has to stand because the seats are all taken is generally not the same as he or she would be if seated comfortably.

A few circumstantial factors are shown as follows in
Exhibit 2.1:

Temperature
Room Size
Lightning
Seating Arrangement
Equipment in room
Voice qualities
Visual quality

Many more circumstantial factors exist. However, these brief examples should serve as reminders that the setting contributes a great deal to the identification of the participants.

3. ***Defects in the Medium:*** Defects in the devices used for transmitting communication are external and usually not in the control of the sender or receiver. The telephone, the postal system, the courier service or even the electronic media may fail or break down.

3.3 TECHNICAL ASPECTS IN COMMUNICATION BARRIERS

A few technical aspects in communication barriers are briefly narrated by Murphy's Law on communication: Following are the basics in this law on communication:

(a) ***Communication usually fails.*** Except by chance, it succeeds. On account of various barriers, the possibility of success in the flow of communication is rare.

(b) ***If the message can be understood***, in different ways, it will be understood in just the way that does the most harm. People receive the massage in their own way. In most of the cases, the most harmful side of communication is considered.

(c) ***Filtering.*** It refers to the sender manipulating information so that the receiver will see it as more favourable. In organizations, the information is condensed and synthesized. Objective information does not reach to the authority. The more the vertical levels in the organization's hierarchy, the more opportunities there are for filtering.

(d) ***Meta communication.*** In a communication apart from the message, there is a Meta message. Meta message exists in the people's minds because of their actions such as being hard to contact. It is the most important thing in seat word language.

(e) ***Noise in communication process.*** Noise can enter the communication process because of situational factors. It is one of the factors influencing the communication process. Noise is mostly related to mechanical distractions. A few noise distractions

are as follows: (i) Human sounds, (ii) Traffic, (iii) Telephone instruments (iv) Channel defects (v) Birds (vi) Trees (vii) Fans (viii) Chalk writing (ix) Use of Duster (x) Projector and (xi) Nasal Voice.

3.4 OVERCOMING THE BARRIERS IN COMMUNICATION

Constant effort is required to overcome the barriers which unconsciously creep up in the process of Communication. Barriers can be overcome if sufficient effort is put into the communication process and it is desired that communication be effective and efficient. One way of reducing the effects of these barriers is to check continuously during the communication process what the massage really is. The actions to be taken by the Sender, Receiver and together the two of them, to achieve this are listed below:

Sender: The sender should be clear about the following Ws and H:

WHO : To whom should the message go?

WHY : Why should I communicate? What are the motives?

WHAT : Decide what to communicate. Be clear about what one needs to communicate.

WHEN : The best time for optimum reception is chosen.

HOW : Use a language, which the receiver will understand and which is unambiguous.

WHERE : Choose a location which will not interfere with the reception, understanding and acceptance of the message: Privately? Home or away? In a group? At work or outside?

Receiver: The receiver can be aware about the following, to overcome the barriers:

_ Be fully attentive to sender.

_ Listen actively to the message being sent.

_ Ask for clarification and repetition wherever necessary.

_ Keep checking the receipt of information with sender.

Both: Receiver and Sender can make the Communication Flawless if they:

_ Realize that misunderstandings are bound to occur, and be alert for all cues to this effect.

_ Listen, listen, listen, and listen again.

_ Share opinions, feelings and perceptions generated by the message.

Thus, both parties separately as well as together have to work to remove the barriers and achieve the communication effectiveness. For example, a manager tries to get things done through other people. The management of people can be called leadership, and all

of us have our own preferred leadership styles, which affect the ways in which we communicate with others, especially our staff.

3.4.1 Measures to Overcome Barriers in Communication

Following are some of the additional measures to overcome the barriers to communication:

1. ***Fostering good relationship:*** Strong relationships must be fostered between the employer and the employee in order to avoid misunderstanding and accept each other's view points in order to remove the barriers and to facilitate proper communication in the organization.
2. ***Purposeful and well focused Communication:*** Communication should be purposeful and directed to an individual. At the end of the Communication, the receiver should not be left to feel that communication had been meaningless or useless.
3. ***Coordination between superior and subordinates:*** In case the superior thinks on one line, which is different from the subordinate and vice versa, it will affect the effectiveness of communication. Therefore, there should be good and proper coordination and cooperation between the superior and subordinate for effective communication.
4. ***Avoid technical language:*** The specialized language should be avoided. There should be all efforts to use the language commonly understood by the receiver and sender of the message. There should be least use of technical jargons in communication process.
5. ***Feedback:*** The selective perception of receiver should be minimized through proper feedback. The drawback of the selective perception should be explained to minimize the barriers.
6. ***Accuracy:*** There should be accuracy in the message to be transmitted between parties to the communication to improve its effectiveness.
7. ***Clarity in message:*** The message to be transferred should be clear, practical accurate and without any ambiguity.
8. ***Communication of organizational philosophy:*** Efforts have to be made in a planned way to sensitize people with the organizational philosophy. It should be properly communicated to its employees so that they give proper attention to their day to day communication.
9. ***Flat organizational structure:*** The organization should have clear cut and simple organization structure. Tall hierarchical structure should be removed, and it should be changed to flat structure to avoid excessive control of information. Wrong information to be transferred to any one in the organization will prove detrimental. Proper redesign of organizational structure will reduce the status gap. Status effect can occur when one person is considerably higher in the hierarchy than another.
10. ***Division of labour:*** There should be proper division of labour between the persons

in order to reduce information overload and prevent delay in information transfer.

11. ***Organization policies:*** The organization should formulate their policies in such a way that it will give full advantage to all members of the organization. It should be flexible and easy to implement. While organization's goal must be clear, everyone must know about his position, his right in the organizational communication. The network has to be fully developed so that no such type of barriers exists. Moreover, there should be consistency when message a passed from sender to receiver. One should not introduce his own view in the message. It must be clear and understood by everyone easily. Timeline in message should be there. If it is not passed in time, such message will be of no use.

12. ***Minimize semantic problem:*** People use either the same word in different ways or different words in the same way. One will be surprised to know that there are 15 different meanings of the word 'charge' in the English language. They also occur when people use jargons or professional shorthand which they expect other to understand, or language which is outside the other's vocabulary.

13. ***Proper communication channels:*** If one wants immediate action from the receiver, there is not need to send a lengthy discussion report. One would probably pick up the telephone or go to his office to tell him what to do. Remember also that one picture is worth a thousand words, and in this age of computer graphics, the information can be produced more quickly in this way too.

14. ***Right feedback:*** Although one -way communication is quicker, two –way communication is more accurate. In complex situations, it helps both sender and receiver to measure their understanding and improves their joint commitment to the task. It enables both parties to identify and correct misunderstanding leading to a higher quality of reception and acceptance.

To communicate effectively, we need to overcome all the barriers and own skills to improve the existing communication abilities.

LET US SUM UP

Communication is defined as “the process of passing information and understanding from one person to another, it is essentially a bridge of meaning between people” All communication is essentially sharing of information or some message.

Communication is the most important of our social activities. We can classify communication as interpersonal, intrapersonal, group communication, Meta communication, upward, downward, lateral, diagonal, formal, informal, oral, written or non verbal communication.

Reading, writing, speaking and listening are the four skills of communicationThe objective of communication may to inform, to persuade, to train, to motivate, to educate, to relate, to reprimand, to rectify and so on. The scope of Communication covers the internal and external dimensions of communication. The importance of Communication can be gauged from the functions it performs Communication is the lifeblood of an organisation. Communication facilitates all the functions of management including planning, organising, instructing, coordinating and controlling.

KEYWORDS

Communication: "Communication is the sum of all things, one person does when he wants to create understanding in the minds of another. It involves a systematic and continuous process of telling, listening and understanding."

QUESTIONS FOR DISCUSSION

1. Give the importance of Business Communication.
2. Communication is the lifeblood of an organisation. Elaborate the statement with suitable examples.
3. What is the scope of business communication?
4. Briefly explain the objectives/ purpose of Communication.
5. What is meant by Communication Barriers? How and why do they occur?
6. What can be done to overcome the Barriers to Communication?
7. Discuss the Semantic Barriers to Communication.
8. What are the Cross Cultural Barriers to Communication?

9. "The individual factors of a person act as Barriers to Communication." Is this statement true? How?

10. Explain Communication Process.

MBA I Sem. II Paper IX: Marketing Management

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Chapter 1 Introduction: Marketing Management

- **1. Introduction: Marketing Management and its evolution, Scope, the Core concepts,**
- marketing objectives, Marketing environment – macro and micro environments, components and their impact on marketing decisions. **(8)**

After studying this chapter, you should be able to:

1. Explain Concept of Market
2. Explain Concept of Marketing
3. Explain evolution of marketing

The term marketing; is derived from the word market, which refers to a group of sellers and buyers that co-operate to exchange goods and services.

The modern concept of marketing evolved during and after the industrial revolution in the 19th and 20th centuries

Market

- The concept of transactions leads to the concept of a market. A market is the set of actual and potential buyers of a product. It may exist in a physical environment as a marketplace or in a virtual environment (on the internet platform) as a marketspace.

Marketing Concepts

- EXCHANGE- It is defined as an act of obtaining a desired product from someone by offering something in return. It is the process of creating value because it leaves both the parties better off. There are 5 conditions which must be satisfied for exchange to take place.
- They are as follows:
- 1. The foremost condition is that there must be at least 2 parties
- 2. Each party must possess something of value that can be exchanged with another party.
- 3. Each party must have the ability to communicate and delivery.
- 4. Acceptance or rejection of the exchange offer lies at the discretion of each party.
- 5. Each party is in opinion that it is appropriate or desirable to deal with the other party.

Cont.

- TRANSACTION- It is defined as a trade of values between two or more parties. It is considered as marketing's unit of measurement. It engulfs at least two things of value, agreed upon conditions, a time of agreement and ace of agreement.

MARKETING CONCEPTS

- **Marketplace**
  - Physical
  - Store
- **Marketspace**
  - Digital
  - Internet
- **Metamarket**
  - Cluster of complementary products
  - Spread across a diverse set of industries
  - Automobile
  - www.marutitruevalue.com

Orientation Towards The Market Place
Production Concept
• Emphasis On Producing Goods
Product Concept
• Producing Quality Goods
Selling Concept
• Aggressive Selling & Promotion
Marketing Concept
• Right products for Customers
Holistic Marketing Concept
• Do everything possible

Production Concept

- Oldest Concept
- Believed that consumers prefer available goods
- Focus is on efficient production and mass distribution
- This orientation makes sense in developing countries
- Efforts on reducing costs to provide inexpensive goods

Product Concept

- Focus is on making superior goods
- Believed that consumers prefer goods with best quality & innovative features
- Importance is given to improvising the product
- Less focus on consumers need
- Goods sell themselves

Selling Concept

- Aggressive
- Selling and promotion effort sell more stuff to more people and more often
- Used with goods which buyers usually don't think of buying (unsought goods) such as insurance
- Sell what is made not what market wants
- Carries high risk as can result into negative word of mouth

Marketing Concept

- Emerged in mid 1950s
- Find right product for the customers
- Focus is on creating, communicating and delivering superior customer value
- Build profit through customer satisfaction and loyalty
- Begins with well defined market and ends with long term relationship

What Is Marketing Management?

- Marketing management is the art and science of choosing target markets and getting, keeping, and growing customers through creating, delivering, and communicating superior customer value.

DEFINITION of MARKETING

- Social Definition
- Marketing is a societal process by which individuals and groups obtain what they need and want through creating, offering and freely exchanging products and services of value with others
- AMA Definition
- Marketing is the process of planning and executing the conception, pricing, promotion and distribution of ideas, goods and services to create exchanges that satisfy individual and organizational goals.

- Kotler Definition
- Marketing Management is the Art and Science of choosing target markets and getting, keeping and growing customers through creating, delivering and communicating superior customer value

WHAT IS MARKETED

- GOODS
- PLACES
- SERVICES
- EXPERIENCES
- EVENTS
- PERSONS
- PROPERTIES
- INFORMATION

MARKETING CONCEPTS

Needs, Wants and Demands

- **Needs** – Basic Human Requirements
- **Wants** – Directed at specific objects
- **Demands** – Backed by ability to pay

Target Markets, Positioning & Segmentation

Offerings and Brands

- **Offering** – Value Proposition made Tangible
- **Brand** – Offering from a known source

Value & Satisfaction

- **Value** – Benefits / Cost
- **Customer Value Triad** – Quality, Service and Price
- **Satisfaction** – Product's perceived performance

Marketing Channel

- **Communication Channel** – Deliver & Receive message
- **Distribution Channel** – Display, sell & Deliver
- **Service Channel** – Carry out transactions

What Motivates a Consumer to Bye /Purchase

- Needs - state of felt deprivation for basic items such as food and clothing and complex needs such as for belonging. i.e. I am thirsty
- Wants - form that a human need takes as shaped by culture and individual personality. i.e. I want a Coca-Cola.
- Demands - human wants backed by buying power. i.e. I have money to buy a Coca-Cola.

- Customer Needs
- States of deprivation
- Physical—food, clothing, warmth, safety
- Social—belonging and affection

  Individual—knowledge and self-expression

  Needs
- Form that human needs take as they are shaped by culture and individual personality
- Wants
  - • Human wants backed by buying power
- Demands Customer Needs, Wants, and Demands

Market vs Marketing

- Market is an arrangement to provide an opportunity to exchange goods.
- Marketing is sum total of all those activities that are related to flow of goods from production to consumption. - Marketing, Selling & Merchandizing Marketing is a broader concept which is driven from customer's demand.
- Selling is one part of marketing which deals with persuading customers to buy products that are available with seller.
- Merchandizing refers to the process offering a variety of products to a retail consumer in a manner which stimulates demand.

Importance OF MARKETING

- 1. Marketing helps to achieve, maintain and raise the standards of living - Marketing is means through which production and purchasing power are converted into consumption.
- Better marketing → Mass production → Mass production → Low cost → Low cost → More buying power → Higher standard of living

3. Marketing increases national income

- More purchasing power
- Increase in national income

4. Helps maintain economic stability & development –

- By maintaining demand supply balance

5. Link between producer & consumer

6. Removes imbalance of supply & demand by transferring surpluses

7. Helps create utilities of time, place & possession

Importance of Marketing to Business Firms

1. Marketing Generates Revenue, by generating sales & thereby profits
2. Marketing helps decision making process (what, when & how much to produce, store or transport)
3. Helps change management & innovations

- Questions Please

Marketing Concepts

- 1. Exchange Concept - Exchange is only a small part of the total marketing process.
- - Other parts of marketing like customer orientation, satisfaction, value creation, creative selling etc are not covered
- Transactions - trade of values between parties. Usually involves money and a response.

Nature OF MARKETING

- Marketing is customer oriented
- Marketing is the delivery of value
- Marketing is network of relationships
- Marketing is business
- Marketing is dynamic:

Scope OF MARKETING

- Marketing Research
- **Setting Marketing Goals:**
- **Selecting Target Market:**
- **Formulating Suitable Marketing Organisation:**
- **Maintaining Healthy Relations with other Departments:**
- **Establishing and Maintaining Profitable Relations with Outside Parties:**
- **Sales Management:**
- **Exercising Effective Control on Marketing Activities:**
- Pricing
- Advertising and Sales Promotion:
- Channels of Distribution
- Financing:
- After-Sales Service

Marketing Environment –

- Concept, Major Macro-environmental Forces of Marketing Environment-
- Demographic, Economic, Socio-cultural, Political & Regulatory, Physical/
- Natural, Technological and International.

Learning Objectives

After studying this chapter, you should be able to:

1. Describe the environmental forces that affect the company's ability to serve its customers
2. Explain how changes in the demographic and economic environments affect marketing decisions
3. Identify the major trends in the firm's natural and technological environments
4. Explain the key changes in the political and cultural environments
5. Discuss how companies can react to the marketing environment

1. **The Company’s Microenvironment**
2. **The Company’s Macroenvironemnt**
3. **Responding to the Marketing Environment**

The Marketing Environment

The **marketing environment** includes the actors and forces outside marketing that affect marketing management's ability to build and maintain successful relationships with customers.

Marketing environment consists of all those internal and external forces which affect the marketing strategies.

According to Philip Kotler " Marketing environment as the external factors and forces that affect a firm's ability to develop and maintain successful transactions and relationships with the target customers."

Marketing environment includes all factors that effect marketing policies, decisions and operations of a company.

The internal environment of a firm include controllable factors or variables such as product design, branding packaging, pricing, advertising and distribution policies of the firm.

A firm or a company can achieve its marketing objectives by selecting a balanced Marketing Mix.

Marketing Mix The policies adopted by manufacturers to attain success in the marketing constitute the marketing mix.

Marketing Mix is considered as an important part of marketing system of the company. It is controllable factor of marketing environment.

The Marketing Environment

Marketing Environment

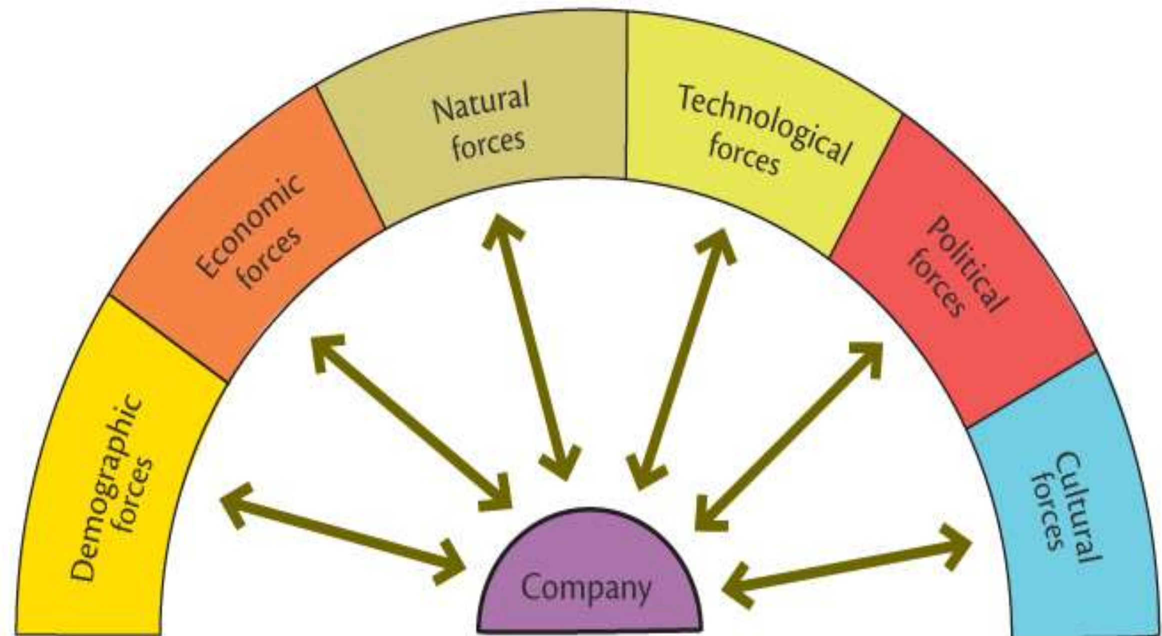
The **microenvironment** consists of the actors close to the company that affect its ability to serve its customers, the company, suppliers, marketing intermediaries, customer markets, competitors, and publics.

The Marketing Environment

Marketing Environment

The **macroenvironment** consists of the larger societal forces that affect the microenvironment.

- Demographic
- Economic
- Natural
- Technological
- Political
- Cultural



The Company’s Microenvironment

- The company
- Suppliers
- Marketing intermediaries
- Customers
- Competitors
- Publics

The Company's Microenvironment

The Company

Internal environment includes:

- Top management
- Finance
- R&D
- Purchasing
- Operations
- Accounting

The Company's Microenvironment

Suppliers

- Provide the resources to produce goods and services
- Treated as partners to provide customer value

The Company's Microenvironment

Marketing Intermediaries

- Help the company to promote, sell, and distribute its products to final buyers
- Include:
  - Resellers
  - Physical distribution firms
  - Marketing services agencies
  - Financial intermediaries

The Company's Microenvironment

Marketing Intermediaries

- **Resellers** are the distribution channel firms that help the company find customers or make sales to them. These include:
  - Wholesalers
  - Retailers
- **Physical distribution firms** are the distribution channel firms that help the company to stock and move goods from their points of origin to their final destination.

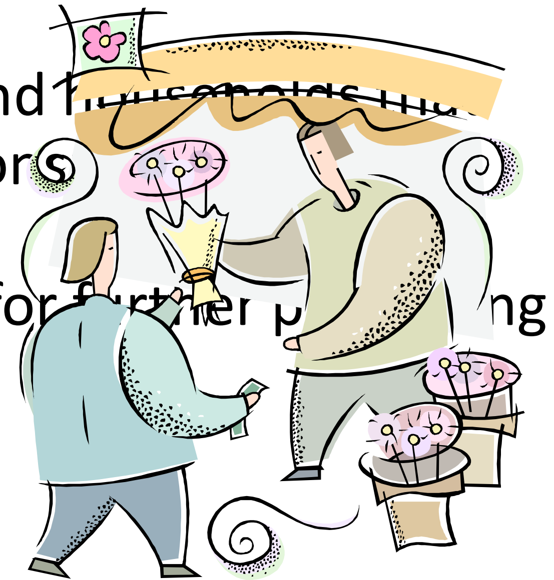
The Company's Microenvironment

Marketing Intermediaries

- **Marketing service agencies** are the marketing research firms, advertising agencies, media firms, and marketing consulting firms that help the company target and promote its products to the right markets.
- **Financial intermediaries** include banks, credit companies, insurance companies, and other businesses that help finance transactions or insure against the risks associated with the buying and selling of goods.

The Company's Microenvironment

Customers



Customer markets consist of individuals and [illegible] buy goods and services for personal con[illegible]

Business markets buy goods and services for [illegible] ng or for use in their production process.

The Company's Microenvironment

Customers

- **Reseller markets** buy goods and services to resell at a profit.
- **Government markets** buy goods and services to produce public services or transfer goods and services to others who need them.
- **International markets** consist of buyers in other countries including consumers, producers, resellers, and governments.

The Company’s Microenvironment

Competitors

- Firms must gain strategic advantage by positioning their offerings against competitors’ offerings.
- Each firm should consider its own size and industry position compared to those of its competitors.

The Company’s Microenvironment

Publics

- Any group that has an actual or potential interest in or impact on an organization’s ability to achieve its objectives:
  - Financial publics
  - Media publics
  - Government publics
  - Citizen-action publics
  - Local publics
  - General public
  - Internal publics

The Company’s Microenvironment

Publics

- **Financial publics** influence the company’s ability to obtain funds—banks, investment houses, and stockholders.
- **Media publics** carry news, features, and editorial opinion—newspapers, magazines, and radio and television stations.
- **Government publics** influence product safety and truth in advertising.

The Company's Microenvironment

Publics

- **Citizen-action publics** include consumer organizations, environment groups, and minority groups
- **Local publics** include neighborhood residents and community organizations
- **General publics** influence the company's public image
- **Internal publics** include workers, managers, volunteers, and directors

The Company's Macroenvironment

- Demographic environment
- Economic environment
- Natural environment
- Technological environment
- Political environment
- Cultural environment

The Company's Macroenvironment

Demographic Environment

- **Demography** is the study of human populations in terms of
  - size,
  - density,
  - location,
  - age,
  - gender,
  - race,
  - occupation,
  - and other statistics.
- **Demographic environment** is important because it involves people, and people make up markets.
- **Demographic trends** include age, family structure, geographic population shifts, educational characteristics, and population diversity.

The Company's Macroenvironment

Demographic Environment

Changing Age Structure of the Population

- **Generational marketing** is important in segmenting people by lifestyle of life state instead of age.

The Company's Macroenvironment

Demographic Environment

Changing Age Structure of the Population

- **Baby boomers** include people born between 1946 and 1964
  - Includes most affluent Asians

The Company's Macroenvironment

Demographic Environment

Changing Age Structure of the Population

- **Generation X** includes people born between 1965 and 1976. They tend to:
  - Have high divorce rates
  - Are concerned about the environment
  - Respond to socially responsible companies
  - Are less materialistic
  - Emphasize quality of life
  - Consumer organizations, environment groups, and minority groups

The Company's Macroenvironment

Demographic Environment

Changing Age Structure of the Population

- **Generation Y** includes people born between 1977 and 1994.
  - The Internet generation

The Company's Macroenvironment

Demographic Environment

The Changing Asian Family

More people are:

- Divorcing or separating
- Choosing not to marry
- Choosing to marry later
- Marrying without intending to have children
- Higher divorce rates
- Increased number of working women
- More stay-at-home dads

The Company’s Macroenvironment

Demographic Environment

Geographic Shifts in Population

- Trends include:
  - Migratory movements between and within countries
  - Moving from rural to metropolitan areas
  - Changes in where people work
    - Telecommuting
    - Home office
    - Divorce or separation

The Company's Macroenvironment

Demographic Environment

Changes in the Workforce

Trends include:

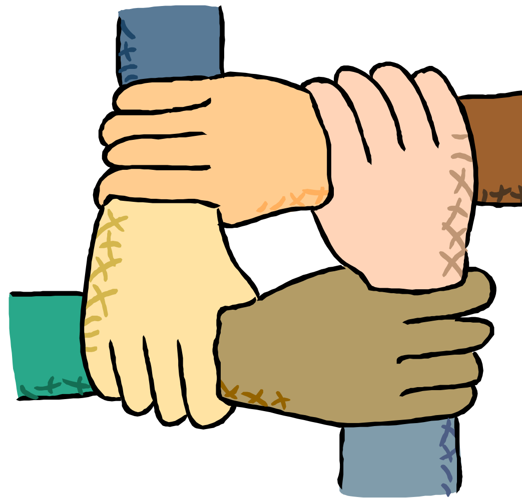
- More educated
- More white collar
- More professional

The Company's Macroenvironment

Demographic Environment

Increasing Diversity

- Markets are becoming more diverse
  - International
  - National
- Trends include:
  - Ethnicity
  - Gay and lesbian
  - Disabled



The Company's Macroenvironment

Economic Environment

- **Economic environment** consists of factors that affect consumer purchasing power and spending patterns.
  - **Subsistence economies** consume most of their own agriculture and industrial output.
  - **Industrial economies** are richer markets.

The Company's Macroenvironment

Economic Environment

Changes in Income

- **Value marketing** involves ways to offer financially cautious buyers greater value—the right combination of quality and service at a fair price.
- **Income distribution**
  - Upper-class consumers
  - Middle-class consumers
  - Working-class consumers
  - Underclass consumers

Changing consumer spending pattern

The Company's Macroenvironment

Natural Environment

- **Natural environment** involves the natural resources that are needed as inputs by marketers or that are affected by marketing activities.
  - Trends
    - Shortages of raw materials
    - Increased pollution
    - Increased government intervention
    - Environmentally sustainable strategies
    - Green marketing

The Company's Macroenvironment

Technological Environment

- Most dramatic force in changing the marketplace with many positive and negative effects
- Rapid change
- Provides new markets and new opportunities
  - Internet
  - Medicine
  - Miniaturization
  - Weapons
  - Credit cards
  - Communication

The Company’s Macroenvironment

Political Environment

Political environment consists of laws, government agencies, and pressure groups that influence or limit various organizations and individuals in a given society.

The Company’s Macroenvironment

Political Environment

- Legislation regulating business
  - Public policy to guide commerce—sets of laws and regulations that limit business for the good of society at large
- Increasing legislation to:
  - Protect companies
  - Protect consumers
  - Protect the interests of society

The Company's Macroenvironment

Political Environment

Increased Emphasis on Ethics and Socially Respon

- **Socially responsible behavior** occu seek out ways to protect the long-t consumers and the environment
  - Cause-related marketing

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The Company's Macroenvironment

Cultural Environment

The **cultural environment** consists of institutions and other forces that affect a society's basic values, perceptions, and behaviors.

The Company's Macroenvironment

Cultural Environment

Persistence of Cultural Values

- **Core beliefs and values** have a high degree of persistence, are passed on from parents to children, and are reinforced by schools, churches, businesses, and government.
- **Secondary beliefs and values** are more open to change.

The Company's Macroenvironment

Cultural Environment

Shifts in Secondary Cultural Values

- Major cultural values of a society are expressed in people's view of:
  - Themselves
  - Others
  - Organization
  - Society
  - Nature and the universe

The Company’s Macroenvironment

Cultural Environment

Shifts in Secondary Cultural Values

- People’s view of themselves
  - Yankelovich Monitor’s consumer segments:
    - Do-It-Yourselfers—recent movers
    - Adventurers
- People’s view of others

The Company’s Macroenvironment

Cultural Environment

Shifts in Secondary Cultural Values

- People’s view of organizations
- People’s view of society
  - Patriots defend it
  - Reformers want to change it
  - Malcontents want to leave it

The Company's Macroenvironment

Cultural Environment

Shifts in Secondary Cultural Values

- People's view of nature
  - Some feel ruled by it
  - Some feel in harmony with it
  - Some seek to master it
- People's view of the universe
  - Renewed interest in spirituality

Responding to the Marketing Environment

Views on Responding

- Uncontrollable
  - Reacting and adapting to forces in the environment
- Proactive
  - Taking aggressive actions to affect forces in the environment
- Reactive
  - Watching and reacting to forces in the environment

Scanning of Marketing Environment

- Though, future is unpredictable, but marketer can obtain appraisals of what is ‘most probable’.
- To monitor changes in the marketing environment effectively, marketer must engage himself in the scanning and analysis of marketing environment.
- Advantages of scanning of marketing environment
- There are several benefits that accrue to a marketer by scanning of marketing environment, such as;
- Trendy products can be brought out in the market.
- Competitor moves can be anticipated and countered.
- Marketing mix strategy can be properly formulated
- Adapting to the uncontrollable environment become easy.

Group Exercise 1

- Choose an industry. Search from recent business news to look for examples of influences of competitors, economy, politics, law, technology, society and culture on marketing decision making.

Competitive Environment
Economic Environment
Political-Legal Environment
Technological Environment
Social-Cultural Environment

- 2. Marketing Increases employment opportunities –
- Marketing involves various functions / subfunctions (Buying, Selling, Transport, Warehousing, Financing, Risk management etc)
- - These functions create need for different specializations
- - About 30-40% population depends directly or indirectly on marketing

- Any question

Prin. K.P. Mangalvedhekar Institute of MGt.

EVENT MANAGEMENT

MBA I Sem II

MRS. Vaidya savita Pramod

Net, MBA ,BSC.

Course Objectives

To understand different types of events and scope.
2. To know various procedures, licenses and permissions required for events
3. To familiarize students with various opportunities in Event Management industry.

Course Outcomes:

At the end of the course, students shall understand and get overview of Event Management, thereby take interest and can find employment and business opportunities in this attractive industry.

- To Understand them regarding Factors for successful conduct of an event.
- To make aware students regarding Permissions – Policies, Government and Local Authorities for an event

- Outcome
- Students will understand various factors should be taken care while planning an event.
- Students will understand various legal, local & govt. permissions required for an event.

Module 2 Event Management Procedure

- Factors for successful conduct, General Details, Permissions – Policies, Government and Local Authorities – Phonographic Performance, License, Utilities – Fire Brigade, Ambulance, Catering, Electricity, Water, Taxes.

- Learn about various laws influencing event management;
- Become familiar with different licenses required during event execution; and
- Understand the permissions and NOCs required to be obtained.

15 factors that can influence the success of your event

- **Date** – You'll want to avoid clashes with competing events, popular cultural, tv and sporting occasions. Some days of the week may also attract smaller numbers than others (eg: Monday mornings and Friday afternoons). On the day you can but hope there are no widespread problems with local traffic and transport arrangements.
- **Timing** – Early morning is not so good for those with child minding/school obligations, early evening impacts social and family life, daytime is dependent on work obligations. Attendees may also be disinclined to travel or drive during the rush hour.
- **Length** – Is it long enough to warrant making the effort to attend? Is it too long such that it requires potential attendees to give up too much time?
- **Venue** – Does it have any form of reputation – good or bad? How easy is it to get to from wherever the attendees are starting out? How easy is it for attendees to get to where ever they will be going afterwards? Make sure all these points are clearly spelled out on the invitation and promotional material
- **Parking** – Might anyone want to come by car? It helps to make clear the parking options up front
- **Advance notice** – It's important to give enough notice when you issue the first invites (a few weeks is better than a few days). You also need to issue reminders both to those who have yet to book and to see if any of those who have booked are no longer able to attend.

- **Structure** – Is there, for example, time for networking before, during and/or afterwards and will this appeal to prospective attendees.
- **Food and drink** – Is the extent to which refreshments will be provided clear? Will those with restricted diets or tastes feel catered for?
- **Content** – Are the topics perceived as relevant, topical and appealing? Can you sense check these beforehand with prospective attendees?
- **Speaker(s)** – Do they have a positive reputation? Do they engage the audience? Are they easy and stimulating to hear? Are they sufficiently well known to your target audience? Have you highlighted their credibility to talk on the chosen subjects? Are you keeping their name(s) a secret? if so, why? If only confirmed after initial promotions have started, remember to update the promotions.
- **Ticket price** – Is this perceived to be good value? Charging a fee, even a low one, can result in fewer drop-outs than when you run a free event. BUT even low cost tickets can discourage those who need to get authority for the expense
- **Payment methods** – How easy are you making it for people to pay? Consider online booking facilities that include credit card and paypal options.
- **Changes** – If any element of the event has to change, what impact does this have on potential attendees? It might make them more or less likely to book or to attend. Some changes have to be notified beforehand. Others can be shared at the start of the event, only to those who are there.
- **Promotion** – How will you get the event into the minds of those you seek to attract? Will they see and respond to a single email or is a more sustained campaign required? Will social media help? Which channels? Can the speaker(s) assist here?
- **Your list of invitees** – Do you have one? How relevant and uptodate is it? Can you get one? Are you reliant on marketing to (relative) strangers? Can you get help or collaborate with someone else who has a suitable list? Can the speaker(s) help here?

- Venue / Property related Laws
- The selection of venue is influenced by many factors. Event planners have to select a venue which perfectly matches with the needs of the event to be hosted. However, to hold an event at the selected venue needs either buying or owning the venue or acquiring it for the purpose of holding an event there. It has been observed that the most popular mode of gaining access to event venue is by acquiring it. However, here we will briefly study about three modes to get a venue for hosting an event and the laws related to them.
- 1) Owning a Property for hosting an event through Sale - Section 5 of the Transfer of Property Act 1882 describes the term sale as a transfer of ownership in exchange for a price paid or promised or part paid and part promised. A sale of immovable property for value more than INR 100 can only be made through a registered instrument which in normal terms is known as a sale deed. The essential elements of a sale are:
- • Parties : Normally there are two parties - a buyer and a seller.
- • The subject matter: The subject matter is the land / venue for hosting the event.
- • The transfer of conveyance: There are two recognized modes of conveyance, the delivery of possession and registration of sale deed.
- • The sale price or consideration: The price is the essence of the contract of sale and unless the price is there the contract of sale cannot be enforced under law.
- 2) Acquiring access to property to hold an event through License - According to the Indian Easement Act 1882, a license is when one person grants to another, or to a definite number of other persons, a right to do, or continue to do, in or upon the immovable property of the grantor, something which would, in the absence of such right, be unlawful, and such right does not amount to an easement or an interest in the property. This right is called a license. So an event planner has to seek license from the owner of the property 7 Laws, Permits and Licenses in Event Management to use the venue for hosting the event. Here it is worth mentioning that it is the duty of the event manager to ensure that the venue which s/he has hired for hosting the event is as per the needs and demand of the event.

- 3) Acquiring access to property to hold an event through Lease - As per the transfer of Property Act 1882 - A lease of immovable property is a transfer of a right to enjoy such property, made for a certain time, express or implied, or in perpetuity, in consideration of a price paid or promised, or of money, a share of goods, service or any other thing of value, to be rendered periodically or on specified occasions to the transferor by the transferee, who accepts the transfer on such terms. Lessor, lessee, premium and rent defined: The transferor is called the lessor, the transferee is called the lessee, the price is called the premium, and the money, share, service or other things to be so rendered is called the rent. Usually event managers holding events of similar nature apply for a lease of the venue for a certain period.
- They enter into an agreement with the owner for the lease of the venue. Event managers who host events like marriage parties, fundraising, gala dinners, birthdays, weddings, and anniversaries, take lease of venues like lawns and marriage halls for conducting these ceremonies. It is the responsibility of the event company to find out and comply with all pertinent rules, regulations and license requirements. It is worth mentioning that the event managers must make it a practice to pay particular attention to work place health and safety regulations. Some of the relevant regulations which a public event must comply during buildup or break down of the venue as per event requirements are:

- Environmental Protection Act, 1986
- Pollution Check Measures- eg-Here the event manager needs to obtain a permit from the licensing unit of the Delhi police before organizing an event which has threats to the environment.
- The Noise Pollution (Regulation and Control) Rules, 2000 eg-For example, a loud speaker in public event or a public address system can only be used after obtaining permission from the authority. It is mostly not allowed to be used at night (between 10:00 pm to 6 am),

- Electricity Regulation Act eg-use of electricity and electricity tariff. The event organiser must collect thorough information on these aspects when organising events in different states or nations.

- Building Regulations Act Building Regulations is a set of rules that specify the minimum standards for constructed objects such as buildings and non-building structures. The prime objective of these regulations is to protect public health, safety and general welfare in the context of the construction and occupancy of buildings and structures. Regulations also provide specific requirements applying to special construction objects such as canopies, signs, pedestrian walkways, parking lots, radio and television antennas and minimum standards for sanitation, water supply, light, ventilation, fire prevention and control, energy efficiency, stairs and halls, mechanical, electrical, plumbing, site drainage and storage, appliance, lighting, fixtures standards, occupancy rules, swimming pool regulations and so on.

- Fire Precautions Regulation Act
- Goods and Services Tax (GST)
  - GST registration

  - Customs Duty Customs duty is levied on import of goods into India. Events such as exhibitions and musical shows entail import of various goods into India. All imports are liable to customs duty depending upon the description of the product and its classification under the internationally accepted classification nomenclatures.

- Health and Safety at Work
- Securing the health, safety and welfare of persons at work.
- Protecting persons, other than persons at work, against risks to health or safety arising out of or in connection with the activities of persons at work.
- Controlling the keeping and use of explosive or highly inflammable or otherwise dangerous substances, and generally preventing the unlawful acquisition, possession and use of such substances.
- Controlling emission into the atmosphere of noxious or offensive substances, whcih comes under the Environmental Protection Act 1990.

LICENSES AND APPROVALS Intellectual Property Rights (IPR)

- To play music: An event manager needs valid licenses and permissions to play music especially by live performers. In case one does not have a valid license from an authorised organisation to play their music, an event can be sued under IPR laws.
- 2) Use of trademarks and logos: Under Trademarks act, the registered logos and trademarks cannot be used in any event without prior permissions.
- 3) Use of Designs and Art work: The copyright Designs and Patents Act ensures that patented designs (any type) cannot be used by any other person.

- PPL (Phonographic Performance Limited)
- License The law protects music rights in different ways. This means that businesses and organisations playing recorded music in public (whether live or via CDs, radio/ TV broadcasts, background music systems or other sources) will usually need to obtain PPL. The license allows the event organisers to use other artistes' music with freedom at the event. Playing music in public without the appropriate licenses in place is copyright infringement and is unfair to the members (performers, record companies, songwriters, composers and music publishers).

- IPRS (Indian Performing Right Society Limited)
- License This license is required for playing / performing non-recorded music in public. It is a license 'for the artists, of the artists.' For instance, in India, when a popular artist performs live, the event will require an IPRS license. Also, the artist needs to be a registered member of IPRS. Unlike PPL, IPRS issues licenses to the music users. It collects royalties for the artists, from the artists on behalf of its registered artist members (such as lyricists, composers, publishers and performers of music) and distributes the royalty to the music owners / members.

- Excise License Excise license is the license which the event organizer needs to procure in order to serve alcohol in a live or recorded music event in India. However, when the event is organized at an 'alcohol on-licensed premise', the organizer is not required to procure the license. In excise license, apart from obtaining the license the event organizer is also required to ensure that the event attendees are of legal drinking age (LDA). Usually, identity cards are compulsory at the event to verify and confirm their age.
- Loudspeaker License Any event held in any public or private venue needing to use a loudspeaker requires a loudspeaker license. The permission needs to be obtained from the local police authorities. Depending on the nature of the event, the authorities may limit the size and number of speakers to be used at the event

- Premise License A license of the premise allows the event organisers to carry out all the permissible activities at the venue. The activities include late night entertainment between 11 p.m. and 8 a.m., large-scale events allowing an audience of over 500 people, selling alcohol as well as serving food and beverages during specific timings and so on. The license can be obtained from the municipal authority under which the venue falls.

- Performance License This is the license which allows a child (anybody below 18 years of age) to take part in a musical event and make a paid performance. Again, the license can be obtained from the local authority. So, if the event has a performance made by a child and is a paid performance, the event organizers are required to procure performance license from local authority.
- Public Works Department License You need to get this when you have a generator at your event.
- Foreign Artist Permission Whenever you have people from another nationality performing at your event, you require to get a license for it separately.

- PERMISSIONS AND NOC NOC (No Objection Certificate) is a written document obtained as approval from the local authority. In case of organising an event, the event organiser needs to obtain NOCs from different departments. The list is as follows:
- ▯ No Objection Certificate from the Additional Collectors office
- ▯ No Objection Certificate from the Local Police Station
- ▯ No Objection Certificate from the Traffic Police Department
- ▯ No Objection Certificate from the Fire Brigade
- ▯ No Objection Certificate from the Electrical Inspector
- ▯ No Objection Certificate from the Health Department
- ▯ Police Commissioners Note ▯ No Objection Certificate from the Rangabhumi Parinirikshan Mandal (for Maharashtra only)
- ▯ Certificate regarding fitness of the machinery (in case of amusement rides)

- Event application details when writing to authorities: 1) Event / Venue Details
- • Event Location
- • Brief history of the event/venue
- • Duration of the event (schedule and timing)
- • Expected number of people
- • Admission arrangement (open to public / by invitation / with tickets)
- • Details of activities and how / when / where they will take place
- • Event management structure (set out the key management personnel)
- • Functions of key personnel (event controller, safety officer, and health and sanitation in-charge)

- Event control and communications (location of central control room, who will be there, and what means of communication will be used) for reporting
- • Any particular arrangements (for spectators with special needs with any or disability, pre-lunch ceremonies etc.)
- • Overview of large equipment and temporary structures (like staging, sanitary, facilities and lighting)
- • Contact details of event organisers / administrators and venue owner

- 2) Site Plan: The site plan must include maps showing location and details of:
- • Transportation hubs (like bus-stops, railway stations, and taxi stands) • Places of stay
- • Information kiosks
- • Places of interest at the venue / event
- • Meeting points
- • Entry or exit points at the venue / event
- • Meeting points
- • Holding area(s), queue complex(s), routes for movement
- • Watch towers at vantage locations for observing and monitoring the crowd.
- • CCTV coverage at all vulnerable locations to be monitored at the control room.
- • Sector wise deployment of policemen with sector wise responsibility and wireless communication network between watch towers, CCTV control room and deployment inside the crowd.
- • Police ‘chowkies’/ stations

- • Reporting places for lost / stolen / found items, missing persons etc.
- • Parking lots
- • Health facilities
- • Shopping areas
- • Food joints
- • Hazard points
- • Emergency exits
- • Emergency assembly points
- • First aid services
- • Emergency services (fire, ambulance)
- • Emergency operations center and incident command posts

- 1.FIRE BRIGADE: Fire Brigade is a Combine process of Man and machine to protect the fire.
- 1.Fire safety should be provided for in event management right from the planning stage which can reduce the destruction caused by fire and save lives in prompt manner.
- 2.Fire brigades can be on stand by at large events. Circus events or dare devil shows require organizers to assess the nature of events and possibilities of mishaps and how they can be avoided.
- 3.Maintaining proper fire exists and proper exit signage. Exit signs pointing to them that can function in power failure.
- 4.Compliance with electrical codes to prevent overheating, overloading wiring, conductors or other fixtures with more electric current than they are rated for.
- 5. Setting up of fire alarm systems for detection and warning of fire

AMBULANCE SERVICES

- : 1. Events like marathons, sporting events may require more than one ambulance on stands by unlike other events like movie Screenings, Collage or School festivals.
- 2.Ambulance service provide first aid as well as ensure that those patients that are seriously ill or injured received rapid paramedic level care and transport to hospital were required.
- 3.All event organizers are responsible for the well being and safety of all participants and spectators and hence must take all necessary precautions by having ambulance services.
- 4.When accidents are illness occur at events it helps to have emergency services upfront that help prevent further harm and save lives.
- 5.They should have a crew of paramedics / Doctors that are well qualified and skilled to handle emergency situations.
- 6.The ambulance must also be well equipped with latest equipment including oxygen ther by kit ,defibrillators, Carry chairs and stretchers.
- 7. The ambulance and crew should be also be connected with close by hospitals or emergency

CATERING SERVICES

- Catering service refers to the activity of providing food, refreshments and food service at events, hotels, pubs or any other location.
- 1.Cateering for weddings: Caters play a very important role at weddings. From the special guests to bride and groom, one needs to make sure everyone eats well. Catering requirements depend on the nature of weddings. For example South Indian wedding need south cuisine .
- 2.Catering for corporate: from the small meeting and training to large regional events, the ability to have great food delivered on site saves time and Money. Continental breakfast, box lunches and buffets are all popular for corporate catering.
- 3.Catereing for social Events: from the birth day and retirement parties to social events cover a wide range of vents. Social events range from weddings, birthday parties and wedding anniversaries to gatherings such as New year bash.
- 4.Mobile catering: Mobile catering is gaining popularity these days such as caterers move from one place to place in van or truck designed to carry food and equipment.

- 4.ELECTRICITY Event organizers ,contractors and others using electrical equipment must do all that is reasonably practicable to ensure to ensure that electrical installations and equipment at an event are properly selected, installed and maintained. The following elements should be considered by event organizers.
- 1. Power requirements, Details of power supply
- 2. Emergency power requirements, Environmental conditions, Event time table for power requirements.
- 3. Use of power generators, special power supplies for some equipment, portable tools.
- 4. Electrical requirement for emergency lighting and exit signs.
- 5.Power supplies for catering equipment, first aid points, incident control room, CCTV cameras etc.
- 6. Power supplies for heating and air conditioning.

- 5.WATER Events must have sufficient supply of freely available or at nominal charge, potable water and clear directional signage to water.

- 1.Drinking dispensers.
- 2.Water bottles
- 3.Disposal of Waste water
- 4.Water management
- 5.Water testing.

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Subject Digital Business

Programme:- MBA I SEM II

Information Security Problem

what is Cybercrime

- Cyber crime or computer-oriented crime is a crime that includes a computer and a network. The computer may have been used in the execution of a crime or it may be the target.
  Cyber crime is the use of a computer as a weapon for committing crimes such as committing fraud, identities theft or breaching privacy. Cyber crime, especially through the Internet, has grown in importance as the computer has become central to every field like commerce, entertainment and government. Cyber crime may endanger a person or a nation's security and financial health.
- Cyber crime encloses a wide range of activities but these can generally be divided into two categories:
- Crimes that aim computer networks or devices. These types of crimes involves different threats (like virus, bugs etc.) and denial-of-service (DoS) attacks.
- Crimes that use computer networks to commit other criminal activities. These types of crimes include cyber stalking, financial fraud or identity theft.

Types of Cyber Crime:

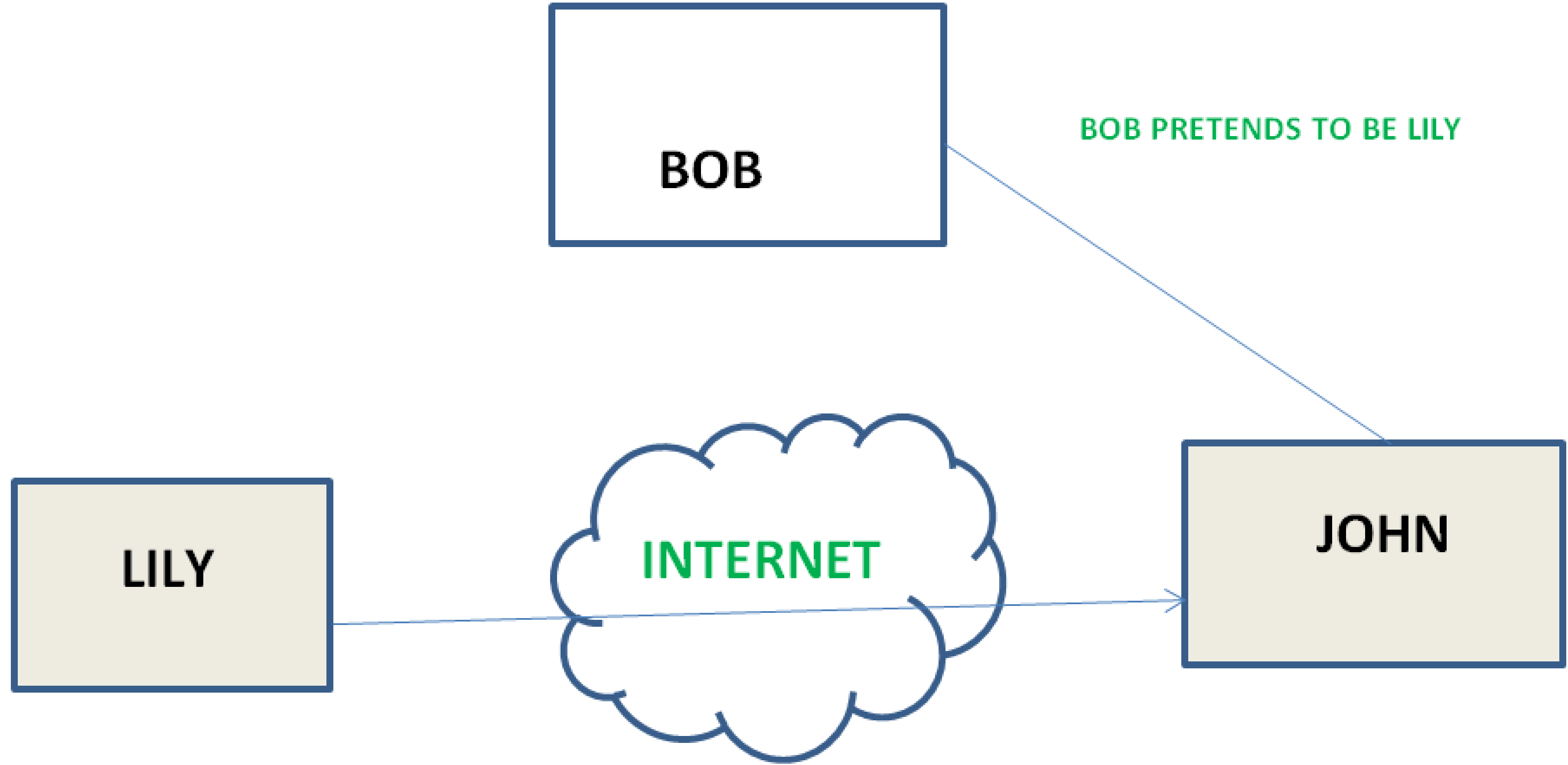
- **Cyber Terrorism:**
  Cyber terrorism is the use of the computer and internet to perform violent acts that result in loss of life. This may include different type of activities either by software or hardware for threatening life of citizens.
  In general, Cyber terrorism can be defined as an act of terrorism committed through the use of cyberspace or computer resources.
- **Cyber Extortion:**
  Cyber extortion occurs when a website, e-mail server or computer system is subjected to or threatened with repeated denial of service or other attacks by malicious hackers. These hackers demand huge money in return for assurance to stop the attacks and to offer protection.

- **Cyber Warfare:**
  Cyber warfare is the use or targeting in a battle space or warfare context of computers, online control systems and networks. It involves both offensive and defensive operations concerning to the threat of cyber attacks, espionage and sabotage.
- **Internet Fraud:**
  Internet fraud is a type of fraud or deceit which makes use of the Internet and could include hiding of information or providing incorrect information for the purpose of deceiving victims for money or property. Internet fraud is not considered a single, distinctive crime but covers a range of illegal and illicit actions that are committed in cyberspace.

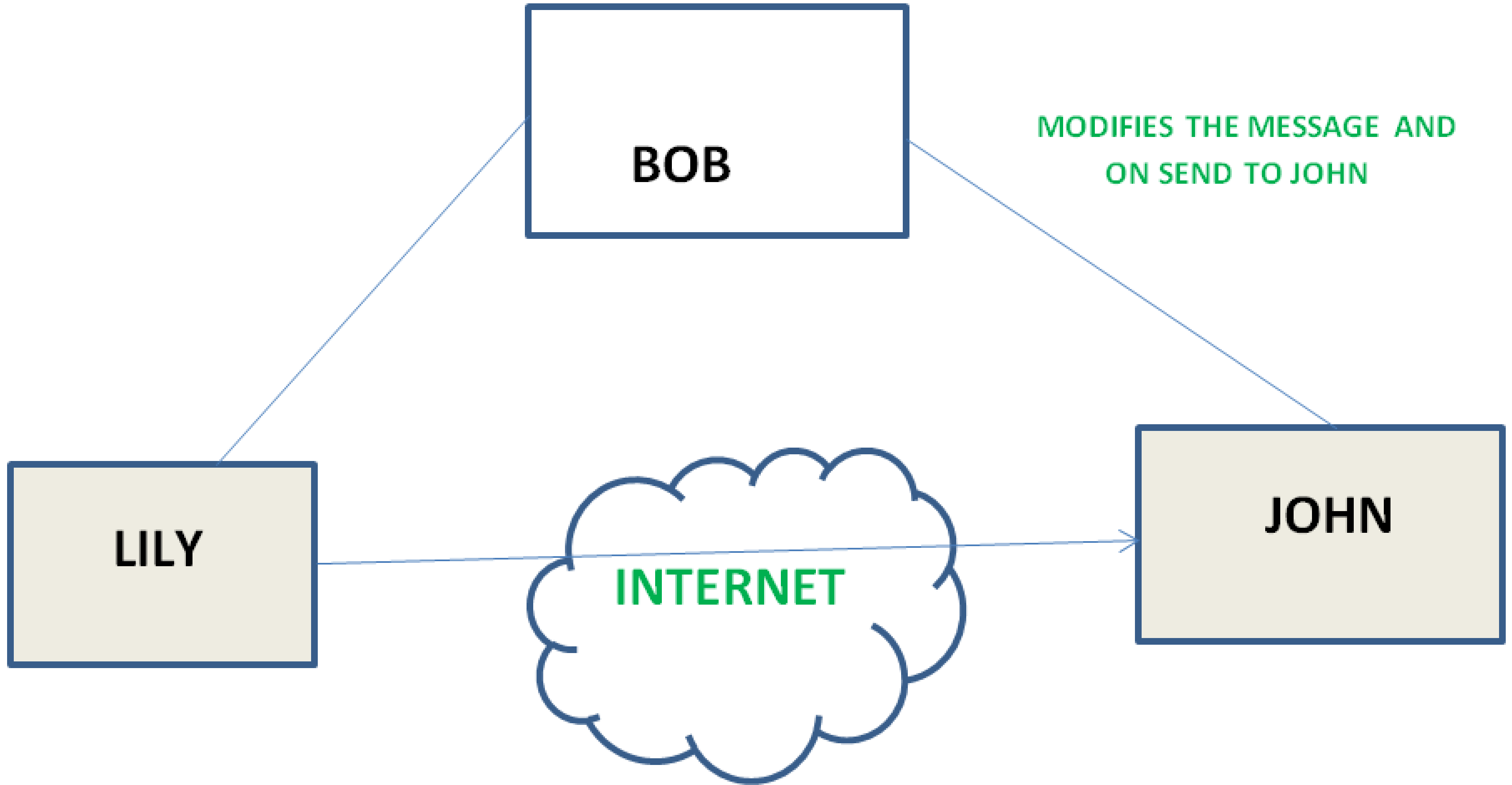
- **Cyber Stalking:**
  This is a kind of online harassment wherein the victim is subjected to a barrage of online messages and emails. In this case, these stalkers know their victims and instead of offline stalking, they use the Internet to stalk. However, if they notice that cyber stalking is not having the desired effect, they begin offline stalking along with cyber stalking to make the victims' lives more miserable.

Classifications of Security attacks (Passive Attacks and Active Attacks),

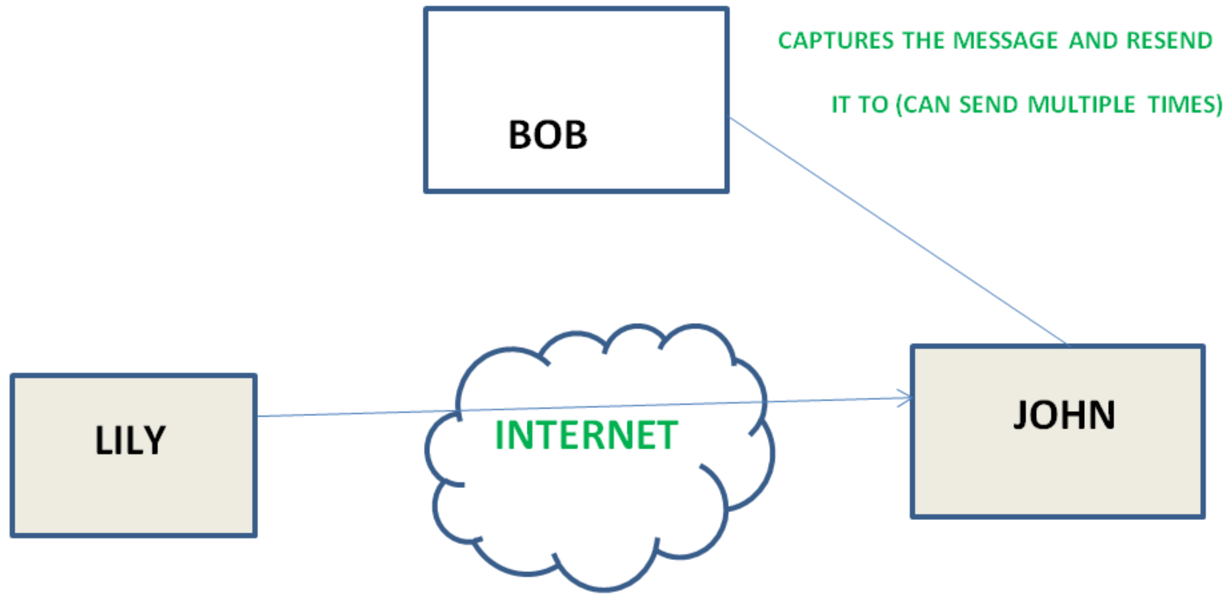
- **Active attacks:** An Active attack attempts to alter system resources or effect their operations. Active attack involve some modification of the data stream or creation of false statement. Types of active attacks are as following:
- **Masquerade –**
  Masquerade attack takes place when one entity pretends to be different entity. A Masquerade attack involves one of the other form of active attacks.


BOB
BOB PRETENDS TO BE LILY
LILY
INTERNET
JOHN

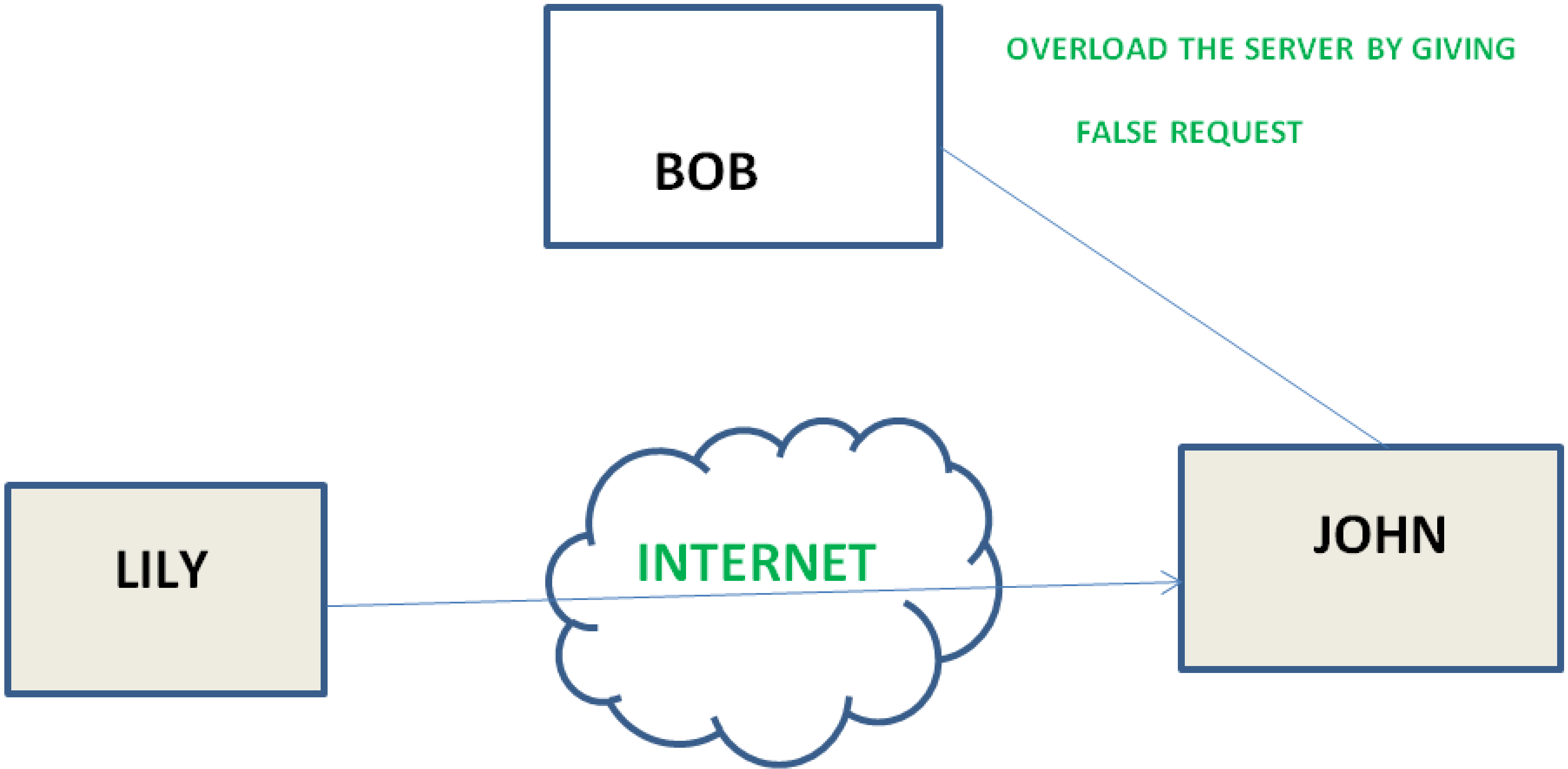
- **Modification of messages –**
  It means that some portion of a message is altered or that message is delayed or reordered to produce an unauthorised effect. For example, a message meaning “Allow JOHN to read confidential file X” is modified as “Allow Smith to read confidential file X”.


MODIFIES THE MESSAGE AND
ON SEND TO JOHN
BOB
LILY
INTERNET
JOHN

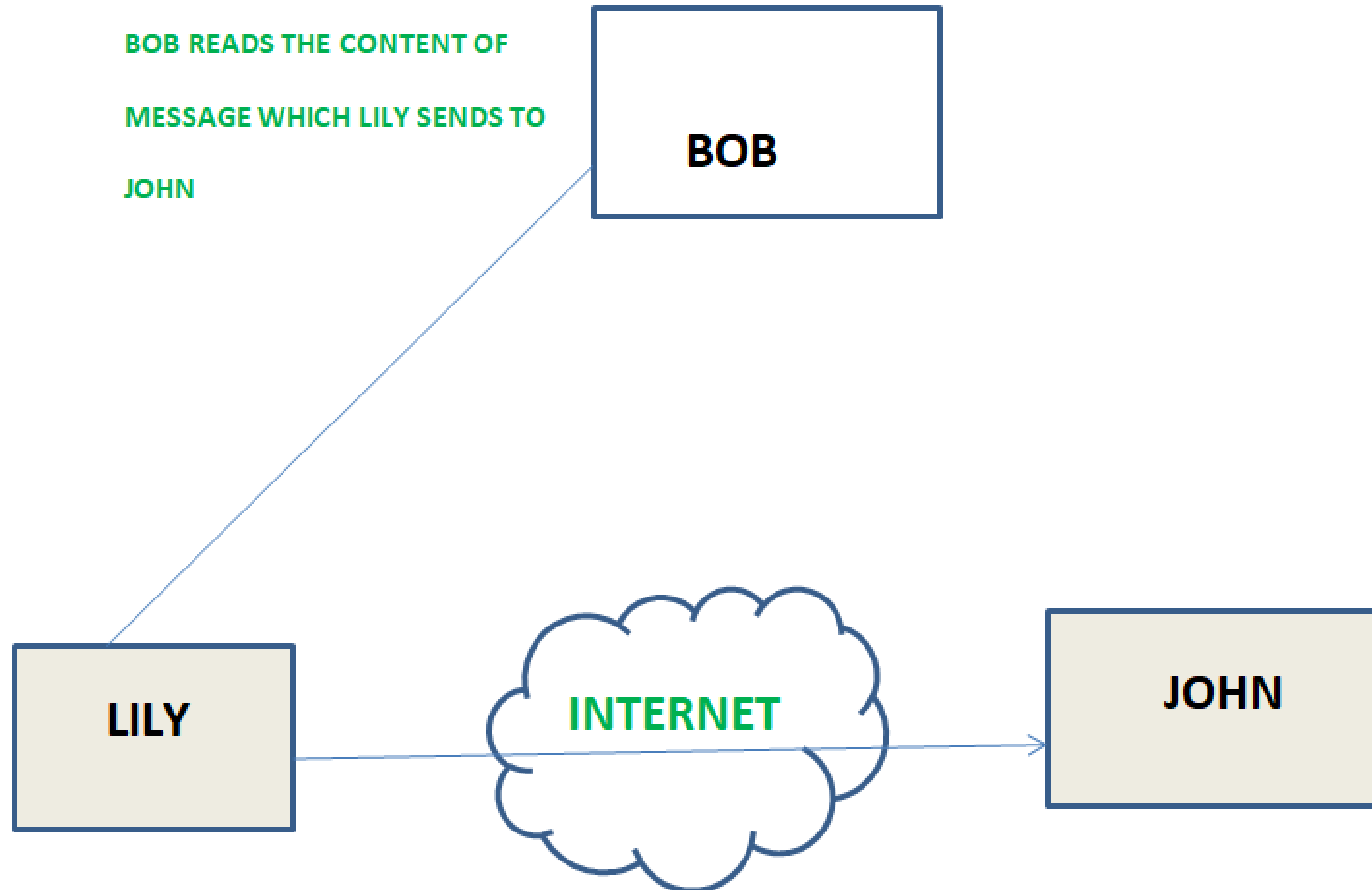
- **Repudiation –**
  This attack is done by either sender or receiver. The sender or receiver can deny later that he/she has send or receive a message. For example, customer ask his Bank “To transfer an amount to someone” and later on the sender(customer) deny that he had made such a request. This is repudiation.
- **Replay –**
  It involves the passive capture of a message and its subsequent the transmission to produce an authorized effect.


CAPTURES THE MESSAGE AND RESEND
IT TO (CAN SEND MULTIPLE TIMES)
BOB
LILY
INTERNET
JOHN

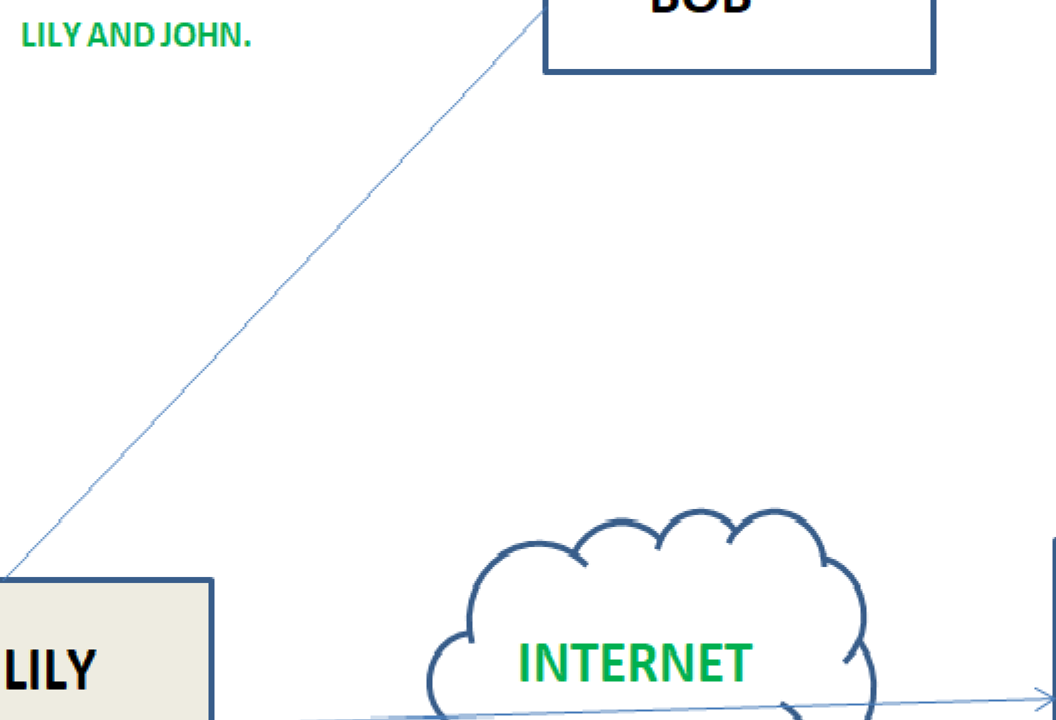
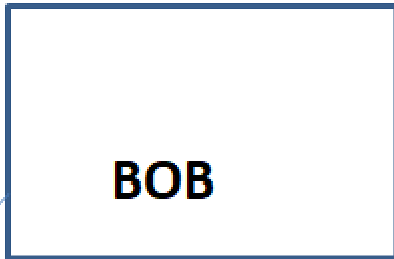
- **Denial of Service –**
  It prevents normal use of communication facilities. This attack may have a specific target. For example, an entity may suppress all messages directed to a particular destination. Another form of service denial is the disruption of an entire network wither by disabling the network or by overloading it by messages so as to degrade performance.


BOB
OVERLOAD THE SERVER BY GIVING
FALSE REQUEST
INTERNET
LILY
JOHN

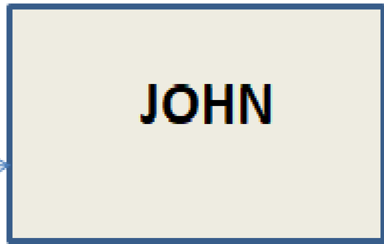
- **Passive attacks:** A Passive attack attempts to learn or make use of information from the system but does not affect system resources. Passive Attacks are in the nature of eavesdropping on or monitoring of transmission. The goal of the opponent is to obtain information is being transmitted. Types of Passive attacks are as following:
- **The release of message content –** Telephonic conversation, an electronic mail message or a transferred file may contain sensitive or confidential information. We would like to prevent an opponent from learning the contents of these transmissions.


BOB READS THE CONTENT OF
MESSAGE WHICH LILY SENDS TO
JOHN
BOB
LILY
INTERNET
JOHN

- **Traffic analysis –**
  Suppose that we had a way of masking (encryption) of information, so that the attacker even if captured the message could not extract any information from the message.
  The opponent could determine the location and identity of communicating host and could observe the frequency and length of messages being exchanged. This information might be useful in guessing the nature of the communication that was taking place.


BOB OBSERVES THE PATTERN OF
MESSAGES EXCHANGED BETWEEN
LILY AND JOHN.

BOB

LILY

INTERNET

JOHN

Essential Terminology

- **Threat** can be anything that can take advantage of a vulnerability to breach security and negatively alter, erase, harm object or objects of interest.
- **Software attacks** means attack by Viruses, Worms, Trojan Horses etc. Many users believe that malware, virus, worms, bots are all same things. But they are not same, only similarity is that they all are malicious software that behave differently.

- **Malware** is a combination of 2 terms- Malicious and Software. So Malware basically means malicious software that can be an intrusive program code or a anything that is designed to perform malicious operations on system. Malware can be divided in 2 categories:
- Infection Methods
- Malware Actions

- **Virus –** They have the ability to replicate themselves by hooking them to the program on the host computer like songs, videos etc and then they travel all over the Internet. Ther Creeper Virus was first detected on ARPANET. Examples include File Virus, Macro Virus, Boot Sector Virus, Stealth Virus etc.
- **Worms –** Worms are also self replicating in nature but they don't hook themselves to the program on host computer. Biggest difference between virus and worms is that worms are network aware. They can easily travel from one computer to another if network is available and on the target machine they will not do much harm, they will for example consume hard disk space thus slowing down the computer.

Difference between virus and worm

- Worms usually spread using a computer network, whereas viruses use executable files to spread from one system to others.
- Worms can automatically replicate to different systems, while viruses require human action to replicate.
- The spreading speed of viruses is comparatively slower than worms. Because worms can replicate automatically, they spread at a much faster speed.
- The viruses are designed to corrupt, delete, or modify the target devices' data or software, whereas worms don't harm the stored data but aim to harm the resources.

- **Ransomware** is a type of malicious software cyber criminals use to block you from accessing your own data. The digital extortionists encrypt the files on your system and add extensions to the **attacked** data and hold it “hostage” until the demanded ransom is paid.

- **Ransomware** is malicious software that infects your computer and displays messages demanding a fee to be paid in order for your system to work again. This class of malware is a criminal moneymaking scheme that can be installed through deceptive links in an email message, instant message or website.

- Viruses are found in executable files or can attach themselves to executable files to operate on target devices, whereas worms remain independent in an infected device's memory.
- The viruses require hosts to spread from one device to another. Worms, on the other side, don't need any host.
- Viruses usually destroy and damage the stored data, whereas worms can harm the entire network by using maximum resources. For example- by consuming bandwidth, sending mass emails, or deleting or copying files in bulk.

- Malware on the **basis of Actions:**
- **Adware –** Adware is not exactly malicious but they do breach privacy of the users. They display ads on computer's desktop or inside individual programs. They come attached with free to use software, thus main source of revenue for such developers. They monitor your interests and display relevant ads. An attacker can embed malicious code inside the software and adware can monitor your system activities and can even compromise your machine.
- **Spyware –** It is a program or we can say a software that monitors your activities on computer and reveal collected information to interested party. Spyware are generally dropped by Trojans, viruses or worms. Once dropped they installs themselves and sits silently to avoid detection.

- **Theft of intellectual property** means violation of intellectual property rights like copyrights, patents etc.
- **Identity theft** means to act someone else to obtain person's personal information or to access vital information they have like accessing the computer or social media account of a person by login into the account by using their login credentials.

- **Theft of equipment and information** is increasing these days due to the mobile nature of devices and increasing information capacity.
- **Social media attacks –** In this cyber criminals identify and infect a cluster of websites that persons of a particular organisation visit, to steal information.
- **Mobile Malware –**There is a saying when there is a connectivity to Internet there will be danger to Security. Same goes to Mobile phones where gaming applications are designed to lure customer to download the game and unintentionally they will install malware or virus in the device.

- **Corporate data on personal devices –** These days every organization follows a rule BYOD. BYOD means Bring your own device like Laptops, Tablets to the workplace. Clearly BYOD pose a serious threat to security of data but due to productivity issues organizations are arguing to adopt this.

Vulnerabilities

- **Vulnerabilities** are weaknesses in a system that gives threats the opportunity to compromise assets. All systems have vulnerabilities. Even though the technologies are improving but the number of vulnerabilities are increasing such as tens of millions of lines of code, many developers, human weaknesses, etc. Vulnerabilities mostly happened because of Hardware, Software, Network and Procedural vulnerabilities.

- **. Software Vulnerability:**
  A software error happen in development or configuration such as the execution of it can violate the security policy. For examples:
- Lack of input validation
- Unverified uploads
- Cross-site scripting
- Unencrypted data, etc.

- **Network Vulnerability:**
  A weakness happen in network which can be hardware or software.
  For examples:
- Unprotected communication
- Malware or malicious software (e.g.:Viruses, Keyloggers, Worms, etc)
- Social engineering attacks
- Misconfigured firewalls

- **Procedural Vulnerability:**
  A weakness happen in an organization operational methods.
  For examples:
- Password procedure – Password should follow the standard password policy.
- Training procedure – Employees must know which actions should be taken and what to do to handle the security. Employees must never be asked for user credentials online. Make the employees know social engineering and phishing threats.

Target of Evaluation

- **Target of Evaluation** (**TOE**) – the product or system that is the subject of the **evaluation**. The **evaluation** serves to validate claims made about the **target**. To be of practical use, the **evaluation** must verify the **target's** security features.

- A **cyber attack** is launched by cybercriminals using one or more computers against a single or multiple computers or networks. A **cyber attack** can maliciously disable computers, steal data, or use a breached **computer** as a launch point for other **attacks**.Types of Attacks
- Active Attacks
- Passive Attacks

Classifications of Cybercrimes

- **Cyber crimes** are **classified** based on the subject of the crime, the person or organization against whom the crime is committed, and the temporal nature of the crimes committed online. ... Crimes against individuals – These are committed against individuals or their properties. Some examples are: Email harassment.

Cybercriminals

- Cybercrime involves such activities as credit card fraud,cyberstalking,gaining unautorised access to computer systems,ignoring copyright,software piracy to perform criminal acts e.g. hackers,organised criminals,former employees seeking revenge,competing companies using employees to gain economic advantage through damage or theft

- Classifications of Cybercrimes
- Email Spoofing
- A spoofed E-Mail is one that appears to originate from one source but actually has been sent form another source.

- Spam is a form of email which is used to send to different email accounts and in general contains advertising about any product or services. But the real problem is when they contain malwares that can damage the user's data.
- Generally, they are sent to a massive list of emails for the mail purpose that a small percentage of users might open them and respond. They are used to such treatment because they are cheap in infrastructure investment, not too much time consuming and simple.

Sent Mail
Spam (372)
Trash

- People who create electronic spam are called spammers

- Cyber defamation
- **Cyber defamation** occurs when a computer connected to the internet is used as a tool, or a medium to defame a person or an entity
- Cyberdefamation happens when defamation takes place with the help of computers and the internet. For example. Someone publishes defamatory matter about someone on a website or sends an E-Mail containing defamatory information to all driens of that person

Internet Time Theft

- It refers to the **theft** in a manner where the unauthorized person uses **internet hours** paid by another person. The authorized person gets access to another person's ISP user ID and password, either by hacking or by illegal means without that person's knowledge
- However pme can identify time theft if the internet time is not used but recharged often .The issue of internet time theft is related to the crimes conducted through " identity theft"

Newsgroup Spam/Crimes from Usenet Newsgroup,

- **Newsgroup spam** is a type of **spam** where the targets are **Usenet newsgroups**. **Spamming** of **Usenet newsgroups** actually pre-dates e-mail **spam**. The first widely recognized **Usenet spam** (though not the most famous) was posted on 18 January 1994 by Clarence L. Thomas IV, a sysadmin at Andrews University.

Industrial Spying/Industrial Espionage

- **Industrial espionage/Spying** is the illegal and unethical theft of business trade secrets for use by a competitor to achieve a competitive advantage. It is often done by an insider or an employee who gains employment for the express purpose of **spying** and stealing information for a competitor.

- Some common **examples of industrial espionage** include: Breaking into company files or trespassing onto property without proper authorization. Posing as a worker in order to learn company trade secrets or other confidential information. Placing a wiretap on a competitor's phone

- Spying is not limited to govenrnments .Carporations often spy on enemy.Spies can get information about products research and development and marketing startegies. This activity is known as industrial spying e.g. A software engineer in London created a trojan horse programme specifically designed to extract critical data gatered from machines infected by his brogram. He had made a business out of selling his trojan Horse Program to companies in Israel

Trojan Horse

- A standalone malicious program which may give full control of infected PC to another PC is called Trojan horse. It may make copies of them, harm the host computer systems, or steal information.The Trojan horse will actually do damage once installed or run on your computer but at first glance will appear to be useful software. Trojans are designed as they can cause serious damage by deleting files and destroying information on your system.

- Trojans allow confidential or personal information to be compromised by system creating a backdoor on your computer that gives unauthorized users access to your system. Unlike Trojans do not self replicate reproduce by infecting other files nor do they self-replicate. Means Trojan horse viruses differ from other computer viruses and do not spread themselves.
- Most popular Trojan horses are Beast, Zeus, The Blackhole Exploit Kit, Flashback Trojan, Netbus, Subseven, Y3K Remote Administration Tool, Back Orifice.

Cyber offenses: How Criminals Plan that attacks,

- Technology is used for both good and bad purposes. People with the tendency to cause damages or carrying out illegal activities for bad purpose.
- Computers and tools available in It are also no exceptions In today's worlds of internet and computer networks a criminal activities can be carried out across world They are the most commonly occuring crimes that target the computer.

- Cybercriminal use the world wide web and internet to an optimum level for all illegal activities to store data,contacts and account information. The criminals take advantage of the widespread lack of awareness about cybercrimes and cyber laws among the people who are constantly using the It infrastructure for official and personal purpses.

- People who commit cybercrimes are known as “crackers”

How criminals plan the attacks

- Criminals use many methods and tools to locate their target. The target can be individual or an organization .Criminals plan active and passive attacks Active attacks are usually used to alter the system whereas passive attacks attempt to gain information about the target.

- In addition to the active and passive categories attacks can be categorized as either inside or outside.
- An attack originating or attempted within the security perimeter of an organization is an inside attack.It is usually attempted by an insider who gains access to more resources than expected . An outside attack is attempted by a resource outside thesecurity perimeter may be attempted by an insider or an outsider, who is indirectly associated with the organisation, it is attempted through the internet or remote access connection.

- The following phases are involved in planning cybercrime

1) Information gathering is the first phase and is treated as passive attacks
2) Scanning and scrutinizing the gathered information for the validity of the information as well as to identify the existing limitations
3) Launching an attack (gaining and maintaining the system access

Thank You !!!

Any Queries

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Academic Year 2022-23

Class: - MBA I SEM II

Course Name: - Financial Management

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M.Com. , CA Intermediate

Module No. 3 Capital Budgeting

Meaning of Capital Budgeting

Capital budgeting decision may be defined as "Firms decisions to invest its current funds most efficiently in long term activities in anticipation of an expected flow of future benefits over a series of year. The firm's capital budgeting decisions will include addition, disposition, modification and replacement of fixed assets".

Definitions:

1.Charles. T.Horngreen defined capital budgeting as "Long term planning for making and financing proposed capital out lay".
2. According to Keller and Ferrara, "Capital Budgeting represents the plans for the appropriation and expenditure for fixed asset during the budget period".
3. Robert N. Anthony defined as "Capital Budget is essentially a list of what management believes to be worthwhile projects for the acquisition of new capital assets together with the estimated cost of each product".

Importance & Need of capital Budgeting Decisions :-

The selection of the most profitable project of capital investment is the key function of Financial Manager. The decisions taken by the management in this area affect the operations of the firm for many years. Capital budgeting decisions may be generally needed for the following purposes:
a) Expansion;b) Replacement;c) Diversification;
d) Buy or lease e) Research and Development.

a) Expansion: The firm requires additional funds to invest in fixed assets when it intends to expand the production facilities in view of the increase in demand for their product in near future. Accordingly the current assets will increase. In case of expansion the existing infrastructure – like plant, machinery and other fixed assets is inadequate, to carry out the increased production volume. Thus the firm needs funds for such project. This will include not only expenditure on fixed assets (infrastructure) but also an increase in working capital (current assets).

b) Replacement: The machines and equipment used in production may either wear out or may be rendered obsolet due to new technology. The productive capacity and

competitive ability of the firm may be adversely affected. The firm needs funds or modernisation of a certain machines or for renovation of the entire plant etc., to make them more efficient and productive. Modernization and renovation will be a substitute for total replacement, where renovation or modernization is not desirable or feasible, funds will be needed for replacement.

c) Diversification: If the management of the firm decided to diversify its production into other lines by adding a new line to its original line, the process of diversification would require large funds for long-term investment. For example ITC and Philips company for their diversification.

d) Buy or Lease: This is a most important decision area in Financial Management whether the firm acquire the desired equipment and building on lease or buy it". If the asset is acquired on lease, there have to be made a series of annual or monthly rental payments. If the asset is purchased, there will be a large initial commitment of funds, but not further payments. The decision – making area is which course of action will be better to follow? The costs and benefits of the two alternative methods should be matched and compared to arrive at a conclusion.

e) Research and Development: The existing production and operations can be improved by the application of new and more sophisticated production and operations management techniques. New technology can be borrowed or developed in the laboratories. There is a greater need of funds for continuous research and development of new technology for future benefits or returns from
such investments.

Importance of Capital Budgeting Decisions

Capital Budgeting decisions are considered important for a variety of reasons. Some of them are the following:

1) Crucial decisions: Capital budgeting decisions are crucial, affecting all the departments of the firm. So the capital budgeting decisions should be taken very carefully.

2) Long-run decisions: The implications of capital budgeting decisions extend to a longer period in the future. The consequences of a wrong decision will be disastrous for the survival of the firm.

3) Large amount of funds: Capital budgeting decisions involve spending large amount of funds. As such proper care should be exercised to see that these funds are invested in productive purchases.

4)Rigid: Capital budgeting decision can not be altered easily to suit the purpose. Because of this reason, when once funds are committed in a project, they are to be coutinued till the end, loss or profit no matter.

Capital Budgeting Techniques :-

These methods are based on the principles to determine the desirability of an investment project on the basis of its useful life and expected returns. These methods depend upon

the accounting information available from the books of accounts of the company. These will not take into account the concept of 'time value of money' which is a signification factors to desirability of a project in terms of present value.

1. Pay-back Period
It is the most popular and widely recognized traditional methods of evaluating the investment proposals. It can be defined as "the number of years to recover the original capital invested in a project". According to Weston and Brigham, "the pay back period is the number of years it takes for the firm to recover its original investment by net returns before depreciation, but after taxes:
a) When cash flows are uniform: If the proposed project's cash inflows are uniform the following formula can be used to calculate the payback period.
Payback period = AnnualCash inflows Initial Investment
b) When cash flows are not uniform
When the project's cash inflows are not uniform, but vary from year to year pay back period is calculated by the process of cumulating cash inflows till the time when cumulative cash flows become equal to the original investment outlay.
The payback period can be used as an accept or reject criterion as well as a method of ranking projects. The payback period is the number of years to recover the investment made in a project. If the payback period calculated for a project is less than the maximum payback period set-up by the company, it can be accepted. As a ranking method it gives the highest rank to a project which has the lowest payback period, and the lowest rank to a project with the highest payback period. Whenever a company faces the problem of choosing among two or more mutually exclusive projects, it can select a project on the basis of payback period, which has shorter period than the other projects.
Merits: The following are the merits of the pay back period method:
(i) Easy to calculate: It is one of the easiest methods of evaluating the investment projects. It is simple to understand and easy to compute.
(ii) Knowledge: The knowledge of payback period is useful in decision-making, the shorter the period better the project.
(iii) Protection from loss due to obsolescence: This method is very suitable to such industries where mechanical and technical changes are routine practice and hence, shorter payback period practice avoids such losses.
(iv) Easily availability of information: It can be computed on the basis of accounting information, what is available from the books.
Demerits: However, the payback period method has certain demerits:
(i) Failure in taking cash flows after payback period: This methods is not taking into account the cash flows received by the company after the payback period.
(i) Not considering the time value of money: It does not take into account the time value of money.
(iii) Non-considering of interest factor: It does not take into account the interest factor involved in the capital outlay.

(v) Failure in taking magnitude and timing of cash inflows: It fails to consider the pattern of cash inflows i.e. the magnitude and timing of cash inflows.

2. Accounting or Average Rate of Return (ARR)

This technique uses the accounting information revealed by the financial statements to measure the profitability of an investment proposal. It can be determined by dividing the average income after taxes by the average investment. According to Soloman, Accounting Rate of Return can be calculated as the ratio, of average net income to the initial investment.

On the basis of this method, the company can select all those projects whose ARR is higher than the minimum rate established by the company. It can reject the projects with an ARR lower than the expected rate of return. This method also helps the management to rank the proposal on the basis of ARR.

Accounting Rate of Return (ARR) = *Original Investment AverageNet Income*

OR

Accounting Rate of Return (ARR) = *Average Investment AverageNet Income*

Acceptance Rule:

The project which gives the highest rate of return over the minimum required rate of return is acceptable

Merits: The following are the merits of ARR method:

(i) It is very simple to understand and calculate;
(ii) It can be readily computed with the help of the available accounting data;
(iii) It uses the entire stream of earnings to calculate the ARR.

Demerits: This method has the following demerits:

(i) It is not based on cash flows generated by a project;
(ii) This method does not consider the objective of wealth maximization;
(iii) It ignore the length of the projects useful life;
(iv) If does not take into account the fact that the profile can be re-invested; and
(v) It ignores the time value of money.

3. Net Present Value (NPV):

The net present value method is a classic method of evaluating the investment proposals. It is one of the methods of discounted cash flow techniques, which recognizes the importance of time value of money. It correctly postulates that cash flows arising at time periods differ in value and are comparable only with their equivalents i.e. present values.

It is a method of calculating the present value of cash flows (inflows and outflows) of an investment proposal using the cost of capital as an appropriate discounting rate. The net present value will be arrived at by subtracting the present value of cash outflows from the present value of cash inflows. According to Ezra Soloman, "it is a present value of the cast of the investment."

Steps to compute net present value:

(i) Estimation of future cash inflows
(ii) An appropriate rate of interest should be selected to discount the cash flows. Generally, this will be the "cost of capital" of the company, or required rate of return.
(iii) The present value of inflows and outflows of an investment proposal has to be computed by discounting them with an appropriate cost of capital.
(iv) The net value is the difference between the present value of cash inflows and the present value of cash outflows.
The formula for the net present value can be written as:

$$NPV = \frac{C1}{(1+K)1} + \frac{C2}{(1+K)2} + \frac{Cn}{(1+k)n}$$

Where
C = Annual Cash inflows,
Cn= Cash inflow in the year n
K = Cost of Capital
I = Initial Investment

Acceptance Rule:
If the NPV is positive or atleast equal to zero, the project can be accepted. If it is negative, the proposal can be rejected. Among the various alternatives, the project which gives the highest positive NPV should be selected.
NPV is positive = Cash inflows are generated at a rate higher than the minimum required by the firm.
NPV is zero = Cash inflows are generated at a rate equal to the minimum required.
NPV is negative = Cash inflows are generated at a rate lower than the minimum required by the firm.
The market value per share will increase if the project with positive NPV is selected.
The accept/reject criterion under the NPV method can also be put as:
NPV>Zero Accept
NPV<Zero Reject
NPV=0 May accept or reject
Merits: The following are the merits of the net present value (NPV) methods:

(i) Consideration to total Cash Inflows: The NPV methods considers the total cash inflows of investment opportunities over the entire life-time of the projects unlike the payback period methods.

(ii) Recognition to the Time Value of Money: This methods explicitly recognizes the time value of money, which is investable for making meaningful financial decisions.
(iii) Changing Discount Rate: Due to change in the risk pattern of the investor different discount rates can be used.
(iv) Best decision criteria for Mutually Exclusive Projects: This Method is particularly useful for the selection of mutually exclusive projects. It serves as the best decision criteria for mutually exclusive choice proposals.
(v) Maximisation of the Shareholders Wealth: Finally, the NPV method is instrumental in achieving the objective of the maximization of the shareholders' wealth. This method is logically consistent with the company's objective of maximizing shareholders' wealth in terms of maximizing market value of shares, and theoretically correct for the selections of investment proposals.
Demerits: The following are the demerits of the net present value method:
(i) It is difficult to understand and use.
(ii) The NPV is calculated by using the cost of capital as a discount rate. But the concept of cost of capital itself is difficult to understand and determine.
(iii) It does not give solutions when the comparable projects are involved in different amounts of investment.
(iv) It does not give correct answer to a question when alternative projects of limited funds are available, with unequal lives.

Module No. 1 Introduction to Financial Management

Meaning :-

Management is an activity which is connected with planning and controlling of different activities in a firm in order to achieve a specific target. If we apply the concept to financial management, it will mean that it is planning and controlling of financial resources of a firm with a specific objective.

The subject of financial management has assumed greater importance today as the financial strategies required to survive in the competitive environment have become very important. In the financial markets also new instruments and concepts are coming and one must say that a finance manager of today is operating in a much more complex environment than before.

Objectives :-

Objectives for the firm can be broadly categorized into the following types:

i) **Maximization of Profits**: This objective aims at the maximization of profits of the firm. The main arguments in favour of this objective are that as the profit is the income of the owner, he will naturally try to maximize the same and thus will ensure his sound position. The profit maximization theory is consistent with the economic theory which prevailed over a century. The main objections to the profit maximization theory are mentioned below.

a) One of the features of the modern form of organization is the separation of ownership from management.

b) It may be necessary for many firms to operate at less than the maximum profits. For giving them competitive edge. A firm will have to adopt such a pricing policy that it will enable them to earn a minimum profits. But they will be able to survive because of their size and other factors also.

c) It is also said that the concept of profit is narrow and vague.

d) Another criticism is that the profit concept do not take into consideration the present value of rupee.

e) Maximisation of profits is only one aspect. There are several other aspects like consumer satisfaction, employee satisfaction and also aspirations of stakeholders like banks, suppliers, Government etc. which should be taken into consideration. If a firm considers only profit maximization, other aspects may be ignored.

ii) **Maximization of Wealth :**

The objective of maximization of wealth is assuming more and more importance. The wealth maximization can be explained as the difference between the present value of the benefits and the present value of the costs. It is suggested that when there are several alternative courses of action in front of a firm, that alternative which will maximize the net present value should be selected.

Wealth maximization objective is supported on the following grounds:

a) It takes into consideration long term perspective of survival of the firm.
b) It suggests that the shareholders should get a regular and consistent dividend.
c) Financial decisions are taken with an objective of improving capital appreciation.
d) Time value of money is taken into consideration.
e) All future cash inflows, dividends, earning per share, ROCE are taken into consideration.
f) Maximisation of wealth is reflected in the market price of shares.

Scope of Financial Management Financial Management today covers the entire gamut of activities and functions given below. The head of finance is considered to be important ally of the CEO in most organizations and performs a strategic role. His responsibilities include:

(i) Estimating the total requirements of funds for a given period;

(ii) Raising funds through various sources, both national and international, keeping in mind the cost effectiveness;

(iii) Investing the funds in both long term as well as short term capital needs;

(iv) Funding day-to-day working capital requirements of business;

(v) Collecting on time from debtors and paying to creditors on time;

(vi) Managing funds and treasury operations;

vii) Ensuring a satisfactory return to all the stake holders;

(viii) Paying interest on borrowings;

(ix) Repaying lenders on due dates;

(x) Maximizing the wealth of the shareholders over the long term;

(xi) Interfacing with the capital markets;

(xii) Awareness to all the latest developments in the financial markets;

(xiii) Increasing the firm’s competitive financial strength in the market &

(xiv) Adhering to the requirements of corporate governance.

Modern Approaches to Financial Management

The traditional approach to the financial management said that the scope of financial management is restricted to raising to funds from various sources and completion of the legal formalities required to do the same. This suggests that a finance manager should know how to raise the funds and he is not supposed to do anything more than this. The modern approach to the financial management says that there are three important functions which are expected to be performed by the financial management. These functions are as follows.

i) How much amount of funds will be required by the firm?
ii) How to raise the amount required by the firm?
iii) How to invest the amount raised so that the objectives of financial management as well as the firm will be achieved?

As mentioned above, a finance manager has to perform three important functions:-

i) Estimating the requirements of funds
ii) Raising the funds and
iii) Investing the funds.
It is clear from this that the following important decisions are involved in the discharge of finance function.

i) Raising of finance

In raising of the funds, a careful consideration is to be given to the mix of owned funds and borrowed funds. The firm Financing decisions are connected with raising optimum finance for achieving the long term and short term objectives of the firm. It is therefore necessary to forecast the needs of the firms for the long term. Capital expenditure plans for the future become very crucial in this connection. At the same time, working capital requirements should also be taken into consideration. In addition to this, financing decisions also require a thorough knowledge and understanding of cost of funds, various sources of raising them, new financial instruments which call for financial engineering, different financial obligations attached to various financial instruments, risks associated with sources of financing and hedging process for minimizing the same etc. Apart from these factors, the impact of taxation and the projected impact of pattern of financing on the earnings per share should also be studied. Thus, to summarise, three crucial aspects should be taken into consideration before financing decisions are taken.

i) Requirements of funds during long term and short term.
ii) Deciding about optimum combination of owned funds and borrowed funds for raising the funds i.e. in other words, the gearing adjustment
iii) Determination of the financing pattern for long term funds requirements and short term requirements.

ii) <u>Investing of funds</u>

After raising the funds, the next important decision that is to be taken is investing of these funds. Investments of funds should be in a well-planned manner. Funds raised from various sources are invested in:

a) Fixed Assets, and
b) Working capital.

An investment in fixed assets is made with a long term perspective and the main objective is to enhance the earning capacity. The decisions regarding investments in fixed assets are usually irreversible and involve heavy amounts. Working capital represents the funds which are required for meeting the day to day requirements of the firm. In every business there is a working capital cycle and funds invested in working capital are recovered back after some period. There should not be an excessive investment in working capital otherwise funds will remain idle. There should be a proper balance between liquidity and profitability.

iii) <u>Dividend Decisions</u>

Another crucial area which requires careful consideration is regarding dividends. How much amount of profits should be distributed amongst the shareholders and how much amount of profit should be retained for investing in the business will have to be decided by the management.

Thus it should be understood that the decisions regarding investments, financing and dividends are interrelated and impact of all these decisions should be considered.

Financial Management is not only considered with raising of finance but it has a wider perspective of managing of the funds. In other words, it can be said that Financial Management is actually a decision making in various areas like deciding asset mix, capital mix and profit allocation.

Finance & Related Disciplines-

As you pursue your study of financial management, you should keep in mind that financial management is not a totally independent area in business administration. Instead, it draws heavily on related disciplines and fields of study. The most important of these are *accounting* and *economics*; in the latter discipline, both *macroeconomics* and *microeconomics* are significant. *Marketing, production, human resources management*, and the study of *quantitative methods* also have an impact on the financial management field. Each of these is discussed here.

Accounting

Financial managers play the game of managing a firm's financial and real assets and securing the funding needed to support these assets.Accountants are the game's scorekeepers. Financial managers often turn to accounting data to assist them in making decisions. Generally a company's accountants are responsible for developing financial reports and measures that assist its managers in assessing the past performance and future direction of the firm and in meeting certain legal obligations, such as the payment of taxes. The accountant's role includes the entrepreneurial ISSUES

Shareholder Wealth Maximization

Entrepreneurial finance deals with the financial issues facing small businesses an important sector of the U.S. economy. Small business firms may be organized as sole proprietorships, partnerships, or corporations. According to criteria used by the Small Business Administration, over 95 percent of all business firms are considered small.

These firms account for the majority of private sector employment and nearly all of the recent net growth in new jobs. It is difficult to arrive at a precise definition of a small, or entrepreneurial, business; however, the characteristics of small business firms can be identified. In general, small businesses are not the dominant firm in the industries in which they compete, and they tend to grow more rapidly than larger firms. Small firms have limited access to the financial markets, and they often do not have the depth of specialized managerial resources available to larger firms. Small firms also have a high failure rate.

financial managers is to maximize shareholder wealth, as measured by the price of the firm's stock. Many entrepreneurial corporations are closely held, and their stock trades infrequently, if ever. Other entrepreneurial firms are organized as sole proprietorships or partnerships. In these cases, there is no readily accessible external measure of performance. Consequently, these firms often rely more heavily on accounting based measures of performance to track their progress.

Relationship between Financial Management and Other Disciplines

Financial managers are primarily concerned with a firm's cash flows, because they often determine the feasibility of certain investment and financing decisions. The financial manager refers to accounting data when making future resource allocation decisions concerning long -term investments, when managing current investments in working capital, and when making a number of other financial decisions (for example, determining the most appropriate capital structure and identifying the best and most timely sources of funds needed to support the firm's investment programs).

In many small and medium-sized firms, the accounting function and the financial management function may be handled by the same person or group of persons. In such cases, the distinctions just identified may become blurred.

Economics

There are two areas of economics with which the financial manager must be familiar: *micro-economics* and *macroeconomics*.Microeconomics deals with the economic decisions of individuals, households, and firms, whereas macroeconomics looks at the economy as a whole.

The typical firm is heavily influenced by the overall performance of the economy and is dependent upon the money and capital markets for investment funds. Thus, financial managers should recognize and understand how monetary policies affect the cost of funds and the availability of credit. Financial managers should also be versed in fiscal policy and how it affects the economy. What the economy can be expected to do in the future is a crucial factor in generating sales forecasts as well as other types of forecasts.

The financial manager uses microeconomics when developing decision models that are likely to lead to the most efficient and successful modes of operation within the firm. Specifically, financial managers use the microeconomic concept of setting marginal cost equal to marginal revenue when making long-term investment decisions (*capital budgeting*) and when managing cash, inventories, and accounts receivable (*working capital management*).

Marketing, Production, Quantitative Methods, and Human Resources Management

We depicts the relationship between financial management and its primary supportive disciplines.Marketing, production, quantitative methods, and human resources management are indirectly related to the key day-to-day decisions made by financial managers. For example, financial managers should consider the impact of new product development and promotion plans made in the marketing area because these plans will require capital outlays and have an impact on the firm's projected cash flows.

Similarly, changes in the production process may necessitate capital expenditures, which the firm's financial managers must evaluate and then finance. The tools of analysis developed in the quantitative methods area are frequently helpful in analyzing complex financial management problems. Compensation policies may impact the extent of agency problems in a firm.

Financial Planning – principles &steps in Financial Planning

Financial planning is the setting and implementation of goals for the utilization of one's money. "Financial planning" is not a product or a service but a series of interrelated activities that a client engages in on a continuing basis. The goal of the financial planning process is to create a financial plan which will serve as the framework for organizing the components of a client's financial situation. A financial plan helps the client to focus on his or her goals and to understand what needs to be done to achieve those goals. The financial plan also helps the client to balance competing financial priorities. For example, saving for one financial goal such as a child's college education may impact another financial goal such as saving for retirement. Once the client is aware of competing goals, he or she can prioritize those goals, implement specific financial planning strategies, and select suitable products and/or services to help them achieve those goals. Financial planning is appropriate when a client has ongoing, current, and/or future financial goals they wish to achieve and need to determine the strategies necessary to successfully attain those goals.

The primary role of the financial planning professional is to work closely with the client throughout the financial planning process. The steps in the process are to:

♦ Define, establish, and prioritize the client's goals and objectives.

♦ Gather the client's data and background information.

♦ Analyze and evaluate the client's current financial situation.

♦ Develop a financial plan.

♦ Outline and educate the client about the strategies that are designed to help implement the plan.

♦ Help implement the plan.

♦ Monitor the plan on a regular basis and make adjustments as needed.

Module No.2 Time Value of Money

Money has time value. A rupee today is more valuable than a rupee a year .

- Individuals, in general, prefer current consumption to future consumption.
- Capital can be employed productively to generate positive returns. An investments of one rupee today would grow to (l+r) a year hence (r is the rate of return earned on the investments).
- In an inflationary period a rupee today represents a greater real Purchasing Power than a rupee a year hence.

Money of the financial problems involves cash flows occurring at different points of the time. For evaluating such cash flows an explicit consideration of the Time Value of money is required. These methods have application in various areas of financial analysis.

Methods of Time Value of Money:

1. Compounding: We find the Future Values (FV) of all the cash flows at the end of the time period at a given rate of interest.
2. Discounting: We determine the Time Value of money at time "O" by comparing the initial outflow with the sum of the Present Values (PV) of the future inflows at a given rate of interest.

Time Value of Money

Compounding (Future Value)	Discounting (Present Value)
(a) Single Flow	(a) Single Flow
(b) Multiple Flows	(b) Uneven Multiple Flows
(c) Annuity	(c) Annuity
	(d) Perpetuity

A) Future value of a Single Flow

Suppose you have ` 1,000 today and you deposit it with a financial institution, this pays 10 percent interest compounded annually, for a period of 3 years. The deposit would grow as follows:

First year: Principal at the beginning ` 1,000

Interest for the year (` 1,000 × 0.10) 100

Principal at the end 1,100

Second year: Principal at the beginning ` 1,100

Interest for the year (` 1,100 × 0.10) 110

Principal at the end 1,210

Third year: Principal at the beginning ` 1,210

Interest for the year (` 1,210 × 0.10) 121

Principle at the end 1,331

Formula: The general formula for the value of single flow as:

S = p (1+i) n

Where, S = Future value n years hence,

p = Amount invested today,

i = Interest rate per period, and

n = Number of periods of investments.

B) Future value of an Annuity

An annuity is a series of periodic cash flows (payments of receipts) of equal amounts. The premium of a life insurance policy, for example, is an annuity. When the cash flows occur at the end of each period the annuity is called a regular annuity or a deferred annuity. When the cash flows occur at the beginning of each period the annuity is called an annuity due. Our discussion here will focus on a regular annuity –the formula of course, can be applied, with some modification, to an annuity due.

Value of annuity is given by the following formula:

Sn= R [((1+i)n -1)/i

Where ,Sn = Future value of an annuity which has a duration of n periods

R = Constant periodical payment,

i = Interest rate per period, and

n = Duration of annuity.

PRESENT VALUE

A) Present value of a Single Flow

some one promise to give you ` 1,000 three years hence. What is the present value of this amount if the interest rate is 10 percent? The present value can be calculated by discounting ` 1,000, to the present point of time, as follows:

Value of three years hence = ` 1,000

Value two years hence = ` 1,000 ___ ___ + 10 .011

Value one year hence = ` 1,000 × 2) 10.01 (1 +

Value now (present value) = ` 1,000 × 3) 10.01 (1 +

Formula The process of discounting, used for finding present value, is simply the reverse of compounding. The present value formula can be readily obtained by manipulating the compounding formula:

$S = p(1+i)n$

Dividing both sides of above Eq. by (1+i) n we get

$p = S^* \frac{1}{(1+i)n} = S \frac{*1}{(1+i)n}$

$\frac{1}{(1+i)n}$ in above equation called the discounting factor or the present value interest (PVIFi,n). The value of PVIFi, n for several combinations of i and n.

B) Present Value of an Annuity

Formula in general terms the present value of an annuity may be expressed as:
S = A(1-(1+i)n) \i

S = Present value of an annuity
A = Amount of each instalment
i = Interest rate per period
n = Number of periods.

Where, pn = present value of an annuity which has a duration of n periods,

R =constants periodic flow, and

i = interest (discount) rate.

Period required for doubling the amount:

A common question which arises among the investors is that how much period will it take for the amount invested to be doubled at a given rate of interest.

For the explanation of this, Rule of "72", is to be applied. It is a short cut way. Under this rule, the period within which the amount will be doubled is obtained by dividing 72 by the rate of interest.

For instance, if the rate of interest is 6%, Then its double period is 72/6 = 12 years.

However, an accurate way of calculating the doubling period is the Rule of "69". Under this Rule, doubling
period = 0.35+ 69\ Interest Rate

Then the doubling period for the above eg. = 11.85 years

Module No. 3 Capital Budgeting

Meaning :-

Capital investment refers to the investment in projects whose results would be available only after a year. The investments in these projects are quite heavy andis to be made immediately but the return will be available only after a period of time. These investment decisions, popularly known as capital budgeting decisions, require comparison of cost against benefits over a long period. The system of capital budgeting is employed to evaluate expenditure decisions which involve current outlays but are likely to produce benefits over a period of time longer than one year. These benefits may be either in the form of increased revenues or reduction in costs. The following basic features of capital budgeting may be derived from the above discussion.

i) Potentially large anticipated benefits.
ii) A relatively high degree of risk.
iii) A relatively long time period between the initial outlay and anticipated return.

Importance of Capital Budgeting

Capital budgeting decisions are quite crucial and critical business decisions. The reasons for this can be summarized as follows :-

a) The capital budgeting decisions relate to fixed assets and the fixed assets represent the true earning assets of the firm. They enable the firm to generate finished goods that can be ultimately being sold at profit. Thus it can be said that capital budgeting decisions determine the future destiny of the company.
b) The effect of capital budgeting decisions will be felt by the firm over a long time, and inevitably affect the cost structure of a company. If the project is unsuccessful, the entire burden of fixed costs will fall on the firm, thus affecting its profitability.
c) Capital budgeting decisions are irreversible. The reason is that, there may not be any market for second hand plant and equipment and they may have to be sold out only at a loss.
d) The capital budgeting decisions require an assessment of future event which are uncertain. It is really a difficult task to estimate the probable future events, the expected benefits and costs in uncertain conditions.

Difficulties in Capital Budgeting Decisions:

Capital budgeting has acquired great significance in the recent past for the following three major reasons:

a) Difference in Capital Projects: No two capital projects are alike. They differ in many respects such as the period, cash outlay, profits etc. So it becomes necessary to devise techniques which can translate all these differing variables into some common denomination, so that meaningful comparisons can be made.

b) Need for Rationing the Capital Resources: There would have been no need for a comparative study of capital projects, had there been abundant resources available with every company for capital investments. Given a chance, every manager is capable for submitting a proposal for huge capital investment which, according to him is, absolutely essential. However the finances available to a company are very limited and it will not be possible for any company, however prosperous it may be, to accept all the proposals for capital investments, put forward by its managers. The available capital has to be rationed among the applicants. This need for rationing the limited capital among several projects forms the basis for developing certain tools and techniques of evaluating and ranking various capital projects.

c) Different from Revenue Budgeting: Unlike the decisions relating to a revenue budget, the capital budgeting decisions are more complex because of four basic reasons.

   i) The cash outlay involved is comparatively heavier many times running to perhaps, several crores of rupees. (The burden of cash outlay is of course of relative to the size of a company.)

   ii) The impact of capital expenditure decision will be felt over a longer period of time. If a machine is purchased, there are many long term implications in the form of annual depreciation charges, repairs, maintenance expenses, etc.

   iii) A revenue budget has time horizon of just a year and so many things can be reasonably forecast and estimated. But it is very difficult to make such a forecast in the long run because of many uncertainties such as technological changes, potential competition, future of national economy, etc.

Classification of Project

a) Projects which are means to maintain or improve profitability :

i) Certain projects may result in cost reduction, e.g., Replacement of manual operations by labour saving device.

ii) Certain projects may lead to increased output and, therefore, increased earnings.

iii) It may become necessary to invest in certain projects in order to protect the company earning potential, in view of growing competition. It may be either a protective investment or even an investment, meant to ward off competition.

iv) Many Capital Investments become necessary because of technological changes and innovations. If a machine with a better design comes into the market, the existing machines (in the same line) become obsolete. If a new manufacturing process is developed (which results in greater economy and / or more output) the existing process has to be discarded.

v) Certain investments may be made because of strategy reasons. If a company wants to acquire or maintain leadership in the industry it spends vast sums of money on Research and Development which may in some cases appear to be output of proportion to its existing level of activities.

The primary motive in making the above types of investment is profitability in contract to the five types of investments classified under b below. What we are going to discuss in this chapter is relevant to the investments which are made for reasons of profit.

b) Projects for which profitability is not the criterion:There are certain projects, in which every company has to invest funds, though such projects do not have any direct impact on increased profitability either in the short run or in the longrun.

Examples:

i) Projects, which are statutorily required, e.g. Effluent clearing plant in a fertilizer factory, dust collection in a cement factory, special equipment to treat noxious gases realized by a chemical factory.

ii) Service Department Projects, e.g., Building and Furniture for administrative finance, legal departments etc.

iii) Welfare Projects such as Health Clinic Recreation Club for employees.

iv) Educational Projects such as School for employees children.

v) Safety Projects, e.g. fencing equipment, special protective cages, etc.

However, it does not mean that some of these projects do not result in increased productivity and profitability in the long run they may. But what is necessary to remember is that in making these investments, profitability is not the chief Criterion.

Capital Budgeting Techniques

1.Pay-back Period

It is the most popular and widely recognized traditional methods of evaluating the investment proposals. It can be defined as "the number of years to recover the original capital invested in a project". According to Weston and Brigham, "the pay back period is the number of years it takes for the firm to recover its original investment by net returns before depreciation, but after taxes:

a) When cash flows are uniform: If the proposed project's cash inflows are uniform the following formula can be used to calculate the payback period.

Payback period = Initial Investment / Annual Cash inflows

b) When cash flows are not uniform

When the project's cash inflows are not uniform, but vary from year to year pay back period is calculated by the process of cumulating cash inflows till the time when cumulative cash flows become equal to the original investment outlay. The payback period can be used as an accept or reject criterion as well as a method of ranking projects. The payback period is the number of years to recover the investment made in a project. If the payback period calculated for a project is less than the maximum payback period set-up by the company, it can be accepted. As a ranking method it gives the highest rank to a project which has the lowest payback period, and the lowest rank to a project with the highest payback period. Whenever a company faces the problem of choosing among two or more mutually exclusive projects, it can select a project on the basis of payback period, which has shorter period than the other projects.

Merits: The following are the merits of the pay back period method:

(i) Easy to calculate: It is one of the easiest methods of evaluating the investment projects. It is simple to understand and easy to compute.

(ii) Knowledge: The knowledge of payback period is useful in decision-making, the shorter the period better the project.

(iii) Protection from loss due to obsolescence: This method is very suitable to such industries where mechanical and technical changes are routine practice and hence, shorter payback period practice avoids such losses.

(iv) Easily availability of information: It can be computed on the basis of accounting information, what is available from the books.

Demerits: However, the payback period method has certain demerits:

(i) Failure in taking cash flows after payback period: This methods is not taking into account the cash flows received by the company after the payback period.

(i) Not considering the time value of money: It does not take into account the time value of money. (iii) Non-considering of interest factor: It does not take into account the interest factor involved in the capital outlay.

(iv) Maximisation of market value not possible: It is not consistent with the objective of maximizing the market value of share.

(v) Failure in taking magnitude and timing of cash inflows: It fails to consider the pattern of cash inflows i.e. the magnitude and timing of cash inflows.

2. Accounting or Average Rate of Return (ARR)

This technique uses the accounting information revealed by the financial statements to measure the profitability of an investment proposal. It can be determined by dividing the average income after taxes by the average investment. According to Soloman, Accounting Rate of Return can be calculated as the ratio, of average net income to the initial investment. On the basis of this method, the company can select all those projects whose ARR is higher than the minimum rate established by the company. It can reject the projects with an ARR lower than the expected rate of return. This method also helps the management to rank the proposal on the basis of ARR.

Accounting Rate of Return (ARR) = Average Net Income/ Original Investment

OR

Accounting Rate of Return (ARR) = Average Net Income/ Average Investment

Acceptance Rule: The project which gives the highest rate of return over the minimum required rate of return is acceptable Merits:

The following are the **merits** of ARR method:

(i) It is very simple to understand and calculate;
(ii) It can be readily computed with the help of the available accounting data;
(iii) It uses the entire stream of earnings to calculate the ARR.

Demerits: This method has the following demerits:

(i) It is not based on cash flows generated by a project;
(ii) This method does not consider the objective of wealth maximization;
(iii) It ignore the length of the projects useful life;
(iv) If does not take into account the fact that the profile can be re-invested; and
(v) It ignores the time value of money.

3. Net Present Value (NPV)

The net present value method is a classic method of evaluating the investment proposals. It is one of the methods of discounted cash flow techniques, which recognizes the importance of time value of money. It correctly postulates that cash flows arising at time periods differ in value and are comparable only with their equivalents i.e. present values. It is a method of calculating the present value of cash flows (inflows and outflows) of an investment proposal using the cost of capital as an appropriate discounting rate. The net present value will be arrived at by subtracting the present value of cash outflows from the present value of cash inflows. According to Ezra Soloman, "it is a present value of the cast of the investment."

Steps to compute net present value:

(i) Estimation of future cash inflows
(ii) An appropriate rate of interest should be selected to discount the cash flows. Generally, this will be the "cost of capital" of the company, or required rate of return.
(iii) The present value of inflows and outflows of an investment proposal has to be computed by discounting them with an appropriate cost of capital.
(iv) The net value is the difference between the present value of cash inflows and the present value of cash outflows.

The formula for the net present value can be written as:

$$NPV = \frac{C1}{(1+K)1} + \frac{C2}{(1+K)2} + \frac{Cn}{(1+k)n}$$

Where

C = Annual Cash inflows,

Cn= Cash inflow in the year n

K = Cost of Capital

I = Initial Investment

Acceptance Rule:

If the NPV is positive or atleast equal to zero, the project can be accepted. If it is negative, the proposal can be rejected. Among the various alternatives, the project which gives the highest positive NPV should be selected.

NPV is positive = Cash inflows are generated at a rate higher than the minimum required by the firm.

NPV is zero = Cash inflows are generated at a rate equal to the minimum required.

NPV is negative = Cash inflows are generated at a rate lower than the minimum required by the firm.

The market value per share will increase if the project with positive NPV is selected. The accept/reject criterion under the NPV method can also be put as:

NPV>Zero Accept NPV

NPV<Zero Reject NPV

NPV=0 May accept or reject

Merits: The following are the merits of the net present value (NPV) methods:

(i) Consideration to total Cash Inflows: The NPV methods considers the total cash inflows of investment opportunities over the entire life-time of the projects unlike the payback period methods.

(ii) Recognition to the Time Value of Money: This methods explicitly recognizes the time value of money, which is investable for making meaningful financial decisions.

(iii) Changing Discount Rate: Due to change in the risk pattern of the investor different discount rates can be used.

(iv) Best decision criteria for Mutually Exclusive Projects: This Method is particularly useful for the selection of mutually exclusive projects. It serves as the best decision criteria for mutually exclusive choice proposals.

(v) Maximisation of the Shareholders Wealth: Finally, the NPV method is instrumental in achieving the objective of the maximization of the shareholders' wealth. This method is logically consistent with the company's objective of maximizing shareholders' wealth in terms of maximizing market value of shares, and theoretically correct for the selections of investment proposals.

Demerits: The following are the demerits of the net present value method:

(i) It is difficult to understand and use.
(ii) The NPV is calculated by using the cost of capital as a discount rate. But the concept of cost of capital itself is difficult to understand and determine.
(iii) It does not give solutions when the comparable projects are involved in different amounts of investment.
(iv) It does not give correct answer to a question when alternative projects of limited funds are available, with unequal lives.

4. Profitability Index (PI)

This method is also known as 'Benefit Cost Ratio'. According to Van Horne, the profitability Index of a project is "the ratio of the present value of future net cash inflows to the present value of cash outflows".

Profitability Index = Present value of cash lnflows / Present value of cash outflows

Decision criteria: If the Profitability Index is greater than or equal to one, the project should be accepted otherwise reject.

Merits:

The merits of this method are:

(i) It takes into account the time value of money
(ii) It helps to accept / reject investment proposal on the basis of value of the index.
(iii) It is useful to rank the proposals on the basis of the highest /lowest value of the index.
(iv) It takes into consideration the entire stream of cash flows generated during the life of the asset.

Demerits: However, this technique suffers from the following limitations:

(i) It is some what difficult to compute.
(ii) It is difficult to understand the analytical of the decision on the basis of profitability index.

5. Internal Rate of Return (IRR):

IRR method follows discounted cash flow technique which takes into account the time value of money. The internal rate of return is the interest rate which equates the present value of expected future cash inflows with the initial capital outlay. In other words, it is the rate at which NPV is equal zero. Whenever a project report is prepared, IRR is to be

worked out in order to ascertain the viability of the project. This is also an important guiding factor to financial institutions and investors.

Acceptance Rule

If the internal rate of return exceeds the required rate of return, then the project will be accepted. If the project's IRR is less than the required rate of return, it should be rejected. In case of ranking the proposals the technique of IRR is significantly used. The projects with highest rate of return will be ranked as first compared to the lowest rate of return projects.

Thus, the IRR acceptance rules are

Accept if IRR > k

Reject if IRR < k

May accept or reject if IRR = k

Where K is the cost of capital.

MERITS

The following are the merits of the IRR method:

(i) Consideration of Time of Money: It considers the time value of money.

(ii) Consideration of total Cash Flows: It taken into account the cash flows over the entire useful life of the asset.

(iii) Maximising of shareholders' wealth: It is in conformity with the firm's objective of maximizing owner welfare.

(iv) Provision for risk and uncertainty: This method automatically gives weight to money values which are nearer to the present period than those which are distant from it. Conversely, in case of other methods like 'Payback Period' and 'Accounting Rate of Return', all money units are given the same weight which is unrealistic. Thus the IRR is more realistic method of project valuation. This method improves the quality of estimates reducing the uncertainty to minimum.

(v) Elimination of pre-determined discount rate: Unlike the NPV method, the IRR method eliminates the use of the required rate of return which is usually a pre-determined rate of cost of capital for discounting the cash flow consistent with the cost of capital. Therefore, the IRR is more reliable measure of the profitability of the investment proposals.

DEMERITS :

The following are the demerits of the IRR:

(i) It is very difficult to understand and use
(ii) It involves a very complicated computational work
(iii) It may not give unique answer in all situations.
(iv) The assumption of re-investment of cash flows may not be possible in practice.
(v) In evaluating the mutually exclusive proposals, this method fails to select the most profitable project which is consistent with the objective of maximization of shareholders wealthy.

The result of this method may be inconsistent compare to NPV method, if the projects differ in their (a) expected lives (b) investment or (c) timing of cash inflows.

IRR vs. NPV: Comparison of both the techniques

(i) Both techniques use Discounted Cash Flow (DCF) method.
(ii) Both recognize the time value of money.
(iii) Both take into account the cash flows over the entire life of the project.
(iv) Both are consistent with the objective of maximizing the wealth of shareholders.
(v) Both are difficult to calculate.
(vi) Both techniques may often give contradictory result in the case of alternative proposals which are mutually exclusive.

6. Discounted Pay Back Method:

Under this method the discounted cash inflows are calculated and where the discounted cash flows are equal to original investment then the period which is required is called discounting pay back period. While calculating discounting cash inflows the firm’s cost of capital has been used.

Formula:

Discounted payback period (DPP) = Investment / Discounted Annual cash in flow

DECISION CRITERIA: Out of two projects, selection should be based on the period of discounting pay back period (Lesser pay back period should be preferred.

Module No. 4 Working Capital Management

The term Working Capital also called gross working capital refers to the firm's aggregate of Current Assets and current assets are these assets which can be convertible into cash within an accounting period, generally a year. Therefore, they are Cash or mere cash resources of a business concern. However, we can understand the meaning of Working Capital from the following:

a. "Working capital means the funds available for day-to-day operations of an enterprise. It also represents the excess of current assets over current liabilities including short-term loans". — Accounting Standards Board, The Institute of Chartered Accountants of India.

b. "Working capital is that portion of a firm's current assets which is financed by short term funds."— Gitman, L.J. From the above definitions, we can say that the working capital is the firm's current assets or the excess of current assets over current liabilities. However, the later meaning will be more useful in most of the times as in all cases we may not find excess of current assets over current liabilities.

Concepts of Working Capital

Working capital has two concepts:

i) Gross working capital and

ii) Net working capital.

Gross Working capital refers to the total of the current assets and not working capital refers to the excess of the current assets over current liabilities. Though both concepts are important for managing it, gross working capital is more helpful to the management in managing each individual current assets for day-to-day operations. But, in the long run, it is the net working capital that is useful for the purpose.

When we want to know the sources from which funds are obtained, it is not working capital that is more important and should be given greater emphasis. The definition given by the Accountants, U.S.A., will give clear view of working capital which is given below:

Working capital sometimes called net working capital, is represented by excess of current assets over current liabilities and identifies the relatively liquid portion of total enterprise capital which constitutes a margin of better for maturing obligations within the ordinary operation cycle of the business."

Each concern has its own limitations and constraints within which it has to decide whether it should give importance to gross or not working capital.

KINDS OF WORKING CAPITAL

There are two kinds of working capital, the distinction of which made keeping in view the nature of such funds in a business concern, which are as follows:

(a) Rigid, fixed, regular or permanent working capital; and

(b) Variable, seasonal, temporary or flexible working capital.

Every business concern has to maintain certain minimum amount of current assets at all times to carry on its activities efficiently and effectively. It is indispensable for any business concern to keep some material as stocks, some in the shape of work-in-progress and some in the form of finished goods. Similarly, it has to maintain certain amount of cash to meet its day-to-day requirements. Without such minimum amounts, it cannot sustain and carry on its activities. Therefore, some amount of working capital i.e., current assets is permanent in the business without any fluctuations like fixed assets and such amount is called Working Capital. To say precisely, Permanent Working Capital is the irreducible minimum amount of working capital necessary to carry on its activities without any interruptions. It is that minimum amount necessary to outlays its fixed assets effectively.

On the other hand, temporary working capital is that amount of current assets which is not permanent and fluctuating from time to time depending upon the company's requirements and it is generally financed out of short term funds, It may also high due to seasonal character of the industry as such it is also called seasonal working capital.

WORKING CAPITAL CYCLE

Working Capital Cycle or Operating Cycle are synonymous terms in the context of management of working capital. Any business concern, whether it is of financial nature, trade organisation or a manufacturing organisation needs certain time to net fruits of the efforts. That is, by investment of cash, producing or doing something for some time will fetch profit. But soon after the investment of cash, it cannot get that profit by way of cash again immediately. It takes time to do so. The time required to take from investment of cash in some assets and conversion of it again into cash termed as operating or working capital cycle. Here the cycle refers to the time period.

<u>Chart for Operating Cycle or Working Capital Cycle</u>

Debtors & Bills Receivables

Sales

Finished Products

Work -in – process

Raw Materials

Determinants of Working Capital

The size or magnitude and amount of working capital will not be uniform for all organisations. It differs from one type of organisation to the other type of organisation. Depending upon various conditions and environmental factors of each and every organisation. There are many factors that determine the size of working capital. However, there are some factors, which are common to the most of the business concerns.Such factors are enumerated below:

1. **Nature and size of the Business**: A company's working capital requirements depends on the activities it carried on and its size too. For instance, public utility organisation or service organisation where its activities are of mere service nature, does not require high amount of working capital, as it has no need of maintaining any stocks of inventories. In case of trading organisation the magnitude of working capital is high as it requires to maintain certain stocks of goods as also some credit to debtors. Further, if we go to manufacturing organisation the cycle period of working capital is high because the funds are to be invested in each and every type of inventory forms of raw-material, work-in-progress, finished goods as also debtors. Industrial units too require a large amount of working capital.

2. **Production Policies**: These policies will have a great significance in determining the size of the working capital. Where production policies are designed in such a way that uniform production is carried on throughout the accounting period, such concern requires a uniform and lesser amount of working capital. On the other hand, the concerns with production policies according to the needs of the customers will be peak at sometimes and require high amount of working capital. In seasonal industries too, where production policies are laid down tightly in the business season requires a high amount of working capital.

3**. Process of Manufacture**: If the manufacturing process of a particular industry is longer due to its complex nature, more working capital is required to finance that process, because, longer the period of manufacture, the larger the inventory tied up in the process and naturally requires a high amount of working capital.

4. **Growth and Expansion of Business**: A business concern at status requires a uniform amount of working capital as against the concerns which are growing and expanding. It is the tendency of any business organisation to grow further and further till its saturation point, if any. Such growth may be within the
existing units by increased activities. Similarly, business concerns will expand their organisation by establishing new units. In both the cases, the need for working capital requirement increases as the organisation increases.

5. **Fluctuations in the Trade Cycle**: Business activities vary according to the general fluctuations in the world. There are four stages in a trade cycle which affects the activities of any business concern.Accordingly, the requirements of working capital are bound to change. When conditions of boom prevail, it is the policy of any prudent management to build or pile up large stock of inventories of various forms to take the advantage of the lower prices. Such fluctuations causes a business concern to demand for more amount of working capital. The other phase of trade cycle i.e., depression i.e., low or absence of business activities cause business concerns to demand for more working capital. In condition of depression, the

products produced are not sold due to fall in demand, lack of purchasing power of the people. As a result of which entire production obtained was not sold in the market and high inventories are piled up. Therefore, there arises the need for heavy amount of working capital.

Thus, the two extreme stages of trade cycles make the business concerns to demand for more working capital. In the former case due to acts and policies of management and in the later case due to natural phenomena of trade cycle.

6. **Terms and conditions of Purchases and Sales**: A business concern which allows more credit to its customers and buys its supplies for cash requires more amount of working capital. On the other hand, business concerns which do not allow more credit period to its customers and seek better credit facilities for their supplies naturally require lesser amount of working capital.

7. **Dividend Policy**: A consistent dividend policy may affect the size of working capital. When some amount of working capital is financed out of the internal generation of funds such affect will be there. The relationship between dividend policy and working, capital is well established and very few companies declare dividend without giving due consideration to its effects on cash and their needs for cash.

If the dividend is to be declared in cash, such outflow reduces working capital and therefore, most of the business concerns declare dividend now-a-days in the form of bonus shares as such retain their cash. A shortage of working capital acts as powerful reason for reducing or skipping cash dividend.

8. **Price Level Changes**: The changes in prices make the functions of a finance manager difficult. The anticipations of future price level changes are necessary to avoid their affects on working capital of the firm. Generally, rising price level will require a company to demand for more amount of working capital, because the same level of current assets requires higher amount of working capital due to increased prices.

9. **Operating Efficiency**: The Operating efficiency of a firm relates to its optimum utilisation of resources available whether in any form of factor of production, say, capital, labour, material, machines etc; If a company is able to effectively operate its costs, its operating cycle is accelerated and requires relatively lessor amount of working capital. On the other hand, if a firm is not able to utilise its resources properly will have slow operating cycle and naturally requires higher amount of working capital.

10. **Percentage of Profits and Appropriation out of Profits**: The capacity of all the firms will not be same in generating their profits. It is natural that some firms enjoy a dominant and monopoly positions due to the quality of its products, reputations, goodwill etc. (for example Colgate Tooth Paste, Bata Chapels etc.,) and some companies will not have such position due to poor quality and other inherent hazards.

The company policy of retaining or distribution of profits will also affect the working capital. More appropriation out of profits than distribution of profit necessarily reduces the requirements of working capital.

11**. Other Factors**: Apart from the above general considerations, there may be some factors responsible for determination of working capital which are inherent to the type of business. Some of such factors may be as follows:

(a) General co-ordination and control of the activities in the organisation.

(b) Absence of specialisation of products and their advantages.

(c) Market facilities.

(d) Means of transport and communication system.

(e) Sector in which the firm works i.e.,private or public sector etc.

(f) Government policy as regard to:

i) Imports and Exports

ii) Tax considerations.

(g) Availability of labour and its organisation.

(h) Area in which it is situated such as backward, rural sub-urban, etc.,

Module No. 5 Financial Statement Analysis

Tools and Techniques of Financial Statement Analysis

1) Ratio Analysis

Ratio Analysis is a quantitative analysis technique that establishes the relationship between two or a combination of more than two items of financial statements. Both are Balance Sheet, Income Statement, and Cash Flow Statement. It is usually used to evaluate various aspects of a company's operating and financial performance. That financial performance, like its efficiency, liquidity, profitability, and solvency, is helpful for the management in making certain decisions.

2) Common-Size Statements

A common-size statement play an essential role in the tools and techniques of financial statement Analysis. Its direct impact on the company's financial statements displays all items as a percentage of a common base figure. It is known as the Common-Size Statements. It facilitates comparative analysis between two or more companies or between two or more periods of a company.

3) Comparative Statements

An organization's financial statements for different periods are called Comparative Financial Statements. And, to know about the comparative statement users need to use the tools or techniques of financial statement analysis. Various items of financial statements are presented in a comparative form which may be a table. It enables one to have a comparative view of multiple parameters for two or more periods at a glance. Comparative statement is important in the sense of financial tools and techniques.

4) Trend Analysis

Trend analysis is also an important part of the tools and techniques of financial statement analysis. It is based on the underlying premise that what has happened in the past indicates what will happen in the future. It may be defined as a mathematical technique that uses historical data to forecast future outcomes. Trend Analysis may be undertaken in respect of two organizations for the same period or an organization for a different period. A trend is a series of information from the financial statements analyzed to arrive at meaningful conclusions. To know about the trend of financial trend user need to use the tools of financial statement analysis.

5) Funds Flow Analysis/Statement

If we have no funds flow statement, we cannot use the tools and techniques of financial statement analysis. It is a statement that depicts the sources. Applications of funds for a specific period. Through the fund flow statement, research concerning the changes in the financial position of an organization from the beginning of a period to its end is undertaken.

6) Cash Flow Analysis/Statement

A cash flow statement is a financial statement, which shows how Cash and Cash Equivalents in a business are affected by the changes. And, it also describes how-to guides in various components of Balance Sheet and Profit and Loss Accounts. It summarizes the reasons behind the changes in the cash position of a business entity between the dates of two balance sheets.

These are the all major tools and techniques of financial statement analysis. All financial tools and techniques play an important role in the financial statement.

Ratio Analysis

Meaning :-

Ratio analysis is the process of determining and interpreting numerical relationships based on financial statements. A ratio is a statistical yard stick that provides a measure of the relationship between variables or figures.

This relationship can be expressed as percent (cost of goods sold as a percent of sales) or as a quotient (current assets as a certain number of times the current liabilities).

The financial analyst has to steer a careful course. His experience and objectives of analysis help him in determining which of the ratios are more meaningful in a given situation.

The persons interested in the analysis of financial statements can be grouped under three heads:

(i)Owners or investors (ii) Creditors (iii) Financial executives

Management is interested in evolving analytical tools that will measure costs, efficiency, liquidity and profitability with a view to making intelligent decisions.

Importance :-

(i) Commercial bankers and trade creditors and the institutional lenders are mostly concerned with the ability of a borrowing enterprise to meet its financial obligations timely.

(ii)Long-term creditors would be interested in the working capital position of the borrower as an indication of ability to pay interest and principle in case earnings decline. So, they are interested in the ratios of total debt to equity, net worth to total assets, long-term debt to equity, long term debt to net working capital, fixed assets to net worth, fixed assets to long term debt, fixed debt to capitalization etc. The number of times fixed charges are

covered by earnings before interested and taxes will be of particular interest for such long-term creditors.

(iii) Investors in shares are primarily interested in per share ratio like earnings per share, book value per share, market price per share, dividends per share, etc.

They would also be interested in knowing the capitalization rate (E/P Ratio = Earnings per share/ Price per share ratio) which is the reciprocal of P/E Ratio (Price/ Earnings ratio) and also the dividend yield, i.e.; D/P Ratio.

Advantages of Ratio Analysis

Ratio Analysis is (useful) relevant in assessing the performance of a firm in respect of the following purposes:

(i) To measure the liquidity position: The purpose of ratio analysis to measure the liquidity position of a firm. Whether the firm is able to meet its current obligations when they become due or not? A firm can be said to be liquid, if it has sufficient liquid funds to pay the interest charges on short-term debt within a year. The liquidity ratio are useful in credit analysis by banks and other financial institutions.

(ii) To know the solvency position: Ratio analysis is helpful for assessing the long-term financial liability of the firm. The long term solvency is measured through the leverage, and profitability ratios. These ratios reveal the strengths and weaknesses of a firm in respect of the solvency position. The leverage ratio indicates the proportion of various sources of finance in the firm's capital structure, particularly the ratio of debt and equity share capital.

(iii) Operating efficiency or turnover of the firm: The ratios are helpful in measuring the operating efficiency or the turnover of the firm. These ratios indicate the efficiency in utilizing the assets of the firm such as fixed assets turnover ratio, total resources turnover ratio etc.

(iv) To assess the profitability position of the firm: The ratios are useful to assess and measure the profitability of the firm in respect of sales and the investments. These ratios are concerned about the over –all profitability of the firm.

(v) Inter - firm and intra – firm comparison: Ratios are not only reflects the financial position of a firm, but also serves as a tool for remedial actions. This is made possible only due to inter-firm comparison. This would demonstrate the relative position of the firm vis-à-vis its competitor ` If there is any variance in the ratios either with the industry average or with, those of competitors, the firm has to identify the reasons and would take remedial measures.

(vi) Trend Analysis: The trend analysis of ratios indicates whether the financial position of a firm is improving or deteriorating over the yea ` The significance of a trend analysis of ratio lies in the fact that the analysis can know the direction of movement whether the movement is favorable or unfavorable.

Limitations of Ratio Analysis:

(i) It is always a challenging job to find an adequate standard. The conclusions drawn from the ratios can be no better than the standards against which they are compared.

(ii) It is difficult to evaluate the differences in the factors that affect the company's performance in a particular year as compared with that of another year and that of another company. The task becomes more difficult when comparison is made of one company with another when they are of substantially different size, age and diversified products.

(iii) While making comparisons of ratios, due allowance should be made for changes in price level. A change in price level can seriously affect the validity of comparisons of ratios computed for different time periods and particularly in case of ratios whose numerator and denominator are expressed in different units of currency.

(iv) Comparisons are also become difficult due to differences in definition. The terms like gross profit, operating profit, net profit etc. have not got precise definitions and there is considerable diversity in practice as to how they should be measured.

(v) A Balance Sheet may fail to reflect the average or typical situation, as it is prepared as of one moment of time. It ignores short-term fluctuations in assets and equities that may occur within the period covered by the two Balance Sheet dates.

(vi) Various differences are found among the accounting methods used by different companies which variously affect the comparability of financial statements. Methods of recording and valuing assets, write-offs, costs, expenses etc differ from company to company.

(vii) As ratios are simple to calculate and easy to understand, there is a tendency to over-employ them. While such statistical approach stimulates thinking, it is also likely to lead to the accumulation of a mass of data; if due care is not taken, that might obscure rather than clarify relationships.

Classification of Ratio:-

A. <u>Profitability Ratios</u>

These ratios give an indication of the efficiency with which the operations of business are carried on. The following are the important profitability ratios:

(i) **Overall Profitability Ratio:**

This is also called as Return on Investment (ROI) or Return on Capital Employed (ROCE) ratio. It indicates the percentage of return on the total capital employed in the business. It is calculated as follows:

ROI = Operating Profit/Capital Employed

The term 'Operating Profit' means "profit before interest and tax

while the term 'capital employed' refer to the sum-total of long-term funds employed in the business.

Significance. ROI measures the profit which a firm earns by investing a unit of capital. It is desirable to ascertain this periodically. The profit being the net result of all operations, ROI, expresses all efficiencies or inefficiencies of a business collectively. Thus, it is a dependable measure for judging the overall efficiency or inefficiency of the business.

(ii) **Price Earning Ratio (P/E Ratio):**

This ratio indicates the number of times the earning per share is covered by its market price. It is calculated as follows:

P/E Ratio = Market Price Per Equity Share Earning Per Share

*Significance.*P/E Ratio helps the investors in deciding whether to buy or not to buy the shares of a company at a particular price.

(iii) **Gross Profit Ratio (GPR):**

This ratio expresses the relationship between Gross Profit and Net Sales. It can be computed as follows:

GPR = Gross Profit Net Sales (i.e. Sales less returns) x 100

Significance. The ratio indicates the overall limit within which a business must manage its operating expenses. It also helps in ascertaining whether the average percentage of mark-up on the goods is maintained.

(iv) **Net Profit Ratio (NPR):**

The ratio indicates net margin earned on a sale of ` 100. It is calculated as follows:

NPR = Net Profit Net Sales x 100

*Significance.*The ratio helps in determining the efficiency with which the affairs of a business are being managed. Constant increase in the above ratio year after year is a definite indication of improving conditions of the business.

(v) **Operating Ratio:**

This ratio is a complementary of net profit ratio. In case the net profit ratio is 20%, the operating ratio will be 80%. It is calculated as follows:

Operating Ratio = Operating Cost Net Sales x 100

Operating cost includes cost of direct materials, direct labour, direct expenses and all overheads. Financial charges such as interest, provision for taxation, etc. are not to be included in operating cost.

Significance. The ratio is the test of the operational efficiency with which the business has carried on. The operating ratio should be low enough to leave a portion of sales for giving a fair return to the investors`

(vi) **Pay-out Ratio:**

The ratio indicates what proportion of earning per share has been used for paying dividend. It can be calculated as follows:

Pay-Out Ratio = Dividend per equity share Earning per equity shareTools for Financial Analysis and Planning .

Significance: The ratio is an indicator of the amount of earnings that have ploughed back in the business. The lower the pay-out ratio, the higher will be the amount of earnings ploughed back in the business. A lower pay-out ratio means a stronger financial position of the company

(vii) **Dividend Yield Ratio (DYR):**

The ratio is calculated by comparing the rate of dividend per share with its market value. It is calculated as follows:

DVR = Dividend Per Share \Market Price Per Share x 100

Significance: The ratio helps an intending investor in knowing the effective return he is going to get on his investment.

(viii) **Return on Shareholders funds or Return or Net Worth:**

This ratio expresses the net profit in terms of the equity shareholders funds. This ratio calculated as follows:

Net Worth = Net Profit after Interest & Tax Net Worth x 100 [Net Worth = Equity Capital + Reserves & Surplus]

Significance: This ratio is an important yardstick of performance for equity shareholders since it indicates the return or the funds employed by them.

B. Turnover Ratios / Activity Ratio

These ratios indicate the efficiency with which capital employed is rotated in the business. The various turnover ratios are as follows:

(i) **Over-all Turnover Ratio:**

The ratio indicates the number of times the capital employed has been rotated in the process of doing a business. The ratio is computed as follows:

Overall Turnover Ratio = Net Sales \Capital Employed

*Significance.*The overall profitability of a business depends on two factors, viz, (a) the profit margin, and (b) turnover.

The profit margin is disclosed by the net profit ratio while the turnover is indicated by the overall turnover ratio. A business with a lower profit margin can achieve a higher ROI if its turnover is high.

This is the reason for wholesalers earning a larger return on their investment even when they have a lower profit margin. A business should not, therefore, increase its profit margin to an extent that it results in reduced turn-over resulting in reduction of overall profit.

(ii) **Fixed Assets Turnover Ratio:**

The ratio indicates the extent to which the investment in fixed assets has contributed towards sales. The ratio can be calculated as follows:

Fixed Assets Turnover Ratio = Net Sales \Net fixed Assets

*Significance.*The comparison of fixed assets turnover ratio over a period of time indicates whether the investment in fixed assets has been judicious or not. Of course, investment in fixed assets does not push-up sales immediately but the trend of increasing sales should be visible.

(iii) **Debtors' Turnover Ratio:**

The ratio indicates the speed with which money is collected from the debtors`

It is computed as follows:

Debtors Turnover Ratio = Credit Sales\ Average Accounts Receivable

The term average account receivable includes trade debtors and bills receivable. Average accounts receivable are computed by taking the average receivables in the beginning and at the end of the accounting year. The higher the ratio, better it is.

Debtors' turnover ratio is used for computing the debt collection period. The formula for its computation is as follows:

Debt Collection Period = Months or days in a year Debtors turnover Ratio \Average debtor Credit Sales x 365

Significance: Debtors Turnover Ratio or Debt Collection Period Ratio measures the quality of debtors since it indicates the speed with which money is collected from the debtors `

A shorter collection period implies prompt payment by debtors `

A longer collection period implies too liberal and inefficient credit collection performance. The credit policy should neither be too liberal nor too restrictive. The former will result in more blockages of funds and bad debts while the latter will cause lower sales which will reduce profits.

(iv) **Creditors Turnover Ratio:**

This is similar to Debtors Turnover Ratio. It indicates the speed with which payments for credit purchases are made to credito` It can be computed as follows:

Creditors Turnover Period = Credit Purchases\Average Accounts Payable

The term 'accounts payable' include trade creditors and bills payable.

From the creditor's turnover, ratio, creditors payment period can be computed as follows:

Credit Period Enjoyed = Months or days in a year Creditors Turnover

Significance: The creditors turnover ratio and the creditors payment period indicate about the promptness or otherwise in making payment for credit purchases. A higher creditors turnover ratio or a lower creditors payment period signifies that the creditors are being paid promptly thus enhancing the credit-worthiness of the company. However, a very favourable ratio to this effect also shows that the business is not taking full advantage of credit facilities which can be allowed by the creditors.

(v) **Stock Turnover Ratio**

The ratio indicates whether the investment in inventory is efficiently used and whether it is within proper limits. It is calculated as follows:

Stock Turnover Ratio = Cost of Goods Sold during the year \Average Inventory

Average inventory is calculated by taking the average of inventory at the beginning and at the end of the accounting year.

Significance: The ratio signifies the liquidity of inventory. A high inventory turnover ratio indicates brisk sales and vice-versa. The ratio is therefore a measure to discover possible trouble in the form of over-stocking or over-valuation of inventory.

C. Financial Ratio

They are also termed as 'Solvency Ratios'. These ratios indicate about the financial position of the company. A company is considered to be financially sound if it is in a position to carry on its business smoothly and meet all its obligations both short-term and long-term without strain. The Financial or Solvency Ratios can therefore be classified into following categories:

(i) Long-term Solvency Ratios, which include fixed assets ratio, debt equity ratio and proprietary ratio;

(ii) Short-term Solvency Ratios, which include current ratio, liquidity ratio, super-quick ratio and defensive interval ratio & debt service coverage ratio.

Each of these ratios is now being discussed in detail in the following pages:

Long-term Solvency Ratios

(i) Fixed Assets Ratio:

The ratio indicates the extent to which fixed assets have been acquired by use of long-term funds. The ratio is expressed as follows:

Fixed Assets Ratio = Net Fixed Assets \Long - term Funds

The term 'Net Fixed Assets' means original cost of fixed assets less depreciation to date. The ratio should not be more than '1'. The ideal ratio is 0.67.

Significance: It is sound principle that fixed assets should be financed out of long-term funds. As a matter of fact a part of working capital termed as core-working capital, should also be financed by long-term funds. The ratio is therefore an indication of the fact whether the company has followed sound financial policy or not. In case the ratio is more than '1', it

shows that a part of working capital has also been used to acquire fixed assets, which may prove quite troublesome for the company.

(ii) **Debt-Equity Ratio:**

The ratio is determined to ascertain the proportion between the 'outsiders' 'funds and share-holders funds' in the capital structure of an enterprise. The term outsiders', funds is generally used to represent total long-term debt. The ratio can be computed as follows:

Debt - Equity Ratio = Total Long - term Debt \Shareholder's Funds

The ratio may also be calculated for ascertaining proportion of long-term debt in the total long-term funds. In such a case the ratio will be computed as follows:

= Total Long - term Debt \Total Long - term Funds

The ratio is considered to be ideal if the shareholders' funds are equal to total long-term debt. However, these days the ratio is also acceptable if the total long-term debt does not exceed twice of shareholders' funds.

Significance: The ratio is an indication of the soundness of the long-term financial policies pursued by the business enterprise. The excessive dependence on outsiders' funds may cause insolvency of the business. The ratio provides the margin of safety to the credito ` It tells the owners the extent to which they can gain by maintaining control with a limited investment.

(iii) Proprietary Ratio

It is a variant of Debt-Equity Ratio. It establishes relationship between the proprietors' or shareholders' funds and the total tangible assets. It may be expressed as follows:

Proprietary Ratio = Shareholder's Funds \Total Tangible Assets

Significance: The ratio focuses attention on the general financial strength of the business enterprise. The ratio is of particular importance to the creditors who can find out the proportion of shareholders funds in the total assets employed in the business. A high proprietary ratio will indicate a relatively little danger to the creditors or vice-versa in the event of forced reorganization or winding up of the company.

Short-term Solvency Ratios

(i) **Current Ratio**

The ratio is an indicator of the firm's commitment to meet its short-term liabilities. It is expressed as follows:

Current Ratio = Current Assets \Current Liabilities

An ideal current ratio is '2'. However, a ratio of 1.5 is also acceptable if the firm has adequate arrangements with its bankers to meet its short-term requirements of funds.

Significance: The ratio is an index of the concern's financial stability, since; it shows the extent to which the current assets exceed its current liabilities. A higher current ratio would

indicate inadequate employment of funds, while a poor current ratio is a danger signal to the management.

(ii) **Liquidity Ratio:**

The ratio is also termed as Acid Test Ratio or Quick Ratio. The ratio is ascertained by comparing the liquid assets i.e., current assets (excluding stock and prepaid expenses) to current liabilities. The ratio may be expressed as follows:

Liquidity Ratio = Liquid Assets \Current Liabilities

Some accountants prefer the term liquid liabilities for current liabilities. The term 'liquid liabilities' means liabilities payable within a short period. Bank overdraft and cash credit facilities (if they become permanent modes of financing) are excluded from current liabilities for this purpose. The ratio may be expressed as follows:

Liquidity Ratio = Liquid Assets Liquid Liabilities

The ideal ratio is '1'.

Significance: The ratio is an indicator of short-term solvency of the company. A comparison of the current ratio to quick ratio should also indicate the inventory hold-ups. For instance, if two units have the same current ratio but different liquidity ratios, it indicates over-stocking by the concern having low liquidity ratio as compared to the firm which has a higher liquidity ratio.

= *EBIT \EBT*

Module No.6 Sources of Finance

SOURCES OF FINANCE

Business firms need finance mainly for two purposes-

(a) To fund the long term decisions.

(b) To meet the Working Capital requirements .

The long term decisions of a firm involve setting up of the firm, expansion, diversification, modernisation and other similar capital expenditure decisions.

All these involve huge investment, the benefits of which will be usually seen only in the long term. In addition to this, they are also irreversible in nature.

Working Capital is required to support the smooth functioning of the normal business operations of a company.

Finance needs of a Business

(i) **Long term financial needs** – Required for a period exceeding 5-10 years. All fixed investments in plant, machinery, land, buildings are considered as long term financial needs.

(ii) **Medium term financial needs** – Required for a period between 1 to 5 years. Identification of medium term financial needs is arbitrary.

Sometimes, long term requirements for which long term funds cannot be arranged immediately may be financed from medium-term sources, thus generating medium-term financial needs.

(iii) **Short term financial needs** – It is related to investment in current assets such as stock, debtors, cash etc. Investment in these assets is called Working Capital. The requirement of Working Capital depends upon a number of factors and may differ from industry to industry. They are usually required for a period upto one year.

Financial Sources of a Business can be classified as follows:

(i) Long term sources e.g. shares, debentures, long term loan, etc.

(ii) Medium term sources, e.g. debentures, public deposits, bank loan/overdraft.

(iii) Short term sources e.g., trade credit, advance from commercial banks, advances from customers etc.

Long term source of Finance

1. Equity Share Capital

Equity Share Capital is a **basic source** of finance for any firm. It represents the ownership interest in the company.

Characteristics :-

Equity Share Capital are a direct consequence of its position in the company's control, income and assets.

Equity Share Capital does not have any maturity and there is no compulsion to pay dividend.

The Equity Share Capital provides funds, more or less, on a permanent basis.

It also works as a base for creating the debt and loan capacity of the firm.

The advantages and limitations of Equity Share Capital may be summarized as follows:

Advantages of Equity Share Financing:

(i) It is a permanent source of funds.

(ii) The new Equity Share Capital increases the corporate flexibility for the point of view of capital structure planning.

(iii) Equity Share Capital does not involve any mandatory payments to shareholders.

(iv) It may be possible to make further issue of share capital by using a right offering.

In general, selling right shares involves no change in the relationship between ownership and control.

Disadvantages of Equity Share Financing:

(i) Cost of capital is the highest of all sources.

(ii) Equity Share Capital has a burden of Corporate Dividend Tax on the company.

(iii) New issue of Equity Capital may reduce the EPS.

2. Preference Share Capital

The Preference Share Capital is also owner's capital but has a maturity period.

In India, the preference shares must be redeemed within a maximum period of 20 years from the date of issue. The rate of dividend payable on preference shares is also fixed.

As against the equity share capital, the preference shares have two references: (i) Preference with respect to payment of dividend, and (ii) Preference with reference to repayment of capital in case of liquidation of company.

However, the Preference Share Capital represents an ownership interest and not a liability of the company. The preference shareholders have the right to receive dividends in priority over the equity shareholders.

A dividend need not necessarily be paid on either type of shares. However, if the directors want to pay equity dividend, then the full dividend due on the preference shares must be paid first. Failure to meet commitment of preference dividend is not a ground for liquidation.

The advantages and disadvantages of the Preference Share Capital are as follows:

Advantages of Preference Share Financing:

(i) The preference shares carry limited voting right though they are a part of the capital.

(ii) The cost of capital of preference shares is less than that of equity shares.

(iii) The preference share financing may also provide a hedge against inflation.

(iv) A company does not face liquidation or other legal proceedings if it fails to pay the preference dividends.

Disadvantages of Preference Share Financing:

(i) The cost of capital of preference shares is higher than cost of debt.

(ii) Non-payment of dividend may adversely affect the value of the firm.

(iii) The compulsory redemption of preference shares after 20 years will entail a substantial cash outflow from the company.

3. Debentures/Bonds

A bond or a debenture is the basic debt instrument which may be issued by a borrowing company for a price which may be less than, equal to or more than the face value.

A debenture also carries a promise by the company to make interest payments to the debenture-holders of specified amount, at specified time and also to repay the principal amount at the end of a specified period.

Since the debt instruments are issued keeping in view the need and cash flow profile of the company as well as the investor, there have been a variety of debt instruments being issued by companies in practice.

In all these instruments, the basic feature of being in the nature of a loan is not dispensed with and, therefore, these instruments have some or the other common features as follows:

(i) Credit Instrument. A debenture-holder is a creditor of the company and is entitled to receive payments of interest and the principal and enjoys some other rights.

(ii) Interest Rate. In most of the cases, the debt securities promise a rate of interest payable periodically to the debt holders. The rate of interest is also denoted as coupon rate.

(iii) Collateral. Debt issue may or may not be secured and, therefore, debentures or other such securities may be called secured debentures or unsecured debentures.

(iv) Maturity Date. All debt instruments have a fixed maturity date, when these will be repaid or redeemed in the manner specified.

(v) Voting Rights. As the debt holders are creditors of the company, they do not have any voting right in normal situations.

(vi) Face Value. Every debt instrument has a face value as well as a maturity value.

(vii) Priority in Liquidation. In case of liquidation of the company, the claim of the debt holders is settled in priority over all shareholders and, generally, other unsecured creditors also.

In practice, different types of debentures have been issued. These are:

(a) On the basis of redemption:

(i) Redeemable debentures

(ii) Irredeemable debentures

(b) On the basis of security

(i) Secured debentures

(ii) Un-secured debentures

(c) On the basis of conversion

(i) Convertible debentures

(ii) Non-convertible debentures

(d) On the basis of registration

(i) Registered debentures (ii) Bearer debentures

4. Term Loans

This is also an important source of long-term financing. There are different financial institutions (National level as well as State level) which provide financial assistance for taking up projects. Term loan, as a source of long-term finance, is discussed in detail, at a later stage in this chapter.

Sometimes, the funds are required in foreign currency to make payment for acquisition and import of plants and equipments. In 1992, the Government of India permitted Indian Companies with good track record of 3 years or more to raise funds by issue of equity/debt capital in international market. There are different means of arranging long-term finance in foreign currency

5. Venture Capital

It has emerged as a new financial method of financing during the 20th century. Venture capital is the capital provided by firms of professionals who invest alongside management in young, rapidly growing or changing companies that have the potential for high growth. Venture capital is a form of equity financing especially designed for funding high risk and high reward projects. There is a common perception that venture capital is a means of financing high technology projects. However, venture capital is investment of long term finance made in:

1. Ventures promoted by technically or professionally qualified but unproven entrepreneurs, or
2. Ventures seeking to harness commercially unproven technology, or
3. High risk ventures.

The term 'venture capital' represents financial investment in a highly risky project with the objective of earning a high rate of return. While the concept of venture capital is very old the recent liberalisation policy of the government appears to have given a fillip to the venture capital movement in India. In the real sense, venture capital financing is one of the most recent entrants in the Indian capital market. There is a significant scope for venture capital companies in our country because of increasing emergence of technocrat entrepreneurs who lack capital to be risked. These venture capital companies provide the necessary risk capital to the entrepreneurs so as to meet the promoters' contribution as required by the financial institutions. In addition to providing capital, these VCFs (venture capital firms) take an active interest in guiding the assisted firms.

The main features of venture capital can be summarised as follows:

i. High Degrees of Risk Venture capital represents financial investment in a highly risky project with the objective of earning a high rate of return.
ii. Equity Participation Venture capital financing. is, invariably, an actual or potential equity participation wherein the objective of venture capitalist is to make capital gain by selling the shares once the firm becomes profitable.
iii. Long Term Investment Venture capital financing is a long term investment. It generally takes a long period to encash the investment in securities made by the venture capitalists.
iv. Participation in Management In addition to providing capital, venture capital funds take an active interest in the management of the assisted firms. Thus, the approach of venture capital firms is different from that of a traditional lender or banker. It is also different from that of a ordinary stock market investor who merely trades in the shares of a company without participating in their management. It has been rightly said, "venture capital combines the qualities of banker, stock market investor and entrepreneur in one".
v. Achieve Social Objectives It is different from the development capital provided by several central and state level government bodies in that the profit objective is the motive behind the financing. But venture capital projects generate employment, and balanced regional growth indirectly due to setting up of successful new business.
vi. Investment is liquid A venture capital is not subject to repayment on demand as with an overdraft or following a loan repayment schedule. The investment is realised only when the company is sold or achieves a stock market listing. It is lost when the company goes into liquidation.

6. Lease Financing

Leasing is an arrangement that provides a firm with the use and control over assets without buying and owning the same. It is a form of renting assets. Lease is a contract between the owner of asset (lessor) and the user of the asset called the lessee, where by the lessor gives the right to use the asset to the lease over an agreed period of time for a consideration called the lease rental. The contract is regulated by the terms and conditions of the agreement. The lessee pays the lease rent periodically to the lessor as regular fixed payments over a period of time.

Types of Leasing

There are two basic kinds of leases:

1. Operating or Service Lease
2. Financial Lease.

Operating or Service Lease

An Operating Lease is usually characterized by the following features:

(i) It is a short term lease. The lease period in such a contract is less than the useful life of asset.

(ii) The lease is usually cancellable at short- notice by the lessee.

(iii) As the period of an operating lease less than the useful life of the asset, it does not necessarily amortize the original cost of the asset. The lessor has to make further leases or sell the asset to recover his cost of investment and expected rate of return.

(iv) The lessee usually has the option of renewing the lease after the expiry of lease period.

(v) The lessor is generally responsible for maintenance, insurance and taxes of the asset.

(vi) As it is a short term cancellable lease, it implies higher risk to the lessor but higher lease rentals to the lessee.

Operating or service leasing is common to the equipments which require expert technical staff for maintenance and are exposed to technological developments, e.g. ; computers, vehicles, data processing equipments, communications systems, etc.

Operating lessors usually limit their activities to field and engage themselves in the purchase of large number of similar types of machines or equipment. They are able to offer attractive terms to their customers because savings in maintenance costs.

Financial Lease

A lease is classified as Financial Lease if it ensures the lessor for amortization of the entire cost of investment plus the expected return on capital outlay during the terms of the lease. Such a lease is usually for a longer period and non cancellable. Financial Leases are commonly used for leasing land, building, machinery and fixed equipments, etc.

A Financial Lease is usually characterized by the following features:

(i) The present value of the total lease rentals payable during the period of the lease exceeds or is equal substantially the whole of the fair value of the leased asset. It implies that within the lease period, the lessor recovers his investment in the asset along with an acceptable rate of return.

(ii) As compared to Operaring Lease, a Financial Lease is for a longer period of time.

(iii) It is usually non cancellable by the lessee prior to its expiration date.

(iv) The lessee is generally responsible for the maintenance, insurance and services of the asset. However, the terms of lease agreement, in some cases may require the lessor to maintain and service the asset. Such an arrangement is called “maintenance or gross lease”. But usually in an Operating Lease, it is lessee who has to pay for maintenance and service costs and such a lease is known as “net lease”.

(v) A Financial Lease usually provides the lessee an option of renewing the lease for further period at a normal rent.

7. Hire purchase

A hire purchase also known as an installment plan or the never-never, is an arrangement whereby a customer agrees to a contract to acquire an asset by paying an initial installment (e.g., 40% of the total) and repays the balance of the price of the asset plus interest over a period of time. Other analogous practices are described as closed-end leasing or rent to own.

The hire purchase agreement was developed in the United Kingdom in the 19th century to allow customers with a cash shortage to make an expensive purchase they otherwise would have to delay or forgo. For example, in cases where a buyer cannot afford to pay the asked price for an item of property as a lump sum but can afford to pay a percentage as a deposit, a hire-purchase contract allows the buyer to hire the goods for a monthly rent. When a sum equal to the original full price plus interest has been paid in equal installments, the buyer may then exercise an option to buy the goods at a predetermined price (usually a nominal sum) or return the goods to the owner.

If the buyer defaults in paying the installments, the owner may repossess the goods, a vendor protection not available with unsecured-consumer-credit systems. HP is frequently advantageous to consumers because it spreads the cost of expensive items over an extended time period. Business consumers may find the different balance sheet and taxation treatment of hire-purchased goods beneficial to their taxable income. The need for HP is reduced when consumers have collateral or other forms of credit readily available.

These contracts are most commonly used for items such as automobiles and high-value electrical goods where the purchasers are unable to pay for the goods directly.

To be valid, HP agreements must be in writing and signed by both parties. They must clearly lay out the following information in a print that all can read without effort:

1. a clear description of the goods
2. the cash price for the goods
3. the HP price (i.e., the total sum that must be paid to hire and then purchase the goods)
4. the deposit
5. the monthly installments (most states require that the applicable interest rate is disclosed and regulate the rates and charges that can be applied in HP transactions)
6. a reasonably comprehensive statement of the parties' rights (sometimes including the right to cancel the agreement during a "cooling-off" period)
7. The right of the hirer to terminate the contract when he feels like doing so with a valid reason.

The seller and the owner

If the seller has the resources and the legal right to sell the goods on credit (which usually depends on a licensing system in most countries), the seller and the owner will be the same person. But most sellers prefer to receive a cash payment immediately. To achieve this, the seller transfers ownership of the goods to a Finance Company, usually at a discounted price, and it is this company that hires and sells the goods to the buyer. This introduction of a third party complicates the transaction. Suppose that the seller makes false claims as to the quality and reliability of the goods that induce the buyer to "buy". In a conventional contract of sale, the seller will be liable to the buyer if these representations prove false. But in this instance, the seller who makes the representation is not the owner who sells the goods to the buyer only after all the installments have been paid. To combat this, some jurisdictions, including Ireland, make the seller and the finance house jointly and severally liable to answer for breaches of the purchase contract.

Implied warranties and conditions to protect the hirer

The extent to which buyers are protected varies from jurisdiction to jurisdiction, but the following are usually present:

1. the hirer will be allowed to enjoy quiet possession of the goods, i.e. no-one will interfere with the hirer's possession during the term of this contract
2. the owner will be able to pass title to, or ownership of, the goods when the contract requires it
3. that the goods are of merchantable quality and fit for their purpose, save that exclusion clauses may, to a greater or lesser extent, limit the Finance Company's liability
4. where the goods are let by reference to a description or to a sample, what is actually supplied must correspond with the description and the sample.

The hirer's rights

The hirer usually has the following rights:

1. To buy the goods at any time by giving notice to the owner and paying the balance of the HP price less a rebate
2. To return the goods to the owner
3. With the consent of the owner, to assign both the benefit and the burden of the contract to a third person. The owner cannot unreasonably refuse consent where the nominated third party has good credit rating.
4. Where the owner wrongfully repossesses the goods, either to recover the goods plus damages for loss of quiet possession or to damages representing the value of the goods lost.

Each jurisdiction has a different formula for calculating the amount of the rebate. Generally, returning the goods is subject to the payment of a penalty to reflect the owner's loss of profit but subject to a maximum specified in each jurisdiction's law to strike a balance between the

need for the buyer to minimize liability and the fact that the owner now has possession of an obsolescent asset of reduced value.

The hirer's obligations

The hirer usually has the following obligations:

1. to pay the hire installment
2. to take reasonable care of the goods (if the hirer damages the goods by using them in a non-standard way, he or she must continue to pay the installments and if appropriate, recompense the owner for any loss in asset value)
3. to inform the owner where the goods will be kept.
4. A hirer can sell the products if, and only if, he/she has purchased the goods finally or else not to any other third party.

The owner's rights

The owner usually has the right to terminate the agreement where the hirer defaults in paying the installments or breaches any of the other terms in the agreement. This entitles the owner:

1. to forfeit the deposit
2. to retain the installments already paid and recover the balance due
3. to repossess the goods (which may have to be by application to a Court depending on the nature of the goods and the percentage of the total price paid)
4. to claim damages for any loss suffered

Short Term Sources of Finance/ Working Capital Financing -

A project requires working capital margin to take up day-to-day operations. The working capital amount is divided into two parts –

(a) Permanent Working Capital, and

(b) Temporary Working Capital. The Permanent Working Capital should be financed from long-term sources and Temporary Working Capital should be financed from short term sources. Some of the short-term sources are:

(i) Trade Credit

When a firm buys goods from another, it may not be required to pay for these goods immediately. During this period, before the payment becomes due, the purchaser has a debt outstanding to the supplier. This debt is recorded in the buyer’s balance sheet as creditors; and the corresponding account for the supplier is that of debtors. The amount of such financing

depends on the volume of purchases and the payment timing. Small and new firms are usually more dependent on the trade credit, as they find it difficult to obtain funds from other sources. Trade credit may take form of open account or bills payable. **Loans from Banks for Short Term**
Bank Credit is one important source which supplies working capital to manufacturing or trading concern. Banks, particularly commercial banks and public sector banks, take keen interest in providing working capital to business units. Bank advances are always secured advances as the borrower has to offer a suitable security while asking for a bank loan. Banks get substantial income or profit by offering loans and advances to business enterprises. Banks usually offer credit facilities to business enterprises through the following methods which are extremely popular and used extensively in the business field.

i) Overdrafts

Under this arrangement, the bank allows its customer to overdraw his current account up to a specific sanctioned overdraft limit. Interest is charged on the amount actually overdrawn and not on the overdraft limit sanctioned. Overdraft facility is offered only to current account holders with credit standing and or against security.

ii) Cash Credits

It is a popular method of financial support by commercial banks. The bank opens a cash credit account in the name of the borrower and sanctions the cash credit limit. The borrower can withdraw money from this account as per his requirement till the amount is fully utilized. This facility is given against the security of single asset or group of assets or guarantees. Interest is charges based on the amount actually utilized.

(iii) Loans

Loan facility is one more facility which banks offer to customers. A separate loan account is opened while granting the loan. Interest at a high rate is charged on such loans. The businessman has to pay full interest on the loan amount sanctioned.

(iv) Discounting of Bills

Commercial banks provide short term finance to business enterprises by discounting their bills of exchange on hands or promissory notes. Bank charges commission for providing this discounting facility and this commission constitutes one important source of profit to banks. Business enterprises get cash against bills and thus provide liquidity to them for business purposes. In short, discounting of bills is one method of providing temporary advances by banks to business enterprises.

(v)Public Deposits

It refers to the deposits given or put up by the public or collected from public for a certain period usually 1 to 3 years. It is an important source of working capital for business enterprises. This has also become a very popular method of raising finance and channelizing the savings of public to the industrial sector. The current rate of interest is about 11 to 12% and is paid on a half yearly basis or on maturity.

In the early days i.e. before independence this method was very popular because of ill developed capital market and poor banking system. As the public trusted big industrialist, it was a major source of fiancé, e.g. textile industries of Mumbai and Ahmedabad. Of late, many other industries like engineering sugar, chemical, electronic, etc., are in this bracket.

The depositor is given a stamped deposit receipt for the amount received. It contains particulars like the period, rate of interest, amount received, time of repayment, etc. public deposits are subject to control and regulation of the RBI. They are

1.Maximum period of deposits is 36 months.

1. The total amount of public deposits should not exceed 35% of paid up capital and free reserves.
2. The companies are asked to deposit in scheduled banks or invest in specified securities, a sum not less than 10% of the amount of its deposits maturing during the year.
3. The company has to give detailed information about its financial position in a public advertisement before accepting such a deposit.

Advantages

1. The method is simple and easy. It requires limited formalities and technicalities.
2. The method is cheaper compared to the loans from commercial banks.
3. The companies obtain deposits without any charge on their assets, as they are unsecured.
4. It is flexible. It can be expanded and contracted as per the company needs.
5. Without losing the control, the company gets finance at a cheaper rate.
6. It is also suitable to depositors.

Limitations

1. This method is not dependable.
2. There are uncertain and unreliable risks like fair weather. A single remour about the financial difficulty is enough to create panic amongst the public.
3. Not suitable for a long period.
4. Various restrictions are imposed by the RBI
5. It prevents healthy growth of capital market.
6. It is suitable to new companies as investors are reluctant to invest in such companies.

Public Deposit as source of working capital fund for companies

In India, public deposits have been an important source of working capital funds for many companies. These are unsecured funds. Such loans are raised from various members of the public subject to the regulatory framework in this regard.

For companies, Section 58 of the Companies Act, 1956 and Companies (Acceptance of Deposits) Rules framed thereunder regulate the terms and conditions of acceptance of public deposits.

Important Conditions Are:

a) Deposits can not be accepted without the issue of an advertisement containing prescribed particulars.
b) Limits:Upto 10% of paid up capital and free reserve in the case of shareholders, and upto 25% of paid up capital and free reserves in the case of others. Thus, at present a company can accept maximum 35% of the paid up capital and free reserves as public deposits.
c) Interest: Subject to ceiling as may be fixed from time to time, usually 15% per annum with quarterly rests.

Annual Return of Deposits to be filed with the Registrar of Companies. Due to periodic fluctuations in availability of bank finance and also on account of cost differential, deposits are mobilized by companies to part finance their working capital requirements.

MBA II SEM IV

Subject :- Project Planning & Mgt of Financial Services

Chapter 4

FINANCIAL MANAGEMENT IN SICK UNITS

Definition:

A sick industrial unit may be defined as one when it fails to generate surplus as a continuous basis and depends on frequent infusion of external funds for its survival. According to the Reserve Bank of India, a sick industrial unit should be considered so if it has "incurred cash loss in the previous accounting year and is likely to continue to incur cash loss in the current accounting year and has an erosion on account of cumulative cash losses to the extent of 50 percent of those of its net worth". A unit is likely to continue to incur cash losses for the current year as well as the following year and which has imbalance in its financial structure such as current ratio of less than 1:1 and worsening debt-equity ratio.

According to ICICI "a sick industry is one whose financial viability is threatened by adverse factors present and continuing. The adverse factor might relate to management, market fiscal burden, labour relations or any other. When the impact of factors reaches a point where a company begins to incur cash losses leading to erosion of its funds, there is threat to its financial stability".

CAUSES OF SICKNESS

Sickness arises due to several reasons. These reasons may broadly classified into two categories namely... Sickness arises due to:

(a) Internal Factors *(b) External Factors.*

(a) Internal Factors: According to RBI study conducted to find the reasons for sickness in industries, it was noticed that mismanagement and Bad administration leads to industrial sickness to the extent 52%. Bad administration may be found in all the functional areas of management: The following chart exhibit the causes for industrial sickness internally:

Internal Causes for Industrial Sickness

Finance	Marketing	Production
Faulty Financial Planning Wrong Capital Structure Ineffective investments Decisions. - Absence of feed back, - Wrong cash management -Neglected accounts Receivable management - lack of efficient capital Budgeting, -Lack of cordial relationship with bankers, -Inadequate tax planning, unfavourable capital gearing, -over trading, Diversion of funds, -High rate of financial indiscipline.	Unscientific Product Mix, High dependence on few customers -Lack of diversification, -Lack of Vision, -Bad forecasting of Demand, -Inadequate sales promotion, poor after and pre-sale service, -Unscientific pricing policy, -Cut throat competition. Poor market research. -Ineffective functioning of marketing department. -Unscrupulous sales and purchases.	Wrong Plant Layouts. Belongingness to old Technology -poor quality control. -Excess inventory. -Wrong production policies. -over usage of Machines -Improper maintenance of equipment. -High cost of production.

Human Resource

- Poor quality leadership,
- Problems of Trade Unions,
- Unscientific allocation of work
- Poor labour welfare measures
- High Labour turnover
- More dependence on manpower,
- Weak employee and employer morale,
- Inefficient handling of labour problems,
- Lack of trained and efficient workers.
- improper Recruitment and Selection policies.

Management :-

Inefficient Management Policies
Improper Information Technology,
Manipulation in Administration,
Lack of Professionalisation in Management,
Centralised Administration,

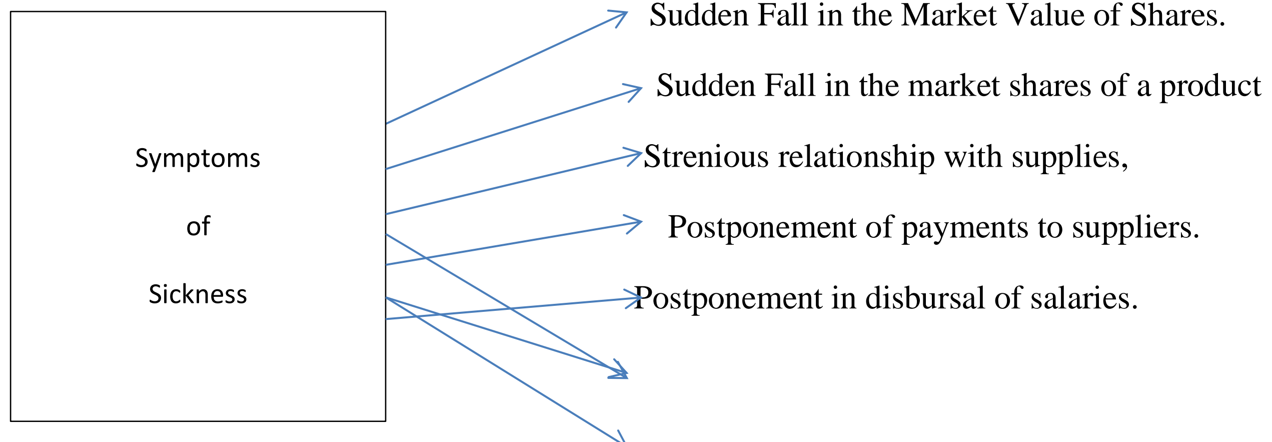
Ineffective Management Control Systems.
Unscientific Approach towards administration.

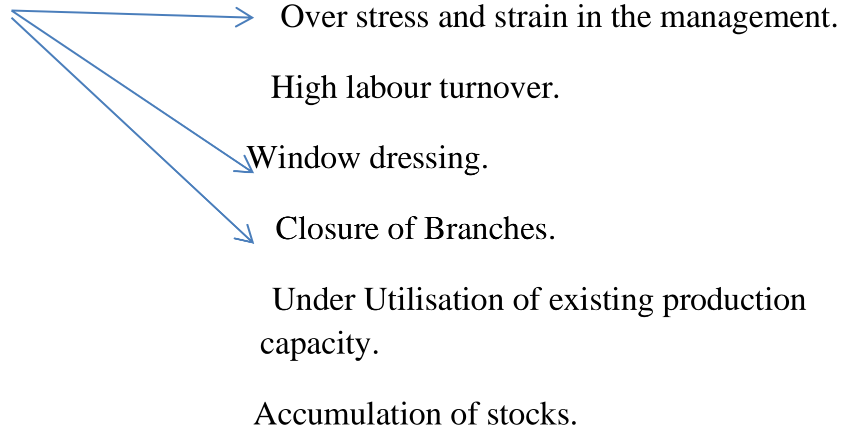
External Causes for Industrial Sickness

Infrastructure	**Financial**	**Market**	**Government**
-Problem of Transportation, -Problem of Power -Problem of Water, Problem of Communication.	Non availability Of external funds .. - High cost of funds, - SEBI and - RBI policies, - Devaluation of Rupee	-Threats from MNCs - Market saturation, -technological Revolution, -Sudden decline of Government orders, -import and Export policies, Change in tastes and fashions,	-Taxation policies –Exercise policies -Export and import duties, -Reservation policies -Change of Gov. and its policies -Imposition Gov. control -fiscal deficits.

Others
Flood, famines,
Earthquakes,
Shortage of Raw Materials,
International Political crises
Strikes and Lockouts,
Social and Ethnic problems.
Industrial recession.

***Symptoms of*Sickness :-**Industrial sickness is experienced at different stages. It may arise in all the phases of Business cycle. The management can visualize the sickness in each stage. Proper diagnostic approach solves the problems ofindustrial sickness. For proper care and curable steps certain symptoms of sicknessis presented below.





Revival Plan : -

When an industrial unit identified as sick, a viability study is initiated to offer rehabilitation measures to over comes the sickness. Viability study will be conducted as all the functional areas of the management, viz., Production, Marketing, Purchase and General administration. The behaviour of the financial ratios and Trend analysis will be used to identify the extent of sickness the management of such units will have continuous discussion with the middle and bottom level management to know the reasons and the extent of sickness to the industries. The following chart explain the various aspects that are used in viability study. This helps the management to go for availing remedial measures.

Various Aspects of Viability study.			
Finance,	Production	Marketing	Personnel
Trend Analysis Ratio Analysis SWOT Analysis Liquidity Position Leverage ratios Turnover of Assets Cost Control measures Working Capital Management	Layout of Plant conditions of machines Supply of Raw materials, supervision of production Distance between RM finished goods Quality Control System	Market share competition Consumer behavior promotional strategies Distribution policies product positioning	Man power planning recruitment and selection policies leadership labour welfare measures.

General Aspects:- Raw Materials- Infrastructure-Environmental aspects RBI policies-Government Policies-International Policies-Competition from MNC.

REMEDIAL MEASURES

The Diagnostic and Viability Studies clearly indicates and guides the management to apply remedial measures to overcome the sickness. Following are some of the important remedial measures used to cure industrial sickness:

(1) The management of sick units must initiate discussion with unions and appraise the situations of sickness and seek their co-operation during the rehabilitation programme.
(2) The company should contact the creditors for their help and co-operation during the process of rehabilitation.
(3) The process of rehabilitation may be implemented by disinvestment and selling of units which are unviable and non profitable.
(4) The management may approach Financial Institution to seek rehabilitation packages offered according to norms of Central Government.
(5) Restructuring of capital and Reorganisation of the structure would be initiated to ease the problem of sickness.
(6) Redesigning the Production and Marketing strategies are to be done.
(7) Effective and Scientific management approach must be initiated to bring back normalcy in the business.
(8) Close monitoring of outflow of funds will bring down cost and increases the earning capacity of the industrial units.
(9) A change in management is very essential to rebuild the confidence in the minds of investors, and stockholders and customers.
(10) To increase the efficiency in production, modernisationprogramme can be adopted.

In addition to the above listed measures sick units may also avail the following

1. Can seek financial and fiscal package.
2. Can seek Management Package.
3. Rescheduling of Banks and Financial Institution loans.
4. Relief and Waiver of interest and loans,
5. Infusion of Promoter's funds,
6. Can avail assistance from Central and State Government for power, water and other supplies,
7. Can adopt new strategies namely 'Seek help', 'Start afresh Turn around . Go-careful Development based' and Quick revival strategies,
8. Can avail the facilities offered by Industrial Reconstruction Bank of India,
9. Can get the approval of BIFR for special concessions and incentives (Board for

industrial and financial reconstruction.)

10 Can also approach SICA for its assistance (Sick industrial companies act,1985)

Practical Approach to Finance Sick Units by a Banker

As the Banker's always deals with the public money they will to take a cautious steps in lending activities. It is more true in case of sick units. Hence bankers always are in a dilemma whether to finance a sick unit or not. However the following few points are to be kept in mind in financing a sick unit.

1) Banker has to carefully observe the sincerity of the promoter and concern shown by them in revival programmes.
2) A constant and effective monitoring of the unit's account and its comparison with other units in the industry must be made.
3) Bankers should insist the promoters to bring 25% margin money to fix the commitment to revival packages. These contribution should come only as a long term source, at least in the form of interest free unsecured loans, as it is easier to with draw a short term source, In order to satisfy in this respect, the bankers may even insist on a certificate from the Chartered Accountant confirming the quantum of unsecured loans brought in.
4) Banker can also think of sanction of adhoc limits to a unit in the stage of incipient sickness.

Chapter No. 5 Financial Services

Meaning

The term "financial services" in a broad sense mean "mobilizing and allocating saving". Thus, it includes all activities involved in the transformation of saving into investment.

Features of financial services :-

1.It is a customer-intensive industry. Identification of need and wants of customer is the first step. It will help the financial service firms to design the financial strategy, which gives due respect to costs, liquidity and maturity consideration.

2. Demand and supply must be properly balanced.

Characteristics of financial services.

1. It is a customer-intensive industry. Identification of need and wants of customer is the first step. It will help the financial service firms to design the financial strategy, which gives due respect to costs, liquidity and maturity consideration.

2. Financial services are intangible in nature. The institution providing the services should have a good image and confidence of the client. The have to focus on quality and innovativeness of their services, this will build credibility and gain the trust of clients.

3.Production and supply of financial services must be performed simultaneously. This demands a clear-cut organization and their clients.

4. Demand and supply must be properly balanced. This is because of the perishable nature of financial services.
5. Marking of financial people intensive. It is subject to variability of performance and quality of service. The personnel in financial services firms need to be selected, based on their suitability.
6. Financial services firm should always be proactive in visualizing in advance what the market wants, or reactive to the needs and wants of customers. They must always be changing to the tune of the market.

Classifications of financial services industry

The financial intermediaries in India can be traditionally classified into two:

1. Capital market intermediaries and
2. Money market intermediaries.

The capital market intermediaries consist of term lending institutions and investing institutions which mainly provide long term funds. On the other hand, money market consists of commercial banks, co-operative banks and other agencies which supply only short term funds. Hence, the term „financial services industry"includes all kinds of organizations which intermediate and facilitate financial transactions of both individuals and corporate customers.

Scope of financial services.

Financial services cover a wide range of activities. They can be broadly classified into two namely:

(i) Traditional activities

(ii) Modern activities

Traditional activities

Traditionally, the financial intermediaries have been rendering a wide range of services encompassing both capital and money market activities. They can be grouped under two heads viz;

1. **Fund based activities and**
2. **Non- fund based activities**

Fund based activities

The traditional services which come under fund based activities are the following:

(i) Underwriting of or investment in shares, debentures, bonds etc, of new issues (primary market activities)

(ii) Dealing in secondary market activities.

(iii) Participating in money market instruments like commercial papers, certificate of deposits, treasury bills, discounting of bills etc.

(iv) Involving in equipment leasing, hire purchase, venture capital. Seed capital etc.

(v) Dealing in foreign exchange market activities.

Non-fund based activities

Financial intermediaries provide services on the basis of non-fund activities also. This can also be called “fee based” activity. They expect more from financial service companies. Hence, a wide variety of service, are being provided under this head they including the following:
(i) Making arrangements for the placements of capital and debt instruments with investments institutions.

(ii) Arrangements of fund from financial institutions for the clients‟ project cost or his working capital requirements.

(iii) Assisting in the process of getting all government and other clearances.

Modern activities

Besides the above traditional services, the financial intermediaries render innumerable service in recent times. Most of them are in the nature of non-fund based activity. In view of the importance, these activities have been discussed in brief under the head „New financial

products and services". However, some of the modern services provided by them are given in brief hereunder:
(i) Rendering project advisory services right from the preparation of the project report till the raising of funds for starting the project with necessary government approval.

(ii) Planning for mergers and acquisitions and assisting for their smooth carry out.

(iii) Guiding corporate customers in capital restructuring.

(iv) Acting as trustees to the debenture-holders.

(v) Recommending suitable changes in the management structure and management style with a view to achieving better result.

Challenges facing the financial services sector

However, the financial service sector has to face many challenges in its attempt to fulfill the ever growing financial demands of the economy. Some of the important challenges are briefly reported hereunder:

1. Lack of qualified personnel

The financial services sector is fully geared to the task of financial creativity. However, this sector has to face many challenges. In fact, the dearth of qualified and trained personnel is an important impediment in its growth.

2. Lack of investor awareness

The introduction of new financial products and instruments will be of no use unless the investor is aware of the advantages and uses of the new and innovative products and instruments.

3. Lack of transparency

The whole financial system is undergoing a phenomenal change in accordance with the requirements of the national and global environments. It is high time that this sector gave up their orthodox attitude of keeping accounts in a highly secret manner. Hence, this sector should opt for better levels of transparency.

4. Lack of specialization

In the scene, each financial intermediary seems to deal in different financial service lines without specializing in one two areas. In other words, each intermediary is

acting as financial super market delivering so many financial products and dealing in different varieties of instrument.

5.Lack of recent dada

Most of the intermediaries do not spend more on research. It is very vital that one should build up proper date base on the basis of which one could embark upon financial

creativity. Moreover a proper date base would keep oneself abreast of the recent developments in other parts of the whole world and above all, it would enable the fund managers to take sound financial decisions.

Present position of the financial service sector in India.

1. Conservation to dynamism

At present, the financial system in India is in a process of rapid transformation, particularly after the introduction of reforms in the financial sector. The main objective of the financial sector reforms is to promote an efficient, competitive and diversified financial system in the country. This is essential to rise the allocate efficiency of available savings, increase the return on investment and thus to promote the accelerated growth of the economy as whole.

2.Emergence of Primary Equity Market

Now, we are also witnessing the emergence of many private sector financial services. The capital markets which were very sluggish have become a popular source of raising finance. The number of stock exchanges in the country has gone up from 9 in 1980 to 22 in 1994. The aggregate funds raised by the industries in the primary markets have gone from Rs. 5976 crore in 1991-92 to Rs. 32382 crore in 2006-07.

3.Concept of Credit Rating

There is every possibility of introducing Equity Grading. Hitherto, the investment decisions of the investors have been based on factors like name recognition of the company, operations of the Group, market sentiments, reputation of the promoters etc. Now, grading from an independent agency would help the investor in his portfolio management and thus, equity grading is going to play a significant role in investment decision-making.

4.Process of Globalisation

Again, the process of globalization has paved the way for the entry of innovative and sophisticated financial products into our country. Since the government is very keen in removing all obstacles that stand in the way of inflow of foreign capital, the potentiabilities for the introduction of innovative international financial products in India are very great.

5. Process of Liberalization

Realizing all these factors, the government of India has initiated many steps to reform the financial services industry. The government has already switched over to free pricing issues by the controller of capital issues. The interest rates have been deregulated. The private sector has been permitted to participate in banking and mutual funds and the public sector undertakings are being privatized.

Chapter No. 6 Housing Finance companies in india

Housing Finance

Introduction

Housing Investment is viewed both as consumption and investment. It is consumption because in buying a house the individual acquires an asset at higher cost, which he 'consumes' over time very much likes a consumer durable. It is an investment, because while he consumes the services having provided the investment appreciates in value, its replacement cost escalates. In this sense housing is considered as an investment. House is a basic human need, and as an intrinsic part of human settlement is closely linked with the process of overall socio-economic development. Though a house is essentially a place of dwelling, it also fulfils many important social needs of the households. Being a necessity, housing industry has been put under priority sector industries. Housing has several components. The usefulness of land depends on its location and area, the services, such as water sewerage, electricity and roads supplied to the plot and the transport available to that location. Land and the materials, capital and labour required for construction and access other than for housing and their co-ordination on the site are very essential. The components together determine the total cost of the dwelling and components may be adjusted depending on the cost per unit. Housing activity serve to fulfil many of the fundamental objectives of the planned development.

Origin and Growth of Housing Finance

Housing is the single largest investment of an individual where credit, legal and technical skills and infrastructure are required, apart from making available finance. Housing Finance Institutions fulfil the housing shortage in the country, and support the development of over 300 other industries. Housing Finance is growing despite economic slowdown. In the earlier days, Banks that were the sole financing agencies in the country were catering mainly to industry, trade and commerce. The 1980's saw a series of development, which has a positive effect on the housing finance sector. They are:

- The planning commission set up several task forces during 1979-84 to review strategies for housing development.

- In 1985, the RBI made many recommendations for liberalization in the housing finance system based on the report of Chakraborthy Committee.
- In 1987, HFC's amended the Insurance Act of India to allow the Life Insurance Corporation (LIC) and the General Insurance Corporation (GIC) to enter the housing finance business.
- In 1988, the National Housing Bank was set up as a subsidiary of the RBI to act as an apex regulatory and promotional agency.

In 1989, the RBI allowed Commercial banks to issue large loans for housing without imposing rigid restrictions on interest rate or loan quantity ceiling. National Housing Bank (NHB) was set up in July 1988 with the equity support from the RBI and is intended to act as the apex institution for coordinating and developing the housing finance schemes. Later, the UTI set up in 1989, a Housing Construction Investment fund for direct investment in construction projects and real estate development. The entry of LIC and GIC and many banks like SBI and Canara Bank through their subsidiaries has been started to be another landmark in the promotion of housing industry.

The setting up of National Housing Bank as a fully owned subsidiary of the RBI, and as an apex institution was the culmination of the fulfilment of a long overdue need of the housing finance industry in India. The system has also been characterized by the emergence of several specialized financial institutions, which have considerably strengthened the organization of the housing finance system in the country.

In 1990's the pace set in the earlier decades was carried forward. Many HFCs were set up under the directions of the NHB. The process of liberalization covered the retail housing finance sector substantially. The most significant change was the enhancement of the amount set aside by the commercial banks for their lending to the housing sector from 1.5 per cent to 3 per cent (Union budget 1999-2000).

Traditionally in India, most people depend on their provident fund and gratuity amounts received after retirement for buying a home. However, with the emergence of housing finance as a major business in the country, an increasingly large number of people are going in for home loans. Socially too, India has changed, and there is no stigma attached today for borrowing funds.
Five-year plans have been emphasizing on the need for promoting housing finance schemes particularly for the poor and weaker sections of the society. The implementation of housing finance policies pre-supposes efficient institutional arrangements. Although there were many agencies that followed direct finance system till the mid-eighties, it has not been integrated with the main financial system of the country. The public sector banks were allowed to provide housing loans directly to retail clients only in 1998, following modifications in RBI guidelines. Earlier, public sector banks could provide housing loans only through special RBI schemes, NHB/ HUDCO bonds or through subsidiaries. The Government of India had recently made the development of the housing sector a priority, both from the demand and the supply side by fiscal concessions to the providers of the house and to the borrowers.

Historical background of Housing Finance Market in India

Stages	**Major Development**
Pre- National Housing Bank (NHB) *(Pre- 1970 – 1988)*	Pre- 1970 – Centralized direct credit 1971 – Establishment of HUDCO – Public sector, wholesale lending 1977 – Establishment of HDFC as1st private sector retail housing finance institution. 1984 – DHFL commences operations. 1988 –Formation of National Housing Bank as regulatory and supervisory body/refinancing agency
Post National Housing Bank (NHB) *(Early 1990's – till date)*	Early 1990's - Public sector banks or insurance companies promote HFC's. Late 1990's – Commercial banks get active in direct lending for housing finance. 2008 – Subprime crises, Indian Mortgage market shows resilience. 2009-2011 – Microfinance Institutions and foreign banks get active in housing finance market. 54 HFC's active in the market.

Different Institutions providing Housing Finance in India

Housing Finance Institutions	Regulator	Target Group
Banks including RRBs, State Cooperative Banks and Foreign banks	Reserve Bank of India	**All segments of society in both urban and rural areas** *(Public Sector Banks - SBI, Bank of Baroda, Canara Bank, Dena Bank etc. Private Sector Banks - HDFC Bank, ICICI Bank, Axis Bank etc. Foreign Banks - Standard Chartered, HSBC etc.)*
Housing Finance Companies	National Housing Bank	**Dedicated institutions which lend towards housing** *(DHFL, HDFC, Indiabulls Housing Finance, Reliance Housing Finance, Sundaram BNP Paribas, Religare Housing Development Corporation etc.)*
Insurance Companies	IRDA	**LIC Housing Finance, GIC Housing Finance etc.**
Micro Finance Institutions/NGOs /SHGs	Unregulated *(Act to be introduced for regulating the same)*	**For the poor and lower income segments** *(Micro Housing Finance Corporation, MAS rural housing and mortgage finance etc.)*
Development Financial Institutions,	Reserve Bank of India	**Refinancing Institutions catering to all segments of the society** *(HUDCO, NABARD, SIDBI)*
Co-operative sector Institutions	State Cooperative Acts	**Deep presence across the country, particularly in the rural areas** *(Apex Co-operative Housing Federations, State Co-operative Agriculture and Rural Development Banks etc.)*

Existing Scenario of Housing Finance

India's housing loan has been one of the star performers amidst an otherwise lacklustre economic environment. In fact, growth has averaged 30 per cent per annum for the last couple of years, and shows no signs of slowing down in the near future. There are several reasons for the growth of housing industry.

- Loans are offered normally up to 85 per cent of the cost of property.
- Attractive tax benefits on housing loans are provided by the government, especially in the last three years.
- Interest rates have fallen to a record at the lowest rate, making loans very affordable.
- Lack of suitable alternative investment avenues-especially with a poorly performing equity market.
- Real estate rates have remained stagnant or declined since 1995. Hence the inflation-adjusted cost of urban housing has fallen considerably over the last few years, making housing much more affordable.
- Deregulation of the sector has brought in many new players, including banks, which has helped widen the range and reach of products offered.
- Demographic and socio-economic changes, such as nuclear families, urbanization, greater mobility amongst young professionals and a mind-set that does not view debt as a bad thing.

Most of these growth drivers are likely to remain in place for a while. In addition, there are some more factors that will help sustain growth in housing finance.

- 50 per cent of Indians do not have "pucca" housing, so the demand for homes will take a long time to reach saturation levels.
- Only an estimate 20 per cent of homes in urban areas are financed through loans. Over the next decade, penetration is expected to reach close to 50 per cent.
- Other initiatives like the development of a market for "Securitisation" of loans will provide more funding options for housing finance companies.

However, the advent of competition (there are more than 380 players now) is bringing forth structural changes in the market. Greater reach and constant innovation from new players, especially banks are causing problems for some of the incumbents. Already small players like Gruh Finance and Home Trust Housing Finance have been gobbled up by HDFC. The cut-throat competition is leading to slimmer and an all-out battle for market share. Already there are reports that HDFC's market share has fallen below 50 per cent, while public sector banks (especially SBI) and ICICI have gained. Some of the smaller incumbents have fared much worse.

The Housing Sector in the country, which was passing through a recessionary phase, has witnessed dramatic changes over the last few years coupled with the much-needed recovery from the reversionary trends and gaining never-before buoyancy. In a lacklustre economic scenario, housing is among a few sectors to have defied the adverse trend. The Government

has been supporting the Housing Sector through a series of fiscal incentives in the budgets. Property prices have more or less stabilized. Interest rates have been showing a steadily declining trend. Purchasing power and borrowing power of the people have significantly gone up. These factors drove the people to invest in Housing Sector.

All these have pushed up the demand for housing as well as housing finance. Increasing demand for housing naturally has increased the demand for housing finance also and there is an exponential growth in housing finance market. This has prompted many new players to enter the housing finance market and become very aggressive apart from the already established ones. Due to the general slowdown in the economy, credit off-take in the industrial sector has been declining. Further, housing finance is considered to be a relatively low risk form of advance. These factors have prompted commercial banks also to become active in housing finance. These developments have fuelled in an unforeseen competition among the various players and triggered an interest rate war in the housing finance market. The interest rates in the housing finance industry have been witnessing a steadily decreasing trend in tune with the decreasing interest rate regime established in the economy. The players in the housing finance market, finding the competition getting tougher day by day, have been offering heavy concessions to the home finance seekers to woo them.

The ultimate beneficiary in the stiff competition prevailing in the housing finance market is the home finance seeker, as the various players are varying with one another to provide most value added and efficient

service to the customer. With various home loan options available for him, the market is virtually dominated by the customer.
A boost to the housing finance industry can push up the Indian economy scenario in a large scale. Housing has a tremendous tendency to create income and insist for resources, tools and services. Finances owed to housing arrive in the profile of profits.
In terms of the financial turnover, institutional sources account for only 10 per cent of the total finance in housing sector. Apart from this the informal sources of finance have significant contribution. Out of the finance for the formal housing sector disbursed mainly through different institutions (HUDCO, HDFC), very little part of the finance reaches the low-income group and the economically weaker sections. The disbursement mechanisms through financial institutions are not at all impressive because of its rigid lending terms. Most of the time the terms and conditions laid down is not easy enough for these groups of people to obtain a housing loan.

Housing Schemes by Government of India

For majority of household, housing has been primarily a self-help activity. It has made it necessary of the state government to launch housing schemes for weaker sections of the population. In India, the formulation and implementation of the housing programmes is the responsibility of the State Governments. The Central Government however, supplements to the effects of the State Governments. The government of India has launched various programmes, schemes and projects for urban development and improvement of housing. These programmes/schemes also envisages for providing financial assistance for construction of houses. Some of the important programmes are:

a) The Jawaharlal Nehru National Urban Renewal Mission (JnNURM) was launched by Ministry of Urban Development, Government of India at National level in December 2005. The aim is to encourage reforms and fast track planned development of identified Cities. Focus is to be on efficiency in urban infrastructure and service delivery mechanisms, community participation and accountability of housing agencies towards citizens. Basic services for the urban poor (BSUP) and The integrated housing and slum development programme (IHSDP) are the two sub-missions of *Jn*NURM.

b) The Indira Awaas Yojana (IAY) has been focused on the provision of cash subsidy scheme to rural BPL families for construction of dwelling units using their own design and technology. The funding under the Scheme is provided by the Centre and State in the ratio of 75:25 respectively.

c) Rajiv Awaas Yojana (RAY) aims to create a Mortgage Risk Guarantee Fund to enable provision of credit to Economically Weaker Sections (EWS) and LIG households and to encourage the States to adopt policies that will create a slum free India on ‘whole City approach’.

d) Valmiki Ambedkar Awaas Yojana (VAMBAY) is a centrally sponsored scheme by Ministry of Urban Development, Govt. of India for the benefit of Slum Dwellers. The objective is to provide shelter or upgrade the existing shelter for people living Below Poverty Line in Urban Slums, with a view to achieve the goal of '*Shelter for All'*.Spectrum July – December, 2014 ISSN – 2249-480

e) Interest Subsidy Scheme for Housing the Urban Poor (ISHUP) has sought to enhance affordability of the urban poor through the provision of an interest subsidy of 5% p.a. on a loan amount of up to 1 lakh for the economically weaker sections and lower income groups in the urban areas for acquisition/construction of houses.

General Problems of Housing Finance Sector in India

Housing finance is comparatively a new concept in the finance sector of India. It is developed rapidly during the last two decades due to the enthusiastic interest of Government of India to cut-short the housing problem of the country. Although, the present environment of finance sector of India seems to be suitable for the uninterrupted growth of housing finance market, but there are few general problems, which create obstacles either directly or indirectly. A brief study of these problems can be made with the help of following headings-

1. Government Policies for Housing Finance Sector

In India the housing shortage has considered as a significant problem by the Government since beginning of last two decade i.e. from 1991. The lower or middle-income group population of India is considered to be suffered by the prospects of owning a house due to lack of affordability of big amount in the present time. The housing finance sector of the country is suffering from considerable financial resources and due to the low paying capacity of most of the Indian population, it finds itself handicapped to provide the financial assistance for dwellings to these people. In the present circumstance, the Government of India is trying to play the role of facilitator by offering a number of housing schemes for different sections of the society, but due to poor administrative control and lack of strong will-power most of the schemes are squeezed only up to the primarily levels and are never attained its ultimate objectives. Besides, the role of Government of India to boost up housing finance sector is limited up to the formation of National Housing Board (NHB). Neither NHB has sufficient powers to regulate the housing finance sector of India nor sufficient funds to handle the problem of shortage of funds in this sector.

2. Role of Housing Finance Regulatory Authority

The word 'Regulation refers to the specific constraints in the natural growth of a sector and 'the Regulatory Body' is considered as a group of people who always indulge in search of the ways which could create checks and balances to hinder the unplanned and improper growth of related area. The regulatory body of housing finance sector of India is National Housing Bank, which came into existence in 1988. The origin of National Housing Bank (NHB) was basically as the apex institution of housing finance sector of the country to facilitate the development of a sound, healthy and sustainable housing finance system. One of the major lacunas of NHB's functioning is that it never took any direct step to protect the interest of housing loan customers and limits itself as a refinancing agency only. Hence, the housing finance sector is not taking any significant advantage of NHB and is keeping itself separated from it.

3. Development of Fundamental Infrastructure for Housing and Technological Innovations

Housing is primarily a urban phenomenon. It needs same basic infrastructural facilities like roads development, electricity and water supply, proper drainage system etc. to grow. Most of these facilities depend upon Government efforts and interest. Secondary, the technological innovations in the area of housing construction also support and promote housing market in the country through cut down the cost of construction up to a reasonable level. Both of these factors affect the housing finance market of the country directly. The basic infrastructural facilities for housing development are not available in most of the areas of the country. Although continuous efforts are made from the side of Indian Government but these are not enough to give a boost to housing industry. The higher income group of society is depending upon the private developers for infra-structural development of residential areas by paying more amounts. What about the middle or lower income group? They are forced to live in

unauthorized and undeveloped areas where housing finance facilities are generally not provided by housing finance companies.

4. Distribution of National Capital among Population

The distribution of national capital among the population of the country affects the housing finance sector directly. If the capital of the nation is distributed among the population in a rational manner, the most of the population of the country will be in a position to dream for their own houses and the chances of growth of the housing finance sector of the country will remain higher. Unfortunately in India, the distribution of capital among population is not justified even after all the efforts of Government of India.

5. Non-Availability of Funds

Financing in any area depends upon the availability of funds for the purpose. Housing finance is a long-term investment, which requires a great amount of funds. One of the main problems of housing finance sector of India is non-availability of long-term capital for investment. Traditionally, the funds for the housing sector have come from the individuals themselves by way of their own savings or from the financial institutions that are primarily engaged in the intermediation process of channelizing funds from the savers to the borrowers.

However, the funds so mobilized through the formal sector financial institutions remain much lower than what is required to tackle the problems of housing finance in India. In the absence of sufficient resources for long-term capital, the housing finance sector of India depends upon the Government of India's policies for its survival and the Government plays a significant role in making long-term funds resources available either directly or indirectly.

6. Higher Cost of Acquisition of Land

It need not to be mentioned that in present time the supply of land is perfectly inelastic for a country. The availability of land in adequate quantity at the right place and at an affordable price by the individual is more important for housing finance sector. The inelastic supply of suitable land results in a spurious increase in the cost of real estate. Besides, the very high stamp duty payable at the time of purchase of property is also cause an increase in the cost of land significantly.

7. Static Culture of the Society

Among Indian society, housing is a life-time dream of an individual and a newly employed person cannot even image for his own house due to his social and cultural backgrounds. Although this attitude of society is changing from last decade due to development of nuclear families tax rebate on housing loans. Secondly, the debt is considered as an evil in Indian society and the concept of 'Deficit Financing' is not appreciated by the masses. This type of thinking discourages a person to avail the facility of housing finance and ultimately hurts the housing finance market of country remarkably.

8. Slow Progress of Housing Co-Operative Movement in India

Housing activities can be promoted easily, when these are made by groups, because a group can handle all the technical as well as financial problems more comfortably in comparison to an individual. Housing financing agencies feel themselves more safe and comfortable to deal with a co-operative housing society.
In India, the National Co-operative Housing Federation of India (NCHF), established in 1969, is functioning under the administrative control of the Ministry of Urban Development and Poverty Alleviation. The primary objective of NCHF is to promote, develop, coordinate and guide the activities of housing co-operative societies in the country. It also strives to provide a common forum for dealing with technical, financial and other practical problems relating to housing cooperatives and to devise ways and means of solving them.

Problems Faced by the Housing Finance Companies

Housing finance is the most crucial element of the housing market. In the field of housing finance market of India private sector is playing much more active role in comparison to public sector. The Indian housing finance market is in its developing stage and is facing a number of problems. A brief study of major problems of housing finance companies of India can be made under following headings:

1. Mushroom Growth of Housing Finance Agencies

For last two decades, a big number of financial institutions, banks and co-operative societies are continuously entering in the housing finance market of India due to the following reasons-

- The Indian Government was promoting housing development activities and willing to provide all possible aid to the financers, developers and customers.
- Housing finance was recognized as almost 100% secured investment.

Although it shows the increasing importance of housing finance sector but creating a disturbed environment in the housing finance market. The main reason of this is that most of the new entrants of housing finance sector do not have required experience, sufficient infrastructure and adequate funds. These Housing Finance Agencies are not sure about their polices and are creating confusion among the mind of prospective home loan buyers by introducing an ambiguous housing loan plans. It is sure that after a certain period all the inefficient players will be vanished from the market, but till then they will prove a major problem for the entire sector.

2. Cut-throat Competition among Housing Finance Companies

Housing loan is considered, as the safe investment by Financial Institutions and every Housing Finance Company wants to capture more and more share of this segment. Hence a fierce competition is found in housing finance market. The competition affects positively to the housing finance sector up to a reasonable

level, but after that, when lenders have to provide loans below their cost of funds, it converts into a threat for the entire housing finance industry. As far as Indian housing financing industry is concerned, there is a fierce competition at present. All housing finance companies are using all possible means to attract home buyers. Alternative choices between floating and fixed rates are being offered. The housing loan amount has gone up to 110 percent of property value to meet out the cost of legal expenses. Most of the Housing Finance Agencies are exempting processing charges to survive in the market. This scenario of housing finance market is not good for the housing finance industry. Even Reserve Bank of India has recently voiced concern over competition in home loan financing and is thinking of making it mandatory for all Housing Finance Agencies to insist on a security margin.

3. Non-availability of Long-Term Fund

Housing finance is a long-term investment. It is not easy for a housing company to arrange a huge amount of funds for long-term investment. As a result most of the housing finance companies generate their funds from short-term savings and current accounts of individuals and deploy these funds is long-term housing loans. It creates an assets-liabilities mismatch. Hence it is essential to provide subsidized funding through the Government for their survival. In India, the financial condition of housing finance companies is not treated as sound as it should be. The Reserve Bank of India has warned these Housing Finance Agencies specially banks about the danger of borrowing short and lending more. For the arrangement of long-term funds, the Indian Housing Finance Agencies are considering over the following resources-

- Having raised a demand to allow pension and provident funds to invest in housing finance, because these funds are the supplies of long-term capital.
- To revise the rulings of National Housing Bank in a liberal way for refinancing of Housing Finance Agencies of India.
- To effort for developing a secondary mortgage market which is also known as 'Securitisation'. It will ensure recycling of funds, but it requires a proper legislative support by making desired amendments in present Mortgage Act.

No doubt the paucity of long-term funds is a major problem of Housing Finance Agencies and affects adversely to their future prospective. Indian housing finance market is passing through a developing stage and everyone is excited to see its growth rate, but to sustain this trend for a long-term period, the government of India and the players of housing finance market should take a very serious note for this forth coming problem.

4. Traditional Marketing Network

A housing loan is inherently different from any other retail loan. This is because a house is probably the life time investment made by an individual. Hence, when an individual plans to purchase a house, he not only requires financial assistance but also seeks technical consultancy and moral supports. It has been discussed earlier in this chapter that the concept of housing finance is not favoured by the Indian society in natural process. Under all these

circumstances, a customer's friendly marketing network is essential for the rapid growth of housing finance sector. Unfortunately, the banking and co-operative sector of housing finance sector are not trying to understand the importance of this fact and are going on with their traditional loaning marketing network. Although the private sector's housing financing agencies are serious about their marketing process, but these agencies do not have a wide branch network and are limited to metropolitan cities only. In the long run, the banking and co-operative sector have to accept the fact that loaning is a bare business which needs professional approach to grow.

5. Typical Process for Foreclosure Action

One of the prime problems of housing financing agencies of the country is the cumbersome and time taking process of enforcing a mortgage in the event of default in payment of loan instalment made by the borrowers. The mortgage and foreclosure laws of the country are not well defined and the Indian courts always have a lenient attitude in favour of borrower on sympathetic grounds. This is resulted in highly conservative lending practices and underwriting norms adopted by the agencies extending financial assistance for housing. Government of India is taking this problem of housing finance sector seriously and has been advised to National Housing Bank (NHB) to amend its own Act in such a way that default lending could place in special

category to be treated on priority bases for the purpose of recovery. In practice, such types of amendments of Acts take its own time in practical execution and till then housing financing agencies have to tackle this problem in their own ways.

6. Unclear Property Rights

Unclear property rights for rural and urban lands are also a major problem for housing finance sector of India. It is a complex and knotty problem and is survived because of a number of reasons i.e. a cumbersome land registration procedure, a high stamp duty, the existence of complex tenancy law, urban land ceiling Act etc. The unclear property titles severely reduce the housing finance market, because housing finance companies do not like to play game after financing such type of disputed properties. At the most these properties are used as collateral securities and limit housing financing to those property owners who have proper title. This problem can be minimized only when the Central and States Government of India take serious steps to amend the related legislative laws and procedures.

Problems faced by the Housing Finance Customers

The present time is considered as the best period for housing finance seekers, but it doesn't mean that they are not facing any problem in availing the housing finance. In fact they have to face a number of problems. A brief study of some major problems are as under:-

1. Cumbersome Nature of Housing Finance
A housing loan deal is entirely different from the other types of loans. It has been noticed that the housing loan customers do not just require finance, they also need ancillary services like loan counseling or legal advice to ensure that the title of property is clear or technical advice to ensure that the structural aspects and valuation of the property are in proper order. A number of offers and promises are announced by different housing finance companies. At this stage, a general housing loan customer finds himself helpless to reach at some fruitful conclusion and is governed by the manipulated advises and approaches. This leads him ultimately to unsatisfactory decisions. The housing finance companies should train their executives properly and instruct them to guide the probable housing loan seekers in true sense without considering the short-term interests of the company.

2. Lack of Reliable Information Regarding Housing Finance Sector
It is a surprising fact that in the present days everybody talks about the housing finance, but does not find him able to make comparative analysis among different housing financing agencies. Generally his discussion limits up to the interest rates of housing finance and monthly instalment only, he does not know about the technical details of the housing loan. Amazingly like other sectors of finance i.e. banking, insurance, stock market, there is no specific magazine of housing finance available in the market through which statistical data and facts of housing finance market could be revealed in a systematic way. The magazine of other financial sectors covers this topic only in its regular features. It's not only a big problem

for housing finance seekers, but also shows the disability of housing finance companies in launching customer's awareness programmes properly. This is not a good sign for the uninterrupted progress of housing finance sector.

3. Hidden Costs and Terms and Conditions of Housing Finance
As discussed in earlier point, a general housing loan customer does not has sufficient knowledge of housing loan and selects a housing finance company randomly. But after taking housing loans when a borrower encounters with the other hidden costs of housing loan such as processing fees and file charges, heavy penalty at any delay in payment of loan instalment, penalty on premature payment of loan etc. he finds himself embarrassed and helpless at that stage. Generally the friendly services of marketing executives of housing finance company remain available up to the sanction of housing loan only. No concept of aftersales- service is found in housing finance sector like the insurance sector. This scenario is neither good for housing finance customers not for the future of housing finance industry.

4. Lack of Flexibility in Payment of Loan Instalments
The business class customers of housing loan feel some problem with the strict term of payment of equal monthly instalment (EMI) of housing loan on due time, otherwise they have to pay abnormal and heavy late payment penalties. A business class person also lives in uncertainty and among the seasonal fluctuations. Due

to the reason he does not like to trap himself with a long time strict regular payment liability. Generally he wants relaxations to make the payments of EMI according to his convenience in housing finance companies at present. This is the prime reason that housing finance schemes are more popular in service class sector in comparison to businessmen.

5. Shortage of Professional Builders and Developers

In India, the culture of professional builders and developers is not very much popular in the small cities. In big cities like Meerut there was only one organized professional colonizer's firm was working till the 10 years back. Although, a number of builders of India level are now functioning for the development of city but they are much more interested in development of market complexes rather than residential colonies. The unauthorized and small builders have ruined the housing market of small cities by adopting several types of malpractices. The housing finance customers feel the shortage of genuine and professional builders in their areas, on which they can depend upon.

6. Tiresome and Technical Paper Formalities

The approval of a housing loan depends upon the proper compliance of the all tiresome and technical paper formalities such as income proof, to prove the genuineness of property purchased, approval of local development authority, mortgage documentation etc. Generally a housing loan customer becomes hopeless to fulfill all these paper formalities several times during the processing period. Moreover, in spite of all positive attitudes, the housing financing agencies remain strict on compliance of these formalities, are aware of the complexity of legal documentation system of the country and want to ensure themselves by all means. This is one of the prime reasons due to which a general person avoids to arrange housing finance through authorized housing finance agencies and explores his personal resources to meet out the requirement of housing finance.

7. Fluctuating Home Loan Interest Rates

The day to day changes in home loan interest rates also creates confusion in the mind of prospective home loan customers. Besides, the home loan interest rates offered by different Housing Finance Agencies vary from customer to customer and company to company. The customers always try to search the most attractive housing finance sector to avail but it proves a tiresome and depressive job. From the last decade home loan interest rates had been falling, but at the end of 2004 till to date these are going up which is making hurdles in the pace of development of the housing industry. Although the Housing Finance Companies offer the fixed or floating rates option for the customers, but it proves to hard to a general customers to opt a suitable option. If a customer finds his decision wrong, he has to bear the switching cost i.e. cost of converting fixed loan rates to floating loan rates or vice-versa. For the smooth growth of housing finance market the stability of interest rates is essential. It will not only ease the individual customers but also support the professional builders to sketch a long-term planning. It is expected that the interest rates for housing finance would be stabilize in the long run when the boom period of this sector will over.

8. Insufficient amount of Housing Finance

When an individual plans to purchase a house with the help of housing finance available in the market, he has to face the problem of inadequate financial support from the side of loaning agencies. First of all, most of commercial banks and co-operative societies have a margin clause in its loan schemes. Margin clause refers to the proportion of the loan amount to be brought in by the borrower from his personal resources. It means, the cost of the house purchased is not entirely financed by the banks or co-operative societies. These institutions generally finance 75 to 90 percent of the cost of the property (the registered value of the property). The balance amount is to be arranged by the borrower from his own resources either from his savings or personal borrowings from other sources. This usually acts as a major constraint for home loan borrowers, especially for the borrower who is seeking for a large amount of finance Further, the home loan buyers also require funds for stamps and registration charges, which remain approximately 15% of the cost of property. All these restrict the imaginations of an individual to become a pride house owner. In the end, it may be concluded that the major problems of housing finance sector of India are shortage of funds, inadequate mortgage and securitisation laws, unhealthy competition among housing finance agencies and traditional thinking of Indians etc. Housing finance is a market with infinite growth potential. The Government as well as the housing financing agencies should effort more to improve the creditability and functioning of housing finance system in India.

National Housing Bank (NHB)

The National Housing Bank (NHB), fully-owned subsiding of the Reserve Bank of India, was set up in 1988 to acceleration sing finance in India and to promote the Housing Finance companies (HFG) by providing support to them. It acts the Apex Institution and a regulator of the Housing Finance Industry.

Genesis of NHB

- The Sub-Group on Housing Finance for the Seventh Five Year Plan (1985-90) identified the non-availability of long-term finance to individual households on any significant scale as a major lacuna impeding progress of the housing sector and recommended the setting up of a national level institution.
- The Committee of Secretaries considered' the recommendation and set up the High Level Group under the Chairmanship of Dr. C. Rangarajan, the then Deputy Governor, RBI to examine the proposal and recommended the setting up of National Housing Bank as an autonomous housing finance institution. The recommendations of the High Level Group were accepted by the Government of India.
- The Hon'ble Prime Minister of India, while presenting the Union Budget for 1987-88 on February 28, 1987 announced the decision to establish the National Housing Bank (NHB) as an apex level institution for housing finance. Following that, the National Housing Bank Bill (91 of 1987) providing the legislative framework for the establishment of NHB was passed by Parliament in the winter session of 1987 and with the assent of the Hon'ble President of India on December 23, 1987, became an Act of Parliament.
- The National Housing Policy, 1988 envisaged the setting up of NHB as the Apex level institution for housing.
- In pursuance of the above, NHB was set up on July 9, 1988 under the National Housing Bank Act, 1987.
- NHB is wholly owned by Reserve Bank of India, which contributed the entire paid-up capital.
- The general superintendence, direction and management of the affairs and business of NHB vest, under the Act, in a Board of Directors.
- The Head Office of NHB is at New Delhi.

Preamble of NHB:

- The Preamble of the National Housing Bank Act, 1987 describes the basic functions of the NHB as –

"to operate as a principal agency to promote housing finance institutions both at local and regional levels and to provide financial and other support to such institutions and for matters connected therewith or incidental thereto.

NHB has been established to achieve, the following objectives:

1. To promote a sound, healthy, viable and cost effective housing finance system to cater to all segments of the population and to integrate the housing finance system with the overall financial system.
2. To promote a network of dedicated housing finance institutions to adequately serve various regions and different income groups.

3. To augment resources for the sector and channelize them for housing.
4. To make housing credit more affordable.
5. To regulate the activities of housing finance companies based on regulatory and supervisory authority derived under the Act.
6. To encourage augmentation of supply of buildable land and also building materials for housing and to upgrade the housing stock in the country.
7. To encourage public agencies to emerge as facilitators and suppliers of serviced land, for housing.

Objectives of NHB

National Housing Bank has been established for the obvious reason of dismal performance of the housing sector and poor institutional housing finance system in our country as at the end of 6th Plan period and for the avowed objective of facilitating fast development of Housing Finance Institutions and an accelerated development of Housing Sector

The NHB has been established to promote a sound, healthy, viable and cost effective housing finance system to cater to all segments of the population and to integrate the housing finance system with the overall financial system.

- NHB has also been assigned the responsibility of promoting a network of dedicated housing fiancé institutions to adequately serve various regions and different income groups.
- It is also responsible to augment resources for the sector and channelize them for housing.
- The NHB is expected to make housing credit more affordable and accessible to common man.
- The NHB has been established with the task of regulating the activities of housing finance companies based on regulatory and supervisory authority derived under the NHB Act, 1987.
- Yet another objective of the bank is to encourage augmentation of supply of buildable land and also building materials for housing and to upgrade the housing stock in the country.
- The bank has been assigned the responsibility to encourage public agencies to emerge as facilitators and suppliers of serviced land for housing.

Functions of NHB

Promoting, establishing, supporting/aiding in the promotion/ establishment / support of housing financing institutions (HFIs).

- Making of loans and advances or rendering any other form of financial assistance, whatsoever, for housing activities to HFIs, banks, state cooperative, agricultural and rural development banks or any other institution/class of institutions notified by the Government. It can subscribe or purchase stocks, shares, bonds, debentures and securities of every other description floated by housing finance companies with a view to enhance the financial resources of these institutions.
- NHB can also extend guarantee to the financial obligations of Housing Finance Institutions (HFIs) and underwrite the issue of stocks/shares/bonds/debentures/other

securities of HFIs. This activity is a part of its promotional effort so that the housing finance institutions do not suffer for want of funds.

 It can draw, accept, discount/ rediscount, buy/sell and deal in bills of exchange, promissory notes, bonds, debentures, hundies, coupons or other instruments of housing finance companies or instruments related to housing finance. The aim behind these activities is to develop a sound capital market for the financial instruments floated by the HFCs.

It can also deal in buying or selling, or otherwise dealing in loans & advances secured by mortgage/charge of immoveable property relating to banks or HFIs.
 It can also deal in creating trust(s) and transferring loans or advances together with or without securities there from to HFIs for a consideration. It can undertake setting up of mutual funds of undertaking housing finance activities. It can also participate in housing mortgage insurance.

 NHB is responsible for undertaking research and surveys on construction techniques and other studies relating to or connected with shelter/housing and human settlement. Organizing training program/seminars/symposia on matters relating to housing is another function of NHB.

 NHB is also responsible for formulating schemes for purpose of mobilization of resources and extension of credit for housing sector in India.

 The Bank is also responsible for formulating schemes for the economically weaker sections of society, which may be subsidized by the Government or any other source. The Bank has a mandate to provide guidelines to HFIs to ensure their growth on sound lines.

 Since it is an apex organization in India in the field of housing finance, it is also responsible to act as agent of the Central/State Government/the RBI or of any ' authority as may be authorized by the RBI. Further it can do any other kind of business which the Government may, on the recommendations of the RBI, authorize. It represents India at international bodies and plate forums on the matters of housing finance and housing sector.

The NHB has been authorized to borrow and accept deposits to augment its resources so that it can lend to HFCs on a large scale. It borrows from the capital market and accepts deposits from the public both for short period as well as long period.

Activities of NHB

A. Promotion and Development Function

The institution had been set up when regional and local level housing finance institution were nearly absent and the banking sector was not willing to do housing finance on any significant level. As a result the sector was grossly capital deficient and the housing shortage in the country was growing at an alarming level. There was a need to set up local and regional level financial institutions for supply of housing credit. The households above the average income could be well served by an institution which raises resources through the open market and deliver credit with minimum necessary prudential regulations by the regulator. For households below the poverty line, the institutional credit will have to take into account the employment and poverty alleviation programmes having an element of subsidy. It is the middle group which constitutes nearly half of the total number of households in the country that needs to be taken care of. NHB is encouraging the financial institutions to lend to this segment through its refinance programmes. There has been a sustained effort at creating and supporting new set of specialised institutions to serve as dedicated centres for housing credit. NHB also participates in the equity of HFCs. NHB is of the opinion that intervention through institutional credit can be made more effective by adoption of different approaches to cater to the needs of different income groups. With the setting up of NHB in 1988, there have been sustained efforts at creating and supporting new set of specialized institutions to serve as dedicated centres for housing credit. NHB's role in this regard can be measured from the fact that from about 90 companies that were acting as dedicated housing finance institutions when NHB came into existence, there are now more than 53 such specialized institutions1 spread over the vast span of the country. NHB has been participating in the equity of the housing finance companies which are financing for the rural and low cost housing for the weaker section of the society. NHB has been imparting training to the banking sector and housing finance companies in particular for developing housing finance skill. It has so far organized more than 200 such trainings for more than 2000 officials.

B. Regulatory and Supervisory Function

The second most important function of NHB is the regulatory role assigned to it. This role assumes more importance as the housing finance system in India enters a secondary phase of development in terms of integration with the debt and capital markets. The case for regulation also emanates from the need for credible and stable housing finance system in the country. Without in any manner against the free market approach, NHB has attempted to put in place an effective system of responsive regulation. The housing finance system as such is still developing in the country and thus there needs to be a great amount of stability in terms of resource development, policy development and institution building. NHB has come up with guidelines for recognising Housing Finance companies (HFCs) for its financial assistance, guidelines for financial assistance. Besides it has also issued guidelines for

prudential norms for income recognition, asset classification etc. NHB also regulate deposits taking activity of the housing finance companies. In terms of section 29A of the National Housing Bank Act, 1987 it is necessary for each of the housing finance companies to obtain registration certificate from NHB before commencement of business of housing finance.

C. Financial Function

The third important role of NHB is to provide financial assistance to the various banks and housing finance institutions. As an apex refinance institution, the principal focus is to generate large scale involvement of primary lending institutions falling in various categories to serve as dedicated outlets for assistance to the housing sector. It supports housing finance sector by extending refinance to different lenders in respect of eligible housing loans extended by them to individual beneficiaries and for project loans extended by them to various implementing agencies. It also supports by lending directly in respect of projects undertaken by public housing agencies for housing construction and development of housing related infrastructure. Other institutions include scheduled banks (both commercial and cooperative), regional rural banks, specialized housing finance

institutions, Agriculture and Rural Development Banks and the Apex co-operative housing finance societies. It helps by guaranteeing the repayment of principal and payment of interest on bonds issued by housing finance companies. Real Estate and Stock Market fluctuations also are monitored. Finally it acts as a special purpose vehicle for securitising the housing loan receivable. So the major things under the financial role that NHB plays are refinance operations, project finance, guarantee and securitisation.

Reverse Mortgages

Reverse Mortgage is a product that will allow senior citizens to avail themselves of funds by mortgaging their residential property. The scheme is similar to a housing loan except that in a home loan the borrower pays a fixed EMI to the lending institution, while in a reverse mortgage the lender pays the borrower a fixed sum of money on a monthly (or quarterly) basis, the total payment being equal to the value of the property and the interest on the loaned amount. After the death of the borrower and the borrower's spouse, the housing company sells the property to recover the amount paid out along with interest at a rate similar to interest on housing loans.
Therefore, A Reverse Mortgage is a form of financial arrangement between an ‘Equity rich-Cash Poor’ Borrower and a Reverse Mortgage Lender. This arrangement allows elderly persons to convert their substantial house equities into loans in the form of cash advances requiring no repayment until a future time. At the same time they will allow the borrowers to remain in their houses until their death, sale of the house property or until they move out permanently. Interest accrues on these loans but no repayment of loan and loan interest is required during as long as any of the events mentioned above do not occur. As the borrower receives payments, the amount of the debt secured by the Reverse Mortgage rises over time. This process of converting house equity into spendable cash while the house owner is still living in the house is called ‘Home Equity Conversion’ or simply Reverse Mortgage. Lenders offer Reverse Mortgages because there is potentially large and growing market as the number of elder house owners is increasing in every country.

Features of Reverse Mortgages

The contract converts the capital value of a home into an annuity over the homeowner's lifetime. The loan is not an income so is tax free. The amount loaned would depend on the estimated value of the property (minus the interest cost), its condition and life. The borrower is given upto 3 business days to exercise his “right of recession” i.e. the right to cancel his transaction. If the loan amount has been disbursed, the entire loan amount will need to be repaid by the Senior Citizen borrower within this three day period. However, interest for the period may be waived at the discretion of the lender. The legal heirs have the option to re-possess the property after the demise of both the borrower and the spouse on clearance of all debts. The borrower or the heir can even prepay the loan amount, but they would have to bear an additional cost. If the borrower outlives the tenure of the loan (normally 15 years), he will not be asked to move out of the house. Although payments made to him will stop after 15 years, the interest will keep accumulating till the accounts are finally settled. It has been

suggested that a certain portion from the payments be parked in bank fixed deposits to fund the years that one may outlive the loan.
The loan amount is sanctioned based on the:
Age of the borrower: On an average the age of the borrower and the spouse should be 60. There is no upper age limit to avail the loan; but the higher the age the easier the loan. The table given hereunder may serve as an indicative guide for determining loan eligibility

Age	**Loan as proportion of Assessed Value of Property**
60 – 65	40%
66 – 70	50%
71 – 75	55%
Above 75	60%

Average value of the property: The aggregate value depends on the capital value of the home. The property is revalued by an in-house property consultant every 5 years, adjusting the payments accordingly (thus it is inflation adjusted). The annuity may be designed to rise, fall or stay steady over the lifetime. However, currently on the basis of present actuarial analysis, the loan to value ratio is fixed at 40-60 per cent of the value of the property based on the age. Some banks are however designing reverse mortgage products with a higher loan to value ratio -- as much as 90% in some cases.

Rate of interest on the loan: The interest rate at which the loan will be given will typically be marginally higher than the prevailing interest rates as the lending company will receive its money when the borrower dies. . The banks have so far not indicated which interest rates they will use to determine the EMI -- however, we can safely assume that it will not exceed the interest rates used for loan against property -- which is currently in the region of 10-12%

Loan Amount: Maximum Loan Amount to borrowers depends on the house value, borrower's age, cost of the loan and the payment plan selected by the borrower. Typically, the loan amount or the Principal Limit is the maximum lump-sum payment a borrower can receive or the net present value of monthly payments or Line of Credit. The loan amount is restricted to percentage of the property value. In Roll up type of Reverse Mortgages offered in UK, higher amounts are granted in return for a higher interest loan. In some other cases, when the borrower get fewer amounts initially, further amounts will be made available depending on the property value. However, there are some restrictions which limit the time at which the borrower can apply for further advance.

Payment Options: Once the loan amount is determined, it will be disbursed according to the payment option chosen. The borrower will have the typical options like receiving a lump sum amount or a series of monthly payments or access line-of-credit.

Repayment: No repayment is required on Reverse Mortgages as long as the borrower lives in the house as a principal residence. The full loan balance becomes due and payable when the borrower sells the house or permanently moves away or when the borrower dies. When the loan is payable due to death of the borrower, borrower's heirs can repay the outstanding loan and take title to the property or lender can sell the property and pay off the loan. If the property value is more than the outstanding loan balance, the difference is paid to the heirs.

Debt Limit: The debt on a Reverse Mortgage equals all the loan advances received including any advances used to finance the loan costs or pay off prior debt, plus all the interest that is added to loan balance. Even if the loan balance grows to be greater than the home's future value, the borrower's debt is limited by the value of the home. This feature is called the "Non-Recourse" or "No Negative Equity Guarantee" and it protects the borrower, his estate and heirs from "deficiency judgments," that is, from being required to pay back more than the home's value.

Loan Costs: Loan costs typically include an origination fee, appraisal fee, mortgage insurance fee, and other closing costs. There are usually caps on these upfront costs, which may be financed as part of the Reverse Mortgage.

Mandatory Occupation: The borrower must occupy the property. The borrower's income and credit worthiness are not of concern because payments are made from the lender to the borrower.

House ownership: Typically, lender does not own the house. The borrowers retain the title to the house and are responsible for taxes, insurance and upkeep. In the Home reversions schemes sold in UK, the lenders buy a share of the borrower property, so that there is transfer in the ownership to the lender.

Other features: Prior to closing, the house is appraised to determine its value and to make sure that it meets minimum property standards. In cases where repairs are needed, the cost of these repairs may be financed as part of the loan.

Types of Reverse Mortgages Type	**Description**
Term	Borrower receives monthly payments for a set period of time. The loan is repaid with interest at the end of the set term unless he moves out or dies during the term.
Split Term	Borrower receives monthly payments for a set term. The payments will stop at the end of the set term. Expiration of the term is not a contingency to repay the loan as in the case of Term Reverse Mortgages. The loan has to be repaid when the homeowner dies or moves or sells the home.

Tenure	Borrower receives monthly payments as long as he lives in the house. Loan has to be repaid on death of borrower or on his move-out.
Line of Credit	Line-of-credit reverse mortgage offers borrowers access to a source of money they can use whenever and however they choose. The principal limit is approved based on the borrower’s home value, age, origination fee, and percentage of shared appreciation the lender is entitled to. The entire line of credit may be advanced at closing.
Hybrid Term/Tenure	Hybrid term/tenure reverse mortgage combines the features of term or tenure plan and line-of credit plan. It allows the borrower to set aside part of the principal limit at origination to establish a line of credit. The borrower receives the rest of the principal limit in the form of equal monthly payments as long as the term does not expire or the borrower lives in the home.
Lifetime	Borrower receives monthly payments as long as he is alive even if he is NOT staying in the mortgaged house. The contingency to repay occurs on the death of the borrower. An annuity attached to this reverse mortgage enables income to be provided for life.
Roll Up	A lifetime Reverse Mortgage offered in UK, with an added feature of lending additional cash advance to the borrower in return for higher loan interest rate.
Fixed Payment Loans	The borrower gets cash in lump sum. Instead of being charged interest on the loan, borrower agrees that when house is sold he will pay the lender a higher sum than the amount borrowed.
Shared Appreciation Mortgage	Borrower agrees with the lender that they can have a share in any increase in the value of the borrower house when it is sold. Here the interest rate may be very less or nothing.

Forward Vs Reverse Mortgage

Reverse Mortgage differs significantly from atraditional mortgage in terms of purpose, borrower population, repayment, and servicing

. **Forward Mortgage**	**Reverse Mortgage**
Purpose is to purchase a home	Purpose is to generate income
Borrower population is general population	Borrower population consists of aging seniors with equity in their houses
Borrower needs income to qualify	No income qualification is necessary
Before closing, borrower has no equity in the home. At closing, borrowers equity is very less	A borrower has substantial equity in the house at closing
During the loan term, borrower makes monthly loan payments and as a result loan balance reduces.	During the loan term, borrower receives monthly payments from the lender and as such loan balance increases.
At the end of the loan term, borrower's liability is zero	At the end of loan term, borrower's liability is more
Borrower's equity increases over time – Loan balance decreases as payments are made to the lender – "Falling Debt and Rising Equity Transactions"	Borrower's equity decreases over time. The loan balance rises as loan advances are made to the borrower, interest is added to the outstanding loan balance, and no repayments are made. "Rising debt, falling equity" transactions.
Borrowers have more incentive to make capital investments to maintain the house	Borrowers have less incentive to make capital investments to maintain the house

Terms and Conditions to Borrower:

- Should be living in a self-owned property, which is free of any other encumbrances, and is an approved construction
- Can pledge their house only if they are using it as their permanent primary residence for a minimum of 1 year
- It may not be possible to provide reverse mortgage for houses on power of attorney
- Need to pay property tax and insurance and maintain the house
- The loan amount cannot be used for any speculative or trading purposes
- The loan does not apply to ancestral property
- The residual life of the property should be at least 20 years
- The borrower will be provided the option to accept the revised terms and conditions to continue the loan. However, if he refuses to accept the revised terms and conditions, no further payments shall be made by the bank/HFC. Interest at the rate agreed before the review will continue to accrue on the outstanding loan amount.
- Commercial property will not be eligible for the loan
- Bankruptcy can lead to foreclosure

 The residential property cannot be donated or abandoned by the borrower(s).

 The borrower(s) cannot effect changes in the residential property that may affect the security of the loan for the lender. For example: renting out part or all of the house; adding a new owner to the house's title; changing the house's zoning classification; or creating further encumbrance on the property either by way taking out new debt against the residential property or alienating the interest by way of a gift or will.

 Lump sum withdrawal of loan shall be permitted for restricted uses such as for upgradation, renovation and extension of residential property

It may lead to foreclosure if the government under statutory provisions, seeks to acquire the residential property for public use; or

 If the government condemns the residential property, for example, for health or safety reasons

 The lender may consider taking an undertaking from the prospective borrower that the "Registered Will" given to the lender is the last "Will", as per which the property will vest in his/her spouse name after his/her demise.

Terms and Conditions to Lender:

 The lender will have the discretion to determine the eligible quantum of loan reckoning the 'no negative equity guarantee' i.e. the costs of the borrower should not exceed the amount of the loan payment.

 The lender may consider ensuring that the equity of the borrower in the residential property (Equity to Value Ratio - EVR) does not at any time during the tenor of the loan fall below 10%.

 The methodology adopted for determining the quantum of loan including the detailed tables of calculations, the rate of interest and assumptions (if any), should be clearly disclosed to the borrower.

 Lenders are advised not to reckon expected future increase in property value in determining the amount of the loan.

 The lenders will observe and maintain high standards of conduct in dealing with the Senior Citizens and their families and treat them with special care.

 The lenders may suggest to the Senior Citizens to nominate their 'personal representatives' usually a close relative who the lender can contact in the event of any potentialities.

 The lenders shall in no way assert or imply to the borrower(s) that the borrower(s) is/are obligated to purchase any other product or service offered by the lender or any other associated institution in order to obtain a reverse mortgage loan.

 Take reasonable steps to check out the background and procedures of third parties before accepting referrals of business from them, and refuse to accept referrals from those that are found unacceptable.

 Lenders shall disclose to clients any third party with a financial interest in the reverse mortgage transaction.

 After the death of the borrower the lender will give 6 months' time to the heir to repossess the loan or else it will bequeath the property.

Advantages to the Borrower:

 Higher standards of living and better access to health care

 Homeowners in reverse mortgages will be protected against inflation

 Retains the principal flavour of a defined benefit scheme by providing a guaranteed base income

 Reverse mortgage can supplement retirement income

 Also with the burgeoning real estate market in India there is a good possibility of the value of the house appreciating more rapidly than the mortgage loan increasing. In such a scenario, there could be some equity left over for heirs.

 There is no upper age limit for getting the benefit of the reverse mortgage facility.

 It is a non-recourse loan, which means the bank/financial institution can never come after any person or estate for repayment of the loan. The lender can only receive payment of the loan from the value of the home.

 Tax free payments from the lender

 The payment method can be setup as a line of credit to be drawn at the time of need (monthly, yearly or quarterly). In case you want a line of credit, then you will be required to pay a commitment fee.

 The spouse can use the property after the borrower's death.

 In case the residential property is already mortgaged to any other institution, the lender may, at its discretion, consider permitting use of part proceeds of loan to prepay/repay the existing housing loan. The loan amount will be paid directly to that institution to the extent of the loan outstanding with that institution with a view to release the mortgage

Disadvantage to the Borrower:

 The biggest challenge would be balancing the need for supplementing retirement income and the desire and wish to bequeath homes to children.

 Compounded with the natural reluctance of many seniors, who have worked a lifetime to pay off a housing loan to go back into debt, irrespective of the merits of the scheme, the psychological acceptance of this concept in itself would, no doubt, be difficult.

 One clause that is likely to draw a lot of criticism is the one that fixes the maximum loan tenure at 15 years

 Very high transaction costs, possibly amounting to as much as 14% make it very unattractive to potential borrowers, especially when there is a desire/ plan to move out.

 If the loan is prepaid then the borrower will have to pay an additional cost

 Homeowners may fear that they may have to vacate their house in case they become too ill in future to afford maintaining the house as per the loan requirements and the lender insists upon foreclosure.

 Excessive procrastination when decisions involve current costs and future benefits

 If the loan proceeds are used to buy an annuity, the interest part of the annuity may attract income tax.

 If the house is sold so as to result in a capital gain, the sale proceeds will attract capital gains tax.

Advantage to lender:

 It would not be unrealistic to presume that property values will double in 15 years

 It is definitely more profitable to offer mortgages to people at older ages, say above age 75, due to reduced life expectancy

 Higher rate of interest than market rate on housing loans so higher return

 Low probability of default

Disadvantage to lender:

 There is the risk that a borrower lives longer than anticipated. The lender might get hit both ways: he has to make annuity payments for a longer period; and the eventual value realised might decline. However, this risk is usually ‘diversifiable’, if the lender has a large

pool of such borrowers. Possibility of adverse selection (of predominance of relatively healthier borrowers) is counterbalanced by the possibility that even borrowers with poor health may be attracted by the credit line or lump sum options.

- If the value of the property does drop below the amount owed on the reverse mortgage, the lender must absorb the loss
- There are other issues such as pricing which can be extremely complex as it involves a number of uncertainties, such as future value of houses, life expectancy, and interest rate risks.
- The principal and unique problem facing the lender is that of predicting accumulated future loan balances under this loan, at the time of origination.
- Since this is a non-recourse loan, the lender has no access to other properties, if any, of the borrower.
- Most of these loans accumulate interest on a floating rate basis to minimize interest rate risks to the lender, which can only be realized only at the time of disposal of the house, if at all.
- For the lender, both the interest and any shared appreciation component added to the loan balance are taxable as current income even though there is no cash inflow
- Once the loan is taken, the homeowners may have no incentive to maintain the house so as to preserve or enhance market value.
- In these loans where the borrower draws down on his loan through a credit line, there is a risk of sudden withdrawals

Chapter No. 7 KPO & BPO

Knowledge Process Outsourcing (KPO)

Knowledge Process Outsourcing (KPO) means information related business task or knowledge-based processes such as research, analysis, consultancy or any other high-level task are outsourced i.e. done by the workers of another company or allocated to the subsidiary of the same organization.

These subsidiaries can be in different countries or geographical location. This is done in order to save resources and costs. KPO firms can take decisions of businesses on the behalf of the parent companies. KPO is nothing but the subset of Business Process Outsourcing (BPO).

Cost-effectiveness, access to the best talent, focus, better utilization of the resources are the advantages of Knowledge Process Outsourcing (KPO). Let us learn about KPO in greater detail.

Definition of KPO

Knowledge Process Outsourcing or KPO refers to the assignment or transfer of knowledge plus information related process to another organization. The organization may be a different entity or the subsidiary of the main organization that can be located in the same country or overseas to minimize cost.

KPO firms perform high-level tasks for which highly skilled personnel are required by the firms. It is an extended version of BPO. Low-level decisions can also be taken by these firms. It requires in-depth knowledge, domain expertise, judgment and interpretation power of the workers, who are capable of applying their knowledge because the work entails decision making on specific issues.

The spectrum of services provided by KPO includes:

- Investment research services
- Market research services
- Data analytics
- Business research services
- Others: Legal Process Outsourcing, Financial Process Outsourcing, Media Process Outsourcing.

What is Knowledge Process Outsourcing?

Knowledge Process Outsourcing (KPO) is when difficult, high-level tasks get outsourced by a company to a vendor. So the activities which the company will be outsourcing are core activities.

They require skills, technical knowledge, and expertise. So a company outsources these tasks to another company (vendor) or a subsidiary company located in the same country or sometimes offshores for cost purposes.

As we know, BPO services are also the outsourcing of activities, but non-core activities. So a KPO will be a subset of a BPO. However, KPO involves more core activities with specialized and technical work.

The company outsources to KPO's for their skilled labor and subject expertise, not to lower their work burden. It is also an opportunity to lower costs because, in developing countries like India, skilled and educated labor is a lot cheaper.

So a KPO is like an umbrella, it covers a variety of activities. So there are many types of KPO's like market research, legal discovery, financial research, pharma and biotech, data analytics, creative design, technical content writing etc.

As it happens India is one of the leading providers of many of these KPO services, especially in the technical and scientific fields. It is currently a $14 billion industry in India.

Some famous companies providing such KPO services in India are Wipro, TCS, WNS Global, Aditya Birla Minacs etc. And still, this sector continues to grow at a very fast pace. But in recent years India is facing huge competition from countries like China, the Philippines, and the Czech Republic etc.

Topics under Emerging Trends In Business

- Network Marketing
- Franchising
- Business Process Outsourcing
- Aggregator
- Digital Economy

- E-Commerce
- M-Commerce

List of KPO Companies in India

- Sutherland Global Services
- WNS
- Boston Analytics
- SG Analytic
- Eclerx
- Syntel
- CRISIL
- iGate
- McKc (Mckinsey Knowledge Centre)
- Deloitte

Advantages of KPO

1. **Cost-effectiveness**: One of the biggest advantages of a KPO is obviously the cost advantage. The company does not have to set up any infrastructure or bear any operational or running costs. And it gets effective, expertizes services at a fraction of the cost.
2. **Access to the best talent**: KPO's provide the company with the best, most knowledgeable and skilled professionals available in the global talent pool. And if the KPO is in a developing country like India or Philippines then the cost of such talent is also relatively low.
3. **Focus**: Outsourcing some of the processes, allows the company to focus on its core functions. The KPO handles the peripheral functions, and the company can better focus on its core functions and improve their efficiency and results.
4. **Better Utilization of Resources**: If the company outsources the process that is not at the core of their business strategy, it can use the resources it saves in better places. Say a company outsources its supply chain management. Then the resources it saves on this can be utilized to streamline the manufacturing process, R&D activities, better marketing etc.

Definition of BPO

Business Process Outsourcing or BPO is the outsourcing of any segment/ process/ function of the business organization to an outside organization. The major cause behind the outsourcing of business process is to reduce costs and maximize efficiency. The focus is made on the process, i.e. the process is predetermined, and the provider has to bring consistency and productivity in the assigned processes. The different types of BPO are explained below:

- **On-shore BPO**: The outsourcing of business activities to another company but in the same country.
- **Nearshore BPO**: The outsourcing of business activities to the company located in the nearby country.
- **Offshore BPO**: The outsourcing of business activities to the company located overseas.

A BPO is capable of handling both front end and back end operations of an entity. BPO provides an array of services such as:

- Customer care, i.e. call center, help desk, etc.
- Human resources, i.e. recruitment and selection, training and placement, payroll processing, etc.
- Technical support
- Services related to finance and accounting.
- Website services, i.e. web hosting, etc.
- Transcription

Key Differences Between BPO and KPO

The important differences between BPO and KPO are mentioned in the following points:

1. BPO is an abbreviation used for Business Process Outsourcing whereas KPO is a short form of Knowledge Process Outsourcing.
2. BPO refers to the outsourcing of peripheral activities of the organization to an external organization to minimize cost and increase efficiency. KPO is described as the functions related to knowledge and information are outsourced to third party service providers.
3. BPO is based on rules while KPO is based on judgment.
4. The degree of complexity in BPO is low in comparison to KPO.
5. BPO requires expertise in the process, but KPO requires expertise in knowledge.
6. BPO depends on upon cost arbitrage. Conversely, KPO is dependent upon knowledge arbitrage.
7. BPO is volume driven. On the other hand, KPO is insights driven.

8. The collaboration and coordination are low in BPO which is just opposite in the case of KPO.
9. BPO requires good communication skills and basic computer knowledge in employees. As opposed to KPO, where only professionally qualified and highly skilled workers are required.
10. BPO focuses on low-level process, whereas focus is on the high-level process.

What BPO is used for

Organizations engage in business process outsourcing for two main areas of work: back-office functions and front-office functions.

Back-office functions -- also referred to as *internal business functions* -- include accounting, information technology (IT) services, human resources (HR), quality assurance (QA) and payment processing. Front-office functions include customer relation services, marketing and sales.

In addition to outsourcing an entire functional area, i.e., HR, organizations outsource specific functions in those areas -- for example, payroll.

Over the decades, the business process outsourcing industry has expanded to offer an extremely wide range of functions and services to organizations.

The breadth of functions that can be outsourced today spans from conventional back-office tasks, such as accounting, data processing and payroll processing, to digital services, such as social media marketing, and to customer support roles, such as call center operations.

Although organizations generally outsource noncore functions, they do indeed still outsource critical tasks, such as customer service, financial services and IT operations. Organizations also outsource strategic tasks, such as data mining and data analytics, both of which have emerged as essential elements for digital transformation and for competitive advantage in a digital economy.

How does BPO work?

Organizational executives arrive at the decision to outsource a business process through a variety of avenues. Startup companies, for example, often need to outsource back-office and front-office functions because they do not have the resources to build the staff and supporting functions to preform them in-house. On the other hand, an established company may opt to outsource a task that it had been performing all along after an analysis determined that an outsourced provider could do the job better and at a lower cost.

Management experts advise enterprise executives to identify functions that can be outsourced and then evaluate that function against the pros and cons of outsourcing to determine if shifting that task to an outsourced provider makes strategic sense for the organization.

If so, the organization then must go through the process of not only identifying the best vendor for the work, but also shifting the work itself from in-house to the external provider.

This requires a significant amount of change management, as the move to an outsourced provider generally impacts staff, established processes and existing workflows.

The shift also impacts the organization's finances -- not only in terms of shifting costs from the internal function to the outsourced providers, but often also in terms of taxes and reporting requirements.

The organization may also have to invest in a technology solution to enable the smooth flow of work from the organization itself to the outsource provider, with the extent and cost of that technology solution dependent on the scope of the function being outsourced and the maturity of the technology infrastructure in place at both enterprises.

Security and regulatory concerns

Additionally, the organization must address any security and regulatory concerns, requirements and restrictions. For example, some regulations require local storage of certain types of data, which could prevent the use of an offshore provider in some circumstances.

As such, organizations seeking to outsource generally need to involve IT, security, legal and financial executives in the transaction in addition to the business unit leader of the function being outsourced and the procurement office. Moreover, these executives need to be involved in periodic reviews of the outsourced function to determine whether regulatory and financial changes, as well as changing organizational strategies, render the need for changes in the outsourcing arrangements.

Scope of work

As an organization moves a function to a new outsourced provider, it must identify the scope of the work shifting from in-house staff to the external partner. Executives should identify the workflows and processes impacted by this shift and adjust, if necessary, those workflows and processes to accommodate the outsourcing of the work.

Executives should also identify the key objectives for outsourcing a function -- whether it's cost savings, increased quality, quicker turnaround or some other objective -- and then use that criteria to determine which provider would be best suited to handle the work. Those objectives should also serve as the basis for contractual obligations that can be used to help assess the performance of the outsourced provider and success of the function once it is actually outsourced.

Types of BPO

Because companies around the world provide BPO services to other organizations, BPO can be divided into different types based on the service provider's location:

- **Offshore outsourcing**, or just **offshoring**, occurs when an organization contracts for services provided with a company in a foreign country.
- **Onshore outsourcing**, or **domestic outsourcing**, happens when an organization contracts for services provided by a company that operates in the same country as the hiring organization.
- **Nearshore outsourcing** is when an organization contracts for services provided by companies based in neighboring countries.

Business process outsourcing is also sometimes referred to as *IT-enabled services*, or *ITES* -- a name that recognizes that IT infrastructure enables outsourcing to happen.

KPO, LPO and RPO

Business process outsourcing is also sometimes categorized by the types of services being provided. The three prevalent categories are the following:

1. **Knowledge process outsourcing**, or **KPO**, is when the outsource service provider is hired not only for its capacity to perform a particular business process or function, but also to provide expertise around it.
2. **Legal process outsourcing**, or **LPO**, is a type of KPO that -- as the name states -- is specific to legal services, ranging from drafting legal documents and performing legal research to offering advice.
3. **Research process outsourcing**, or **RPO** -- another type of KPO -- refers to research and analysis functions; biotech companies, investment firms and marketing agencies are among the types of organizations that would engage in RPO for services.

Benefits of BPO

Organizations engage in business process outsourcing because they expect to benefit from the arrangement.

The benefits typically cited by proponents of BPO include the following:

- **Financial benefits:** Organizations often find that an outsourced provider can perform a business process at lower costs, or they often find that, by contracting with an outsourced provider, they can save money as a result of the relationship in other ways, such as in tax savings.
- **Flexibility:** BPO contracts can allow organizations greater flexibility to adjust how it completes the outsourced business process, enabling them to better react to changing market dynamics.

- **Competitive advantage:** BPO enables organizations to outsource those processes that aren't core to their businesses or missions, thereby enabling organizations to focus more of its resources on the operations that distinguish them in the marketplace.
- **Higher quality and better performance:** Because the core business of BPO providers is performing the specific processes they're hired to do, they are, in theory, able to focus on providing those processes at the highest levels, often with greater accuracy, efficiency and speed.
- **Quicker access to innovations in the process:** BPO providers are also more likely and better positioned to know about advances and innovations happening in the area they specialize in, and they are more likely to invest in new developments in process automation that can improve the speed, cost and/or quality of the work -- benefits that flow back to the organizations that contract with the provider.
- **Expanded coverage:** Outsourced providers can expand the hours or geographical reach of an enterprise in a cost-effective manner. For example, an organization that wants to have 24/7 call center operations may be able to more quickly and more efficiently provide that capability by contracting with a partner which has existing around-the-clock capabilities, perhaps even in multiple geographic locations to enable a follow-the-sun business model.

Risks of BPO

In addition to expecting anticipated benefits, organizations engaged in BPO also take on potential risks and drawbacks. Those potential problems include the following:

- **Security breaches:** Organizations must create technology connections between themselves and their service providers, thereby creating another potential point that could be exploited by bad actors; moreover, organizations often need to share sensitive and/or regulated data with their service providers -- another potential security risk.
- **Unanticipated/higher costs:** Organizations can underestimate the price they'll be charged for the work that they're outsourcing, either because they underestimate the amount of the work or they do not calculate or anticipate the full costs of their contracts with their providers.

- **Relationship challenges:** Organizations can face communication problems with their outsourced providers, or they might find that there are cultural barriers to having a strong business partnership, problems that could hinder hiring organizations from seeing the full benefits of their BPO contracts.
- **Overdependence on the external provider:** An organization that outsources a function or service becomes tethered to the particular partner it has chosen to perform the work. The organization then must manage that relationship to ensure that key objectives are continuously met at the agreed-upon cost. If not, the organization may find it difficult to bring the operation back in-house or even move it to another outsourced provider.
- **Increased potential for disruption:** An organization also must monitor for issues that could interrupt or permanently end the relationship with an outsourced provider. They include financial or workplace problems at the outsourced provider, geopolitical instability, natural disasters or changes in economic circumstances. Organizations thus need to consider such potentials and devise strategies on how to cope, adding layers of complexity to their business continuity and disaster recovery (BC/DR) plans.

Future directions

The practice of business process outsourcing could be at least partially displaced in upcoming years by technology.

Robotic process automation (RPA) and artificial intelligence (AI) can handle some of the business processes now frequently outsourced, and these technologies can often perform those functions at lower costs and higher speeds.

However, not all processes are easily automated; moreover, a BPO provider may be in a better position to utilize those technologies to automate its service offerings than organizations are, thereby helping the BPO provider retain its appeal to organizations looking for the best way to handle business functions.

BPO market size

According to the BPO Services Global Industry Almanac 2013-2022, released in May 2018 and the most recent almanac available, the overall BPO services sector generated revenues of

$144.9 billion in 2017. That represents a compound annual growth rate (CAGR) of 3.3% between 2013 and 2017. The market is expected to reach $140.3 billion by 2022.

According to the report, the BPO services counted include the customer relationship management (CRM) function, KPO, finance and accounting, HR, procurement and vertical-specific processes.

The report further noted that the United States was by far the largest global market for BPO, larger than the European market, as well as the market for the entire Asia-Pacific region.

According to industry research from IBISWorld, the BPO services market size in the United States in 2019 was $130.9 billion, up 2% for the year. That tracks with the overall BPO market growth in recent years, with IBISWorld calculating 2.1% annualized market size growth in the United States since 2014. IBISWorld put the number of BPO businesses in the U.S. market at 160,723, with industry employment topping 1 million.

Controversies around BPO

Although many business leaders see the practice of outsourcing services and functions as a critical component of organizational success in a competitive digital economy that operates 24/7, the practice has also become controversial over the years.

Some labor leaders, politicians and workers have criticized business process outsourcing, saying it encourages organizations to shift good jobs from their home countries, such as the United States, to low-wage countries that have less stringent labor laws and environmental protections. Such criticisms in the past have fueled public outrage against outsourcing. In 2015, for example, Disney made news for laying off technology workers who first had to train their foreign-based replacements.

In fact, outsourcing has become a political point for Democrats and Republicans as both parties focus on the need to sustain good jobs in the United States. In 2019, Congress considered legislation aimed at the practice, with a Democrat-backed proposal that would require companies to disclose the location of their employees.

Conclusion

Almost all the transnational companies, today, outsource their non-core activities, just to pay attention to their primary business. Both forms of outsourcing work in a B2B environment where the service provider and buyer of services both are business organizations.

One thing must be kept in mind that KPO is nothing but an extended version of BPO. Over the time, it has been observed that with the expansion of KPO, the BPO is losing its existence. Now, the service provider companies provide both BPO and KPO services simultaneously to the organization.

Comparison Chart

BASIS FOR COMPARISON	BPO	KPO
Acronym	Business Process Outsourcing	Knowledge Process Outsourcing
Meaning	BPO refers to the outsourcing of non-primary activities of the organization to an external organization to minimize cost and increase efficiency.	KPO is another kind of outsourcing whereby, functions related to knowledge and information are outsourced to third party service providers.
Based on	Rules	Judgement
Degree of complexity	Less complex	High complex
Requirement	Process Expertise	Knowledge Expertise

BASIS FOR COMPARISON	BPO	KPO
Relies on	Cost arbitrage	Knowledge arbitrage
Driving force	Volume driven	Insights driven
Collaboration and Coordination	Low	Comparatively high
Talent required in employees	Good communication skills.	Professionally qualified workers are required.
Focus on	Low level process	High level process

Chapter No. 7 Micro Finance

Introduction

The money lenders used to provide credit to the poor people in India and around the world, at an exorbitant rate of interest since long. Gradually, this type of informal and unorganized type of credit attained the shape of microcredit and was further supplemented by many credit associations ,co-operatives and banks. The concept of microfinance initiated as an introduction by Muhammad Yunus (2006) in the form of Grameen Bank in Bangladesh. The Microfinance has been transforming rapidly in the broader sense to include savings, credits, insurance and funds transfer which has assumed the shape of a revolution in the rural finance. Hence, understanding the Microcredit and Microfinance is very important. The year 2005 was declared "The UN Year of Microcredit" by the United Nations. Mr. Mohammad Yunus and Grameen Bank Bangladesh were given Noble Peace Prize in the year 2006 for their efforts to create economic and social development below through microfinance.
About 60% of India's population is statistically unbanked. Even out of the banked population ,only 15% of the account holders have access to credit. Majority of the transaction are conducted in cash. Domestic credit provided by the financial sector in India is at 77% of GDP as compared to Japan366.5%, USA 240.5%, and U K 184%. Due to the recent initiatives like Financial Inclusion, Aadhar Enabled Payments, Business Correspondent Model and PM Jan Dhan Yojana taken by Government of India, the coverage of microfinance is considerably increasing. The Union Budget (2015) proposed establishment of Micro Units Development Refinance Agency (MUDRA) Bank and setting up of Self Employment and Talent Utilization (SETU) mechanism which are likely to boost microfinance.

Micro Finance

Micro Finance refers to the provision of affordable financial services such as small loans, smallsavings, micro insurance and funds transfer facilities extended to socially and economically poor anddisadvantaged segments of the society to enable them to increase their income levels and improvestandard of living. The main aim of microfinance is to provide small loans to poor people particularlyliving below poverty line, who are not able to raise loan for productive purposes from other sourcesand to improve their standard of living by increasing their earning and saving covering associated risks.
Microfinance is universally recognized as a just and sustainable solution in alleviating the universalwide spread poverty by financing the poor people for carrying out viable and productive activities andprojects thereby generating economic surplus and hence encouraging small savings for investments.The poor people need minimum financial services. They need to open saving bank account in thebank to keep and multiply their small savings by carrying out productive activities and getting smallloans from banks to purchase the assets and increase the level of their activities. In order to cover the life and activities risks, they require micro insurance facilities. They also require funds deposit andtransfer facilities at their nearby places. In order to improve the quality and earning, they need some

basic training facilities. The provision of these minimum financial services is covered in microfinance.
Thus, Microfinance refers to the movement in the entire world where in low income households have some access to the basic affordable financial services from banks or financial institutions to finance their productive economic activities, create assets, generate income after meeting expenses tosave some net surplus and also to protect their life and activities against various hazards and risks .According to International Labour Organization, "Microfinance is an economic development approach that involves providing financial services through institutions to low income clients"
Microfinance has been defined by the National Microfinance Taskforce, 1999 in India as "Provision of thrift, credit and other financial services and products of very small amounts to the poor in rural, semi urban and urban areas for enabling them to raise their income levels and improve living standards."
The poor people do not have access to capital which is required to start and grow their economic activities. Microfinance is the provision of basic financial services like small loans, small savings, funds transfer and micro insurance. With these services, some non financial services like business and activity training is required. By carrying out some economic activities, they can earn income and can afford food, clean water, proper shelter, education for their children and necessary health services.
Microfinance (Microfinance helps in breaking poverty cycle)

Bank/MFIs Microcredit, Micro

Insurance

Training & FundsTransfer

Projects, Net Returns Cash Accruals

Individual/SHG, NGO

Social & Economic up Liftment

Reinvestments Savings

Repay Interest &Installments

The provision of these financial services helps to increase in the income, saving and investment which results into economic and social up-liftment of the poor people.

Micro Credit and Microfinance – Difference

Micro credit refers to very small loans for poor people with little or no collateral security provided by legally registered institutions like MFIs and Banks. Microfinance refers to micro credit, small savings, insurance and money transfers of poor and low income people.

Microfinance is a broad category of financial services which includes micro credit also. Micro credit is the provision of credit services to the poor people and is a part of Microfinance. Micro credit consists of providing a financial service, i.e., micro credit. Micro finance is the provision of financial services like savings, micro credit, micro insurance and funds transfer.

Why Microfinance?

The banks have been more or less hesitant in providing microfinance to the poor people with little or no cash income as they incur substantial amount to manage the borrower's accounts e.g. presanction, assessment, disbursement of loans, inspection follow-up, recovery of loans, handling of accounts and hardly cover break-even point.
The poor people have no or few assets to offer as collateral security for the loans to the banks.
Thus bank fear having little recourse against the defaulting borrowers.
The majority of the poor people does not have saving bank account in the bank and bank need proper identity and address proof before providing microcredit to them. The lack of knowledge ,initiatives and collateral securities are the hindrances in getting the credit from banks. The people need microfinance to carry out their economic activities in commercial manner .Microfinance is needed for the economic growth and transformation of the nation. Microfinance is needed to eradicate poverty and record development of the nation. Microfinance is needed to meet the life cycle needs, emergency needs and investment needs of the people. Microfinance is needed for economic and social upliftment of the people. Microfinance is needed for women empowerment through development.

Role of Microfinance

(i) Microfinance provides finance to the poor people for carrying out their economic activities and helps them to meet the basic needs of life.
(ii) Microfinance helps the poor people to increase their income, savings and standard of living.
(iii) Microfinance provides employment to the poor people by providing self employment opportunities in various sectors and activities.
(iv) Microfinance protects the poor people against the risks by providing life insurance and assets insurance.
(v) Microfinance helps in alleviating poverty by providing affordable financial services.
(vi) Microfinance helps in increasing economic growth and development in the country.
(vii) Microfinance promotes gender equity by supporting women empowerment and their economic participation and hence improving well being of the poor households.
(viii) Microfinance provides improvements in household economic welfare and enterprise stability and growth.
(ix) Micro finance helps in increasing savings, investments and developments.
(x) Micro finance provides employment opportunities to unemployed people and full employment to the under employed people.

Characteristics of Microfinance Clients

(i) Microfinance clients are generally poor people living in poverty.
(ii) Microfinance clients are generally unaware of the various schemes and products which are available in the banks for the poor clients.
(iii) Microfinance clients generally do not have easy access to finance for their activities and most of them do not have saving bank accounts with banks.
(iv) Microfinance clients find it difficult to provide collateral security, margin, balance sheets and profit and loss accounts in the banks.
(v) Microfinance clients cannot afford higher rates of interest and various charges levied by banks.

Benefits of Microfinance

The microfinance industry is fastly growing in India. The recent studies show that the top sixty microfinance institutions in India have nearly ten million customers who have been provided small loans under microfinance. The microfinance aims at removal of poverty, empowering poor, mostly women to start their own economic activities, earn money and achieve financial independence.
The recent studies also show that the recovery in microfinance is as high as 97% which facilitates cycling of banks funds for the productive purposes. Generally, the loan under microfinance is given without any collateral security. Thus the poor are in position to get the loan and come out vicious cycle of poverty.
Microfinance promotes gender equality and empowers women by providing them finance for carrying out economic productive activities. Microfinance helps in creating long term financial independence in the backward and poverty ridden areas.

Case Study

Harsi Pattan is a large and remote village in district Kangra of Himachal Pradesh. The population of the village is about three thousand five hundred people with 52: 48 male female ratio. The prominent castes are Rajputs, Blacksmiths and Brahmins, followed by scheduled castes. The main economy of the village is agriculture. The density of Antyodaya and IRDP identified families is also large. Most of the people are poor. A defunct NGO and some SHGs are there in the village.

Economically and socially the village is poor with some basic problems like stray animals, monkeys menace and lack of irrigation facilities.

You have recently joined as Branch Manager in a Regional Rural Bank branch in the village. Your controlling authority enjoins upon you to initiate microfinance programme in a big way in the village.

In the light of above, please answer the following questions:

(i) Name the major financial services, you would like to introduce in the village for increasing
microfinance?

(ii) What are the facilitating factors and hindering factors prevailing in the village for the development of microfinance?

(iii) Suggest some activities you would like to finance in the village?

(iv) What socio-economic changes you intent to bring in the village?

Suggested Solution

(i) As a promising young Manager of RRB Branch and with the help of Branch staff, we would like to introduce the undernoted financial services in the village:

- Opening of Saving Bank accounts at the branch of all the families in the village with minimum formalities to ensure full financial inclusion and microfinance.
- Providing optimum credit to the identified and needy families to finance their economic activities like crop loans and term loans for agriculture and allied activities like dairy, poultry, pisciculture, apiculture, sericulture etc. besides small business, handicraft and small industries.
- Providing micro insurance cover to the beneficiaries for their life and vocations to cover the risk.
- Providing remittance facilities to the people to transfer funds at other places.

(ii) The stated facilitating factors prevailing in the village for the development of micro finance are:

- Large and diversified population of the village.
- Large base of poor and micro credit absorbing families.
- Existence of NGO and SHGs, which can be activated.
- Agriculture and allied activities potential, besides micro and small enterprises can be financed.
- Large number of Antyodaya and IRDP families for financing.

- The hindering factors which can be converted into leads are:
- Stray animals and monkey menace. Barbed wire fencing and growing suitable crops may be considered.
- Lack of irrigational facilities. Minor irrigation schemes could be considered for financing.

(iii) We would like to finance the undernoted activities:
- Crop loans in the shape of Kisan Credit Cards to the eligible needy families.
- Agriculture Term loans for agriculture and allied activities.
- Working capital and term loans for small business, handicraft and small industries.
- Micro credit to identified Antyodaya, IRDP and poor families.

(iv) We would like to bring the undernoted socio-economic changes in the village:
- Women empowerment in the village by improving the socio-economic position of the women by providing self-employment opportunities through micro finance.
- Increase in income of the families by ensuring economic surplus, hence improvement in their socio-economic status.
- Developing banking habits among families in the village by providing the microfinance products and services.
- Ensuring full self-employment provision in the village by catering their microfinance needs.

S.P. Mandali Pune,30

Prin. K.P. Mangalvedhekar Institute of Management Career Development & Research

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Class: - MBA II SEM III

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STANDARD COSTING

Introduction:

The word standard simply means some norm, specification or target. It gives a reference point, bench mark, model for comparison.

Standard costs are part of cost accounting system whereby standard cost is incorporated directly and formally into the manufacturing accounts. It is divided into two major parts :-

(1) Historical Costs

(2) Pre-determined Costs.

Historical cost means the actual cost or past cost and historical costing is a system in which actual costs incurred in the past are determined.

Historical costs have some limitations:

(1) Such costs are obtained too late and cannot be used for price quotations.
(2) Historical costs do not serve the object of cost control, for the cost has already been incurred before cost records are available for management control.
(3) Historical costs do not provide any benchmark against which efficiency can be measured.

Standard costing is a technique which uses standard for costs and revenues for the purpose of control through variance analysis. Standard costing aims at eliminating waste and increasing efficiency in operation through setting up standards for production costs and production performance.

The objective of this chapter is to underscore the need of standard costing by highlighting its utility. Standard costing requires the historical costing for a comparative analysis which helps set the goals of standard costs. Standard costing is one of the most important tools to control costs. In this method, all standards. The standard committee will generally consist of production manager, purchase manager, personal manager, and other functional heads. It is possible that the standard cost decided by the manager could be idle, normal or expected. The idle standard cost may refer to an estimate of the cost under perfect competition. It is competed on the basis that there is no scrap, no idling of machinery or breakdown and so on. On the other hand, expected standard cost is based upon the attainable result.

Standard Costs are not simple average but they are set with due care after careful study and observation of production activity in the past and the present.

2) Standard Costing:

Standard costing is a perfect system of controlling the costs and measuring efficiency and its development. It is a technique of cost reduction and cost control. It helps to provide valuable guidance in several management functions such as formulating policies, determining price level,

costs are predetermined. Such predetermined costs are then compared with the actual costs and the difference between these costs known as variances.

Meaning:

The word standard means a 'norm' or a 'criterion'. Standard cost is thus a criterion cost which may be used as a yardstick to measure the efficiency with which actual cost has been incurred.

There is a constant process of development effected in business through the help of standard costing method since the standard costs set in are sensible, capable of being attained and are revised from time to time in accord with needs and requirements of the business enterprise.

1) Standard cost:

Standard cost is a figure which represents an amount that can be taken as a typical of the cost of an article or other cost factor. It is established on the basis of planed operations, planed cost efficiency levels, and expected capacity utilization.

Standard cost is a predetermined calculation of the presumed cost under the specified conditions. It is built up from an assessment of the value of cost elements. It correlates technical specification of material, labour and other cost to the price or wage rate which have occurred during the period in which the standard cost is to be determined.

Standard cost is a predetermined cost which is calculated from management standard of efficient operation and relevant necessary expenditure.

- C.I.M.A. London

The standard cost is a predetermined cost which determines what each product or service should cost under given circumstances.

- Brown and Howard

Standard Costing:

A standard costing system is a method of cost accounting in which standard costs are used in recording certain transaction and the actual costs are compared with the standard cost to learn the amount and reason for variations from the standard.

- W.B. Lawrence

Standard costing involves the preparation of cost based on pre-determined standards and continuous comparison of actual with them for the purpose of guidance and control.

- D. Joseph

Concepts of Standard Cost and Standard Costing:

1) Standard Cost:

Standard costs are called pre-determined costs. The different standards regarding all the elements of costs, i.e., material, labor and overheads, are determined on the basis of historical cost and many other factors. These factors are cautiously studied before determining the standards. The standard committee will generally consist of production manager, purchase

manager, personal manager, and other functional heads. It is possible that the standard cost decided by the manager could be idle, normal or expected. The idle standard cost may refer to an estimate of the cost under perfect competition. It is competed on the basis that there is no scrap, no idling of machinery or breakdown and so on. On the other hand, expected standard cost is based upon the attainable result.

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Standard Costs are not simple average but they are set with due care after careful study and observation of production activity in the past and the present.

Standard Costing is used to ascertain the standard cost under each element of cost, i.e., materials, labours, overhead. It can eliminate all kinds of waste. Through the application of this costing it can be ascertained whether or not the activities of production are going on according as the pre-determined plan.

Objectives of Standard Costing:

1. To institute a control mechanism on all the elements of costs that affect production and sales
2. To measure different operational efficiencies and check the wastages
3. To improve the delegation of authority and generate a sense of responsibility among the employees
4. To develop a cost consciousness in the employees
5. To presume the production costs, sales and profit
6. To avail the benefits of 'Management by exception.'
7. To bring about a vivid progressive vision and sagacious decision making at each managerial level.

Preliminaries of Establishment of Standard Cost System:

The following four points are usually considered for setting up a standard cost system in a business:

1) Setting up cost center

2) Classification of Accounts

3) Types of Standards

4) Settings the Standards.

Setting the Standard: The process of setting standard is a valuable activity in itself. The success of standard costing system depends on the reliability, accuracy and acceptance of the standards. If standards have been properly set and maintained, they are a sound basis for determining cost for various purposes. While setting the standards, the following points should be taken into consideration: duration of use of standard, reasonable standard of performance, level of activity. For the given units standard sets for the following items are (i) direct material cost, (ii) direct wage cost,(iii) direct expense,(iv) factory variable overhead cost,(v) selling and distribution variable cost,(vi) selling price and sales margin.

• **Standards for Material:** It includes (1) Determination of standard quantity of material required, and (2) Determination of standard price per unit of material.

• **Material Quantities:** After establishing the standard quality of material, it is more important and necessary to establish the standard regarding quantity of each material. Generally, quantities are expressed in terms of kilograms, feet, units and so forth.

• **Standards for Labour:** This standard is determined with regard to the current rate of pay and any anticipated variations. It should be fixed for each grade of labour and for each operation involved. The standard hours are fixed for all categories of labour i.e., for skilled and unskilled labour. In these standards, number of hours and workers are established.

• **Material Prices:** This is a forecast of the average prices of material during the future period. This standard is quite difficult to establish because prices are regulated more by the external factors than by the company management. While setting standard prices, the past experiences, existing prices and anticipations should closely examine. Price of material in the past, current prices and fluctuating trends are the base for determining standard of price.

Setting for Overheads: Setting standard for overheads is more complex than the development of material and labour standards. It is estimated for variable overheads and fixed overheads.

o **Variable Overheads:** It may be recalled that variable overhead has been defined as a cost which tends to vary directly with the volume of output. It is assumed that the overhead rate per unit is invariable, irrespective of the quantity produced, so it is necessary to calculate only a standard cost per unit or per hour.

o **Fixed Overheads:** Fixed overhead tends to be unaffected by variations in the volume of output. Therefore it is required to determine total fixed overhead for the period and budgeted production in units.

Standard Hour: Production is usually articulated in physical units such as tons, pounds, gallons, numbers, kilograms, liters, etc. When a company is manufacturing different types of products, it is almost impossible to increase the production, which cannot be expressed in the same unit. Standard hour means a hypothetical hour, which represents the amount of work that should be performed in one hour under standard conditions.

- I.C.M.A

Meaning of Analysis of Variance:

Variance means the deviation of the actual cost or actual sales from the standard cost or profit or sales. Calculation of variances is the main object of standard costing. This calculation shows that whether costs are under controlled or not. A variance may be favourable or adverse.

The process of computing the amount of variance and isolate the causes of variances between actual and standard.

- C.I.M.A. London

A controllable variance is when a variance is treated as the responsibility of a person with the result that his or her degree of efficiency can be reflected in size. When a variance arises due to some unforeseen factors, it is known as uncontrollable variance. The management should look more carefully at controllable variance, for it is these variances that require examination and possible corrective measures. The uncontrollable variances may be ignored.

Importance of Variance

There is a lot importance of analysis of variance. There are many objects fulfilled with their analysis. Without analysis of variance, there is no use of standard costing. The important points of variances are as under:

1) Check and control of wastage is possible.

2) It improves the efficiency of the organization by the use of standard costing.

3) It exercises control over all cost centers including department, individuals and so on.

4) Responsibility of a particular person or department can be fixed.

5) In the prediction of production cost, sales and profit, variance analysis is very useful.

6) On the basis of variance analysis, delegation of authority could be made effective.

7) Variance analysis is easy to introduce, apply and orient result.

8) Various operational efficiencies can be measured.

Types of Variances

Initially, standards for all elements of costs should be set and then the actual cost should be compared with the standard costs to obtain the variances. Some deviations are found when actual performances are recorded and compared with the standard set. These deviations are known as variances.

" A variance is the difference between a standard cost and the comparable actual cost incurred during a period"

- C.I.M.A. London

Variances are classified on the basis of:

1) On the basis of control

2) On the basis of profitability

3) On the basis of elements of cost

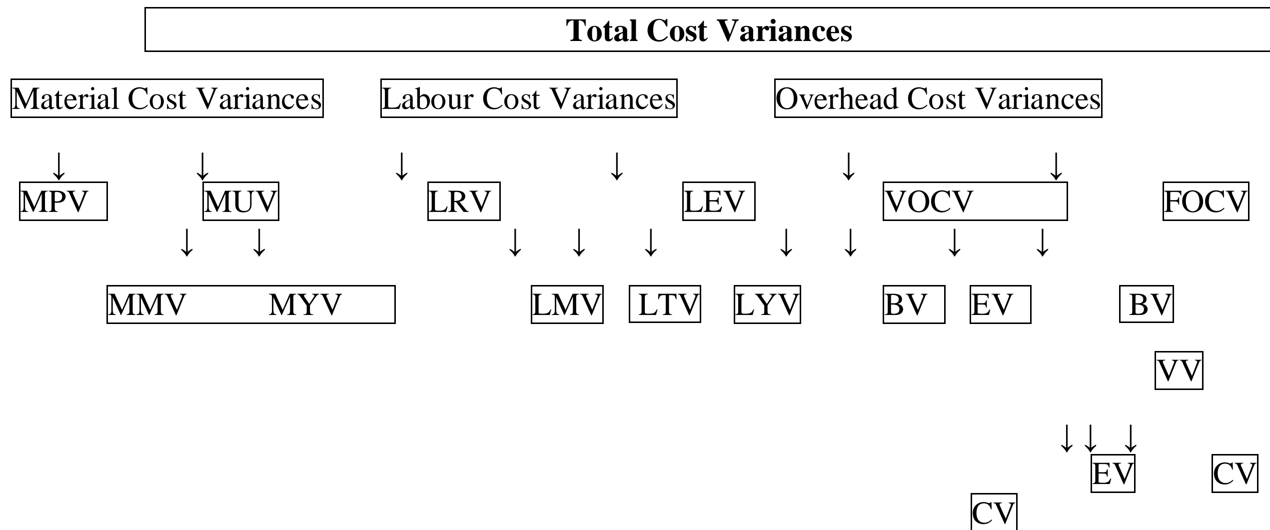
(1) On the basis of control: On the basis of control, variance may be classified as controllable variance and uncontrollable variance.

(2) On the basis of profitability: With regard to the profitability or effect, variance may be classified into two: (i) favourable variance and (ii) unfavourable variance.

These are also known as credit and debit variance or negative and positive variances.

(3) On the basis of elements of cost: Though different types of variances can be calculated, their use may not be much useful. Variance calculated on the basis of different elements of cost. They are as follows:

Total Cost Variance is a difference between the standard cost value of the output achieved in a period and the total cost incurred.



Formulaes :-

Material Variance

Material Cost Variance = (Standard Quantity X Standard Price) – (Actual Qty X Act Price)

Material Price Variance = Actual Quantity (Standard Price - Actual Price)

Material Usage Variance = Standard Price (Standard Quantity - Actual Quantity)

Labour Variance

Labour Cost Variance = (Standard Hrs X Standard Rate Per Hour) –(Actual Hrs X Actual Rate Per Hour)

Labour Rate Variance = Actual Hrs (Standard Rate - Actual Rate)

Labour efficiency Variance = Standard Rate (Std Hrs - Actual Hrs worked)

Idle Time Variance = Idle Hours X Std Rate

Variable Overheads (OH) Variance

Vaiable OH Cost Variance = (Standard Hrs X Standard Variable OH Rate) – Actual OH Cost

Variable OH Expenditure Variance = (Actual Hrs X Standard Variable OH Rate) – Actual OH Cost

Variable OH Efficiency Variance = (Standard Hrs - Actual Hrs) X Standard Variable OH Rate

Fixed Overheads (OH) Variance

Fixed OH Cost Variance = Absorbed OH – Actual OH

Absorbed OH = Actual Units * Standard OH Rate per unit

Fixed OH Expenditure Variance = Budgeted OH – Actual OH

Fixed OH Volume Variance = Absorbed OH – Budgeted OH

Sales Variances

Sales Value Variance = Budgeted Sales – Actual Sales

Sales Price Variance = Actual Quantity (Actual Price - Budgeted Price)

Sales Volume Variance = Budgeted Price (Actual Quantity - Budgeted Quantity)

Chapter I: Introduction

Basis of charge
Finance Bill and Finance Act
Definitions under IT Act
Structure of IT Authorities
Tax Payments (Advance Tax, TDS, TCS, etc.)

Introduction:

The most important source of revenue of the Government is taxes. **The act of levying taxes is called taxation**. A tax is compulsory charge or fees **imposed by the Government** on individuals or corporations. The persons who are taxed have to pay the tax irrespective of any corresponding return from the Goods and Services by the Government. The taxes may be imposed on income and wealth of persons or corporations and the rate may vary.

What is Tax? :

Compulsory monetary contribution to the states revenue, assessed and **imposed by a Government** on the activities, enjoyment, expenditure, income, occupation, privilege, property, etc of **individuals and organizations**. Tax is imposition of financial charge or other levy upon a taxpayer by a state or other the functional equivalent of the state.

1. **Selingman :** ‘Tax means a compulsorily collected donation from public which is used for the benefit of all. Tax does not cater to individual needs’.
2. **Taylor :** ‘Tax means a **compulsory donation** by public **without any direct benefit** for such donation’.
3. **Dr. Dalton :** ‘Tax is mandatory liability and it does not resemble any reciprocal or proportionate benefit’.

Types of taxes :

There are two types of taxes in India – (a) Direct Taxes (b) Indirect Taxes

a) **Direct Tax :** A direct tax is really a tax which is paid **by a person** on whom it is legally imposed and the **burden of which cannot be shifted** to any other person is called a direct tax. For example - Income Tax, Wealth Tax, etc.

i) **Dr. Dalton :** ‘When tax is levied on one person and the same is paid by that person then it is said to be direct tax’.

ii) **Prof. Bullock :** ‘Tax levied on **production of goods** is an indirect tax. Similarly tax

levied on income is direct tax'.

b) **Indirect Tax :** The taxes in which the **burden is passed on to a third party** are called Indirect Taxes. For example - Service Tax, VAT, Excise duty, Custom duty, etc.

i) **Dalton :** The tax which is levied on one person but recovered, partly or fully from some other person can be defined as indirect tax'.

ii) **Prof. Bullock :** 'Tax levied on consumers and tax levied on expenditure could be defined as indirecttax'.

iii) **Prof. J.S.Gill :** 'When tax levied on one person could be transferred on some other person and when the Government does not expect some specific person to pay such tax, then it is an indirect tax'.

Difference between Direct Tax and Indirect Tax

Sr. No.	Point of Distinction	Direct Tax	Indirect Tax
1.	Meaning	Direct tax is a tax wherein the levy of tax is made on a person and the responsibility of paying such tax is **fixed on that person**.	In this the levy of tax is made on one person and the responsibility of paying the tax to the Government is **fixed on some other person**.
2.	Levy	Direct tax is levied on **person**.	Indirect tax is levied on **goods and services**.
3.	Transfer of tax	The burden of direct tax **cannot be transferred to other person**.	The burden of indirect tax **can be transferred to the end users**.
4.	Nature	Direct tax is considered **progressive tax**.	Indirect tax is considered as **regressive tax.**
5.	Effect	The purpose of direct tax is to **redistribute the wealth** of a nation.	Indirect tax **increases the price of goods or services**.
6.	Examples	Income Tax, Wealth Tax, Gift Tax.	Excise Duty, Customs Duty, Sales Tax, VAT, etc.

Income Tax :

Income tax is tax on income. Income tax is a **central subject** according to the Constitution of India. Income tax is a very important **direct tax**. It is an important and most significant source of revenue of the Government. The government needs money to maintain law and order in the country; safeguard the security of the country from foreign powers and promote the welfare of the people. It is the foremost duty of the government to bring out such welfare and development programmes which will bridge the gap between the rich and the poor. For this purpose, mobilization of funds from various sources is required. These sources may be direct or indirect. Income tax is one of the most important tools to achieve balanced socio-economic growth.

Objectives of Income Tax :

The objectives of income tax may be –

1. To **reduce inequalities** in the distribution of income and wealth.
2. To bring out **equity between classes** of tax payers.
3. To **accelerate the economic growth** and development of country.
4. To make available of **funds for economic development**.
5. To **encourage investment** in new capital goods.
6. To **channelize investment** into those sectors which contribute the most economic growth.

Who is liable to pay income tax? :

Every person, whose taxable income for the **previous financial year** exceeds the **minimum taxable limit**, is liable to pay income tax **to the Central Government** during the **current financial year** on the **income of the previous financial year** at the **rates in force during the current financial year**.

Features of Income Tax :

1. Income tax is charged on the **income of previous year**, at a rate which is prescribed by the Finance Act for the relevant Assessment year.

2. The **Finance Act is passed every year** by the parliament in the form of 'Budget'.
3. Income tax is **levied on a person** in relation to his income of the previous year.
4. The tax payer's liability is determined with reference to his **residential status** in the previous year or accounting year.
5. Liability to income tax arises only where the total income in the accounting year **exceeds the maximum tax free amount** prescribed by the Finance Act to that relevant year.
6. The rates of income tax are **progressive** and incidence of tax increases with the rise of income.
7. It is compulsory to **deduct the tax at source** and to pay it to the Government.

Brief History of Income Tax in India:

1. In India, **Sir James Wilson**, who became first **British-India's First Finance Minister**, introduced income tax for the first time in **1860** in order to meet the expenses and losses suffered by the rulers on account of **Military Mutiny** (Freedom Movement) of **1857**. It was introduced as a temporary revenue measures only for five years.
2. The separate Income Tax Act was passed in the year **1886**, which was remained in force up to 1917 with various amendments from time to time.
3. In **1918**, a new Income Tax Act was passed.
4. The Income Tax Act 1918 was replaced by another new act which was passed in the year **1922**. The 1922 Act was remained in force up to the Assessment year 1961-62 with numerous amendments.
5. The Income Tax Act 1922 had become very complicated on account of innumerable amendments. The Government of India referred it to the Law Commission in 1956 with a view to simplify and for the prevention of tax evasion. The law commission submitted its report in September 1958.
6. Meantime the Government of India had appointed the Direct Taxes Administration Enquiry Committee to suggest measures to minimize inconveniencies to assesses and prevent evasion of Tax. This Committee submitted its report in 1959.
7. Finally, the Income Tax Act has been brought into force with effect from **01st April, 1962**. It applies to the whole of India and Sikkim (including Jammu and Kashmir).
8. Income Tax Act 1961 contains **298 sections and XIV (14)**

Schedules.**Short Title, Extent and Commencement (Sec 1) :**

Short Title : This may be called the **Income Tax Act, 1961**,

Extent : It extends to **whole of India**. (It also means people of **Jammu and Kashmir** earning income is required to pay income tax to Government of India).

Commencement : This act comes into force on **1st day of April, 1962**.

Finance Bill :

'Financial Bill' means a bill ordinarily introduced every year to give effect to the financial proposals of the Government of India for the next following financial year and includes a bill to give effect to supplementary financial proposals for any period. A **Financial Bill is a Money Bill** as defined in **Article 110** of the constitution.

The proposals of the government for levy of new taxes, modification of the existing tax structure or continuance of the existing tax structure beyond the period approved by parliament are submitted to Parliament through this bill. The finance bill can be introduced only in Lok Sabha. Rajya Sabha can recommend amendments in the Bill. The bill has to be passed by the Parliament within 75 days of its introduction.

Procedure for passing of the Money Bills :

1. A money bill can be introduced or originated **only in Lok Sabha**.
2. A money bill can be introduced only on **prior recommendations of the President**.
3. **Lok Sabha speaker** will decide whether it is a money bill or not. His decision is final, no one ischallenging his decision.
4. A money bill can be a **government bill** only.
5. Once a money bill is passed in Lok Sabha, it is transmitted to Rajya Sabha for its consideration. Rajya sabha can neither reject nor amend the money bill. It can make only recommendations and has to return the bill with or without recommendation to Lok Sabha in **14 days**.
6. The Lok Sabha **may or may not accept the recommendations** of Rajya Sabha. Thus returned bill is considered passed in both houses. If Rajya Sabha does not even return the bill in **14 days**, it is considered passed in both houses.
7. The bill has to passed by the Parliament within **75 days** of its introduction.

Important Definitions:

Under Sec. 2 and 3 of the Income Tax Act, 1961, definitions of important terms are given -

1) Gross Total Income (Sec. 14) :

Income of a person is computed under the following five heads -

1. Salaries.
2. Income from house property.
3. Profits and gains of business or profession.
4. Capital gains.
5. Income from other sources.

The aggregate income under these heads is termed as 'Gross Total Income'. In other words, gross total income means total income derived from the above five sources before making any deduction under section 80C to 80U.

2) Total Income:

Total income means the amount of income left after making the deductions under sections 80C to 80U from the gross total income. The amount so arrived is rounded off to the nearest multiple of ten rupees.

Difference between Gross Total Income and Total Income

No.	Gross Total Income	Total Income
1.	Aggregate of various heads of income is called Gross Total Income.	After deduction U/s 80C to 80U, the balance is called Total Income.
2.	Gross Total Income is not rounded off.	Total Income is rounded off to the nearest multiple of ten rupees.
3.	Tax is not levied on Gross Total Income.	Tax is levied on the Total Income at the prescribed rates.
4.	Gross Total Income is not less than the Total Income.	Total Income can be equal to Gross Total Income or less than Gross Total Income.
5.	Agricultural income is not included in Gross Total Income.	If agricultural income excess Rs. 5,000/-, it is included in the total income of an individual or HUF to determine the tax payable by the assessee.

3) Person Sec. 2(31) :

The term ‘person’ includes:

i) **An individual :** An individual means a natural person or a human being, who may be male, female, minor child or a lunatic.

ii) **A Hindu undivided family :** A Hindu Undivided Family means a Hindu family which consists of all persons lineally descended from a common ancestor including their wives and unmarried daughters.

iii) **A company :** A company may be defined as an artificial person created by law with perpetual succession, a common seal and shares carrying limited liability.

iv) **A firm :** A firm means a partnership firm which is defined under the Partnership Act. There are two conditions for partnership firm (i) There must be registered partnership deed (ii) Profit sharing ratio must be included in deed.

v) **An association of persons (AOP) or a body of individuals (BOI), whether incorporated or not :** An association of persons means two or more persons joining for a common purpose for the purpose of earning income. It may consist two or more individuals or any other person, i.e., an individual and a company or two or more companies.

vi) **A local authority :** Local authority includes Municipality, Municipal Corporation, District Board, etc.

vii) **Every artificial juridical person not falling within any of the preceding categories :** An idol or deity is assessable as an artificial juridical person, but through persons managing them. Similarly, all other artificial persons, with a juristic personality are artificial persons, like universities.

4) Assessee Sec. 2(7) :

An assessee means a person -

i) Who is liable to pay any tax; or

ii) Who is liable to pay any other sum of money under this Act (e.g., interest, penalty, etc.); or

iii) In respect of whom any proceeding under this Act has been taken for the assessment of his income; or

iv) In respect of whom any proceeding under this Act has been taken for the assessment of the income of any other person in respect of which he is assessable; or

v) In respect of whom any proceeding under this Act has been taken for the assessment of the loss sustained by him; or

vi) In respect of whom any proceeding under this Act has been taken for the amount of refund

due to him; or

vii) Who is deemed to be an assessee under any provision of this Act; or

viii) Who is deemed to be an assessee in default under any provision of this Act.

5) **Deemed Assessee:** A person, who is deemed to be an assessee for some other person, is called 'Deemed Assessee'. For example,

a) After the death of a person, his legal representative will be treated as an assessee for that income of the deceased on which tax has not been paid by the deceased before his death.

b) A person representing a foreigner or a minor or a lunatic is treated as an assessee for the income of such foreigner or minor or lunatic.

6) **Assessee in Default:**

When a person is responsible for doing any work under the Act and he fails to do it, he is called an 'Assessee in Default'. For example, if a person while making any payment to another person, is liable to deduct income tax thereon at source, does not deduct income tax there from, or having deducted it, does not deposit it in the Government Treasury, he will be treated as an Assessee in Default for that income tax.

7) **Assessment Year [Sec. 2(9)]**

Assessment year means the period of twelve months commencing on the first day of April every year and ending on 31st March of the next year. An assessee is liable to pay tax on the income of the previous year during the next following assessment year. For example, during the assessment year 2017-18, tax shall be paid for the previous year 2016-17.

8) **Previous Year (Sec. 3) :**

Previous year means the financial year immediately preceding the assessment year. In other words, the year in which income is earned is known as previous year and the next year in which this income is taxable is known as assessment year. Income tax is charged on the total income of the previous year at the rates prescribed by the relevant Finance Act for the assessment year.

9) **Financial Year :**

The year started from 1st April to 31st March of the next year. A financial year is both a previous year as well as an assessment year. It is previous year for the income earned during that financial year and assessment year for the income earned during the preceding financial year. For example, Financial Year 2017-18 is assessment year for the income earned during the financial year 2016-17.

10) **Rounding-off of income (Sec. 288A) :**

The taxable income shall be rounded off to the nearest multiple of ten rupees and for this purpose any part of a rupee consisting of paise shall be ignored and thereafter if such amount is not a multiple of ten, then if the last figure in that amount is five or more, the amount shall be increased to the nearest higher amount which is a multiple of ten and if the last figure is less than five, the amount shall be reduced to the next lower amount which is a multiple of ten.

11) **Rounding-off of tax (Sec 288B) :**

Any sum payable by an assessee and the amount of refund due, under the provisions of the Act shall be rounded off to the nearest ten rupees.

12) Casual Income :

Any receipt which is of a casual and non-recurring nature is casual income. In other words, casual income is that income the receipt of which is accidental and without any stipulation. It is in nature of an unexpected wind-fall.

Winning from lottery, crossword puzzles, card games and other games of any sort or from gambling or betting of any form or nature, whatsoever are casual incomes. Receipts even from habitual betting are non-recurring receipts and assessable as casual income.

The casual income does **not include** –

i) a) **Capital gains**; or

b) **Receipts arising from business** or the exercise of a profession or occupation; or

c) Receipts by way of **addition to remuneration of an employee**, such as bonus, gratuity,perquisites, etc.

ii) Voluntary payment received in exercise of an occupation is not treated as casual income. For example, if an architect submitted a plan in a competition for construction of a building, the prize won by him, is income from profession.

iii) **A gift from a relative is not income at all**. A gift from a relative does not become income merely because it is repeated year after year. A regular allowance given year after year purely as a voluntary gift, by husband to his wife, by a parent to a child, is merely a fresh gift every time, it is paid and does not amount to income.

iv) Payment by husband to his wife under an agreement to live apart as maintenance allowance is neither causal income nor a personal gift. Hence, it is taxable.

Other provisions relating to Casual Income :

i) Expenses are not deductible : If expenses are incurred to receive casual income, such expenses are not deductible from any income. For example, an individual purchases lottery tickets, the cost of lottery tickets is not deductible from any income.

ii) Set-off off losses not permitted : If instead of casual income there is casual loss, such loss cannot be set-off from any income. For example, If a person wins a card game on the first day and loses the next day, he cannot set-off the loss against any income.

iii) Tax deduction at source :

a) If the winnings from **horse race exceed Rs. 10,000/-**, tax will be deducted at source at theprescribed rate.

b) If the winnings from any **lottery, crossword puzzle, card game and other game of any sortexceed Rs. 10,000/-**, tax will be deducted at source at the prescribed rate.

iv) Rate of tax : On winning from lottery, crossword puzzle, races, gambling, betting, etc **tax ischargeable @ 30%**.

Basis of Charge of Income Tax:

The following basic principles are the basis of charging income tax -

1. Income tax is an annual tax on income.
2. Income of previous year is taxable in the next following assessment year at the rate or rates applicable to that assessment year. However, there are certain exceptions to this rule. For Example, **Tax in the same Financial Year** –

a) Income of non-resident from **shipping** (Sec. 172)
b) Person **leaving permanently** / long time (Sec 174)
c) Bodies form for **short duration** (174A)
d) Person trying to **alienate his assets** to avoid tax (175)
e) Income of **discontinued business** (176)

3. **Tax rates are fixed by the annual Financial Act**.
4. Tax is charged on every person as defined in Section 2(31).
5. The tax is charged on the total income of every person computed in accordance with the provisions ofthe Income Tax Act.
6. Income tax is to be deducted at the sources or paid in advance as provided under provisions of the Act.

Classification of Income :

The total income is computed on the basis of the residential status of the assessee. The income isclassified into the following five heads.

1. Income from Salaries;
2. Income from House Property;
3. Profits of Business and Profession;
4. Capital gains and
5. Income from other sources.

Procedure for computing the total income :

For computing the total income of an assessee and the tax payable by him, following procedure is followed –

1. Classify the income under each of the **five heads** and then deduct from the income under each head the deductions permissible under the Act in respect of that head of income. The balance of amount left under each head of income is its assessable income.
2. Total upto the assessable income of each head and the aggregate of all these assessable income is called the **Gross Total Income**.
3. From the Gross Total Income deduct the **deductions permissible under Sec. 80C to 80U** of the Act for computing the total income. The balance left after subtracting the allowable deductions is called the 'Total Income'.
4. The amount of income tax payable is then calculated on this total income according to the rates prescribed by the Finance Act for the relevant assessment year and the rates prescribed under different sections of the Act.

1) Residential Status of an Individual

On the basis of residence the assessees are divided into three categories. As per the provisions of the Income Tax Act, an individual and a Hindu undivided family can either be –

1) Resident and Ordinarily Resident; or
2) Resident but not Ordinarily Resident; or
3) Non-Resident

1) Resident and Ordinarily Resident:-

An individual is said to be resident in India in any previous year if he satisfies any one of the basic conditions and both the additional conditions.

Basic Conditions:-

a) He is in India in the relevant previous year for a period of **182 days or more**, or
b) He is in India for at least **60 days or more** during the relevant previous year **and** he has been in India for at least **365 days or more during the four years** immediately preceding the previous year.

Exceptions to the above rules of **60 days** stay in India:-

i) An individual who is a **citizen of India and leaves India** in any previous year for the

purpose of employment or as **a member of the crew of an Indian ship** must have stayed in India for at least 182 days during the previous year instead of 60 days;

ii) If any citizen of India or a **foreign national of Indian origin**, who is living outside India, comes on a visit to India in the previous year, he must have stayed in India for at least **182 days** during the previous year instead of 60 days.

Notes:

1. A person is deemed to be of **'Indian origin'** if he, or either of his parents or any of his grandparents, was **born in undivided India**. It may be noted that grandparents include both maternal and paternal grandparents.
2. It is not at all necessary that he should stay at a stretch for 182 days. His total stay for at least 182 days may be with gaps.
3. For calculating number of days stay in India, days of entry and exit should be included in the period of stay in India.

Additional Conditions:

A person has to **satisfy both** the following additional conditions besides satisfying any one of the above mentioned basic conditions in order to become 'Resident and Ordinarily Resident'.

i) He has been resident in India in **at least 2 out of 10 previous years** immediately preceding the relevant previous year.

ii) He has been in India for **at least 730 days** in all **during the seven previous years** preceding the relevant previous year.

Note : The day on which he enters in India as well as the day on which he leaves India shall be takeninto account as the stay of the individual in India

2. Resident but not Ordinarily Resident:

If an individual satisfies any one of the above basic conditions but does not satisfy the two additionalconditions, he is said to be 'Not Ordinarily Resident'.

3. Non-Resident:

If an individual satisfies none of the basic conditions, he is said to be 'Non-Resident'.

2) Residential Status of Firm

A partnership firm is said to be resident in India if –

a) **Resident :** The control and management of their affairs are wholly or partly situated within Indiaduring the relevant previous year.

b) **Non-resident in India :** If the control and management of their affairs are situated wholly outsideIndia.

A firm cannot be ordinarily or not ordinarily resident. The residential status of the partners is notrelevant in determining the status of the firm.

3) Residential Status of Company

a) Resident : A company is said to be a resident in India in any previous year, if -

i) It is an Indian company; or

ii) Its place of effective management, in that year, is in India.

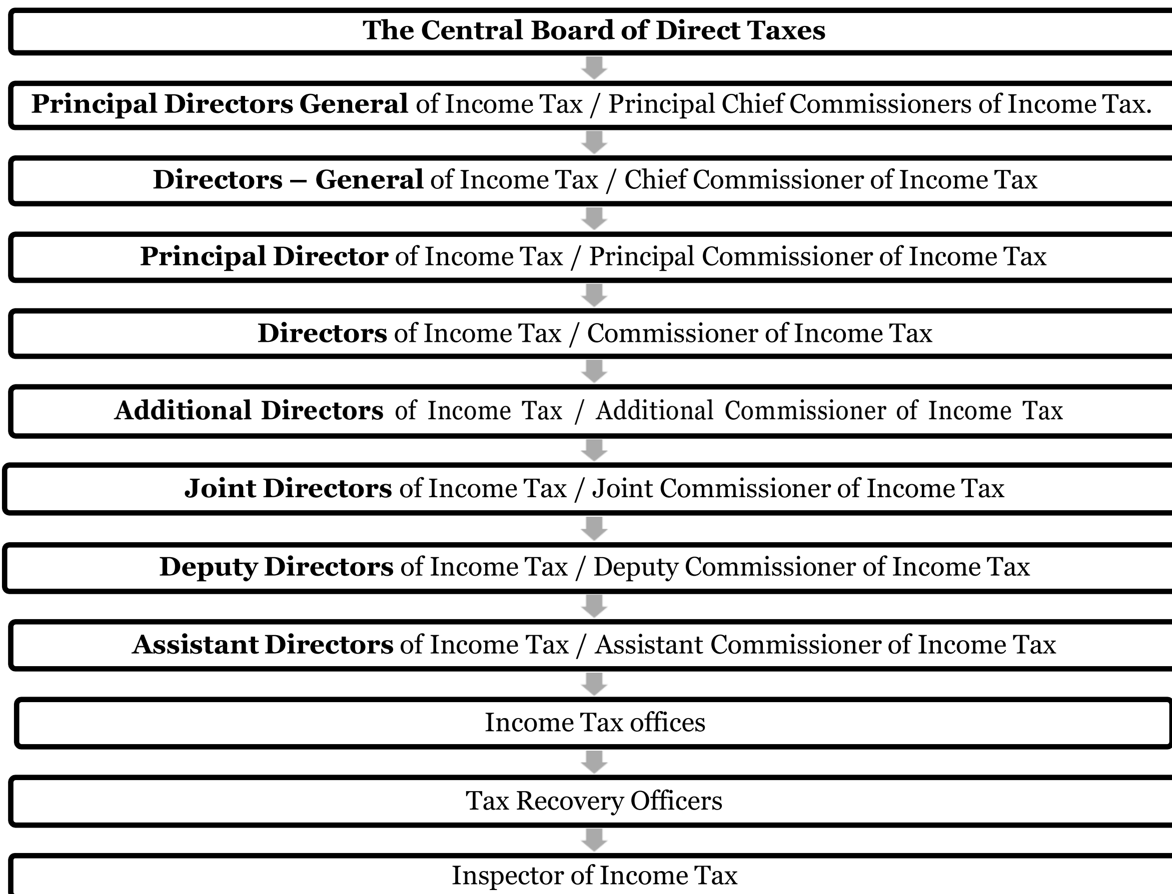
An Indian company is always resident in India. A foreign company is resident in India only if during the previous year, place of effective management is situated wholly in India.

b) Non resident : A foreign company is treated as non-resident if during the previous year, place of effective management is either is wholly or partly situated out of India.

A company can never be ordinarily or not ordinarily resident in India. In case of a foreign company even the slightest place of effective management is exercised from outside India, it would be treated as a non-resident.

Structure of IT Authorities (Sec. 116):

There shall be the following classes of income tax authorities for purposes of the Income Tax Act.



Advance payment of Tax :

Advance payment of tax is also known as the 'pay-as-you-earn' scheme. It means that assese has to pay tax simultaneously along with the earning of his income. This tax is paid on the current year's income in the same year. In fact, it is paid as advance and it is called 'Advance payment of tax'.

Liability for payment of advance tax :

Advance tax shall be payable during any financial year in respect of the total income of the assessee which should be chargeable to tax for the assessment year immediately following that financial year, and it shall be called 'Current Income'.

An individual resident **shall not** be liable, if –

i) He does not have any income chargeable under the head PGBP.

ii) He is of the age of 60 years or more at any time during the previous year.

Condition of liability to pay advance tax :

Advance tax shall be payable if your **tax liability exceeds Rs. 10,000 in a financial year**.

Installments of advance tax and due dates :

Installment	Due Date	Amount Payable
I	One or before 15th June	Not less than 15% of advance tax

II	One or before 15th September	Not less than 45% of advance Tax. It means 45% of advance tax, less the amount paid in earlier installment i.e. 30%
III	One or before 15th December	Not less than 75% of advance Tax. It means 75% of advance tax, less the amount paid in earlier installment i.e. 30%

IV	One or before 15th March	100% of advance Tax. Reduced the amounts paid earlier installments i.e. 25%

Tax deduction at Source (TDS):

The tax deduction at source means that the person responsible for making payment of certain incomes to the income earners, deduct income tax at the prescribed rates on such incomes before payment is made to them. The amount so deducted at source shall be deposited by the deductor in the government treasury within the prescribed time limit. The tax so deducted is called deduction of tax at source. TDS should be deposited to government on or before **7 days from the end of the month** in which the deduction is made.

Tax Collected at Source (TCS) :

Tax collected at source (TCS) is the tax payable by a seller which he collects from the buyer at the time of sale. The Income-tax act governs the goods on which the seller has to collect tax from the purchasers. The seller deposits the TCS amount within **7 days from the last day of the month** in which the tax was collected.

Slab Rates AY (2019-20) :

No.	**Age**	**Tax Rate (Total Income Rs.)**				**Rebate U/s 87A, Total income does not exceed Rs.3,50,000.**
		Nil	**5 %**	**20%**	**30%**	
1.	Individual resident Below 60 yrs. [These rates are also applicable to non-resident]	Below 2,50,000	2,50,000 to 5,00,000	5,00,000 to 10,00,000	Above 10,00,000	Rs. 2,500 or Income tax chargeable whichever is less.
2.	Senior Citizen 60-80 yrs [Only resident]	Below 3,00,000	3,00,000 to 5,00,000	5,00,000 to 10,00,000	Above 10,00,000	
3.	Super Senior Citizen Above 80 yrs [Only resident]	Below 5,00,000	--	5,00,000 to 10,00,000	Above 10,00,000	

Surcharge: 10% of tax where total income exceeds Rs. 50 lakh 15% of tax where total income exceeds Rs. 1 crore

[Surcharge is charges on taxable amount minus rebate]

Health and Education Cess : 4% of the total of Income Tax and Surcharge. [Cess is charged after marginal relief]

Computation of Tax Liability on Total Income (A.Y. 2019-20)

	Tax on Total Income (Normal Rates)	xxx
Less :	Rebate u/s 87A [Max. Rs. 2,500 or 100% tax, whichever is less] [Resident + Individual + Total Income does not exceed Rs. 3,50,000]	(-) xxx
		xxx (a)
Add :	Surcharge (Multiple of one) [Income exceeds Rs. 50 Lakh upto 1 crore @ 10% on [amount (a)][Income exceeds Rs. 1 crore @ 15% on [amount (a)]	(+) xxx
		xxx
Less :	Marginal Relief* (Multiple of one)	(-) xxx
		xxx(b)

Add:	Education Cess @ 4% (Amount (b)] (Multiple of one)	(+) xxx
	Tax Liability	xxx
	Rounding off (Multiple of ten)	xxx

Calculation of Marginal Relief*

	Tax on excess amount @ 30%	xxx
Add :	Total surcharge amount	xxx
		xxx
Less :	Tax on surcharge cannot exceeds Rs. 1 crore [Total income – Rs. 1 crore / Rs. 50 Lakh]	xxx
	Marginal Relief	xxx

Permanent Account Number (PAN) :

PAN means a number which the Assessing Officer may allot to any person for the purpose of identification. **PAN has a ten alphanumeric characters**.

Application for PAN : If an assessee has not been allotted a Permanent Account Number he must apply for it in **Form No. 49A** within the prescribed time. The Assessing Officer has also got power to allot to any other person a Permanent Account Number if tax is payable by such person.

Quoting PAN : Once a Permanent Account Number has been allotted, such number must be quoted in all Returns, correspondence with Income Tax Authorities, challans for payment and in all documents prescribed by the Board.

It helps in linking the aforesaid documents to his assessment records to facilitate quick disposal of his assessment and refund claim.

The assessee must intimate to Assessing Officer about any change in the address, name or nature of business carried on by him.

Tax Deduction and Collection Account Number (TAN) :

Every person, deducting tax or collecting tax at source, who has not been allotted a tax deduction account number or a tax collection account number shall apply in duplicate in **Form No. 49B** within one month from the end of the month in which the tax was deducted or collected to the A.O. for the allotment of a '**Tax Deduction and Collection Account Number' (TAN).**

Where a 'Tax Deduction and Collection Account Number' has been allotted to a person, he shall quote such number in prescribed documents.

Tax Avoidance:

Tax avoidance means taking undue advantage of the **loopholes, lacunae or drafting mistakes** for reducing tax liability and thus avoiding payment of tax which is lawfully payable. Generally it is done by twisting or interpreting the provisions of law and avoiding payment of tax. Tax avoidance takes into account the loopholes of law. Though **it has a legal sanction**, it means following the provisions of law in letter but killing the spirit of the law.

Tax Evasion:

Tax evasion means avoiding tax by illegal means. Generally, it involves suppression of facts, falsifying records, fraud or collusion. It is an attempt to evade tax liability with the help of unfair means. **Tax evasion is illegal** and would result in punishment by way of penalty, fines and sometimes prosecution.

Tax Planning :

Tax planning may be defined as an arrangement of one's financial affairs in such a way that without violating in any way the legal provisions of an Act, full advantage is taken of all exemptions, deduction, rebates and reliefs permitted under the Act, so that the burden of the taxation on an assessee, as far as possible, is the least. **It is within the framework of law**.

Comparison of Tax Planning, Tax Avoidance, Tax Evasion :

No.	Basis	Tax Planning	Tax Avoidance	Tax Evasion
1.	Meaning	Reduce tax liability by claiming deduction, exemption, allowance, rebate, etc.	Reduce tax liability by finding loopholes in the law.	Reduce tax liability in dishonest manner.
2.	Legality	It is fully legal and ethical.	It is also legal but against the intention of law maker.	It is unethical.

3.	Example	Claiming deduction u/s 80Cto 80U	Clubbing of Income.	Increasing expenses by showing fakebills.
4.	Acceptance	Fully accepted in the eyes oflaw.	It is not accepted in the eyes of law. Government makes amendments to stop such loopholes.	It is clearly prohibited because it is fully illegal.
5.	Penalty	No penalty.	May or may not.	Heavy penalty.
6.	Implication	It leads to development ofeconomy.	It leads to generation of black money.	It also leads togeneration of black money.

INCOME EXEMPTED FROM TAX

Meaning and importance of residential status

The taxability of an individual in India depends upon his residential status in India forany particular financial year. The term residential status has been coined under the income tax laws of India and must not be confused with an individual's citizenship of India. An individual may be a citizen of India but may end up being a non-resident for a particular year. Similarly, a foreign citizen may end up being a resident of India for income tax purposes for a particular year.

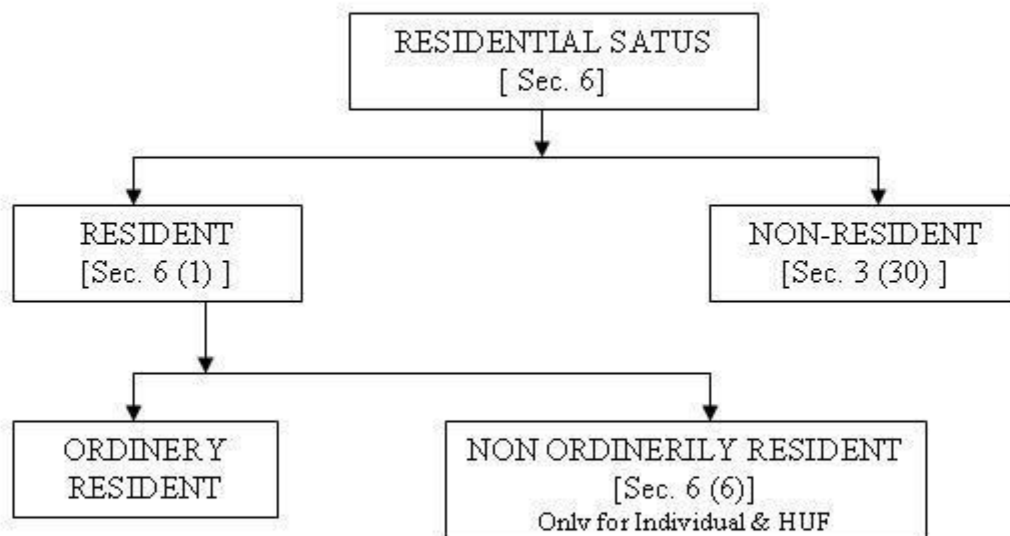
Also to note that the residential status of different types of persons via an individual, a firm, a companyetc is determined differently in this article, we have discussed about how the residential status of an individual taxpayer can be determined for any particular financial year

How to determine residential status?

For the purpose of income tax in India, the income tax laws in India classify taxable persons as:

- A resident
- A resident not ordinarily resident (RNOR)
- A non-resident (NR)

The taxability differs for each of the above categories of taxpayers. Before we get intotaxability, let us first understand how a taxpayer becomes a resident, an RNOR or and NR.



Resident

A taxpayer would be qualified as a resident of India if he satisfies any one of the following 2 conditions:

- Stay in India for a year is 182 days or more
- Stay in India for the immediately 4 preceding years is 365 days or more and 60days or more in the relevant financial year

In the event an individual leaves India for employment during an FY, he will be qualified as a resident of India only if he stays in India for 182 days or more. else the condition (b) above 60 days will not apply to him

Resident Not Ordinarily Resident

If an individual qualifies as a resident, the next step is to determine if he/she is a Resident ordinarily resident (ROR) or an RNOR. He will be a ROR if he meets both the following conditions:

- Has been a resident of India For at least 2 out of 10 years immediately, For the previous years
- Has stayed in India for at least 730 days in 7 immediately after the preceding years

Therefore, if any individual fails to satisfy even one of the above conditions, he would bean RNOR.

Non-resident

An individual satisfying neither of the conditions stated in (a) or (b) above would be anNR for the year.

Taxability

Resident:

A resident will be charged to tax in India on his global income i.e. income earned in Indiaas well as the income earned outside India.

NR and RNOR:

Their tax liability in India is restricted to the income they earn in India. They are not in need to pay any tax in India on their foreign income.

Also note that in case of double taxation of income where the same income is getting taxed in India as well as in abroad, one may resort to the Double Taxation Avoidance Agreement (DTAA) that India would have entered into with the other country in order to eliminate the possibility of paying taxes twice.

Scope of total income

Section -5 of Income Tax Act, 1961 provides Scope of total Income in case a person who is a resident, not an ordinarily resident in India and person who is a non-resident which includes. Income can be Income from any source which (a) is received or is deemed to be received in India in such year by or on behalf of such person; or (b) accrues or arises or is deemed to accrue or arise to him in India during such year; or (c) accrues or arises to him outside India during such year.

Table explaining Scope of total Income under section 5 of Income Tax Act, 1961

Sr. No	Particulars	Resident Ordinary Resident(ROR)	Resident No tOrdinary Resident (RNOR) – 5(1)	Non Resident (NR)– 5(2)
1	Income received in India	Taxed	Taxed	Taxed
2	Income Deemed to be receive in India	Taxed	Taxed	Taxed

3	Income accrues or arises in India	Taxed	Taxed	Taxed
4	Income deemed to accrues or arisesin India	Taxed	Taxed	Taxed
5	Income accrues or arises outside India	Taxed	NO	NO
6	Income accrues or arises outside India from business/profession controlled/set up in India	Taxed	Taxed	NO
7	Income Other than Above (NoRelation In India)	Taxed	NO	NO

Note-

1. Residential status is as per section 6 of Income Tax Act, 1961.
2. Deemed income is not actually accrued but is supposed to be accrued notionally.
3. The income accrued is when the assesse obtains the rights to receive it.
4. Previous year means the financial year immediately preceding the assessmentyear.

Explanation 1 & 2:-

Income accruing or arising outside India shall not be deemed to be received in India within the meaning of this section by reason only of the fact that it is taken into account in a balance sheet prepared in India.

Income which has been included in the total income of a person on the basis that it has accrued or arisen or is deemed to have accrued or arisen to him shall not again be so included on the basis that it is received or deemed to be received by him in India.

Certain Examples of incomes which treated as incomes deemed to have accrued or arisen in India:

- If Mr. X Transfer his Residential Property situated in Delhi then Capital gain arising on transfer of such Capital Asset is deemed to accrue in India. It means Capital gain arising on transfer of property situated in India.
- Income from business connection in India.
- Dividend paid by an Indian company.
- Income from any property, asset or other source of income located in India.

INCOME FROM SALARY

Salary

Salary comes into existence as a result of employer-employee relationship. In a employer-employee relationship, employee performs his duties and the employer provides himsalary.

Allowances

Allowances are part of salary given to employees to meet some particular requirements such as house rent, conveyance, etc. Allowances may be fully taxable, partially taxable or fully exempt.

House Rent Allowance [S. 10(13A) & Rule 2A]

The least of the following is exempt from tax:

- 50% of salary, (residential house situated at Mumbai, Kolkata, Delhi or Chennai)and 40% of salary where residential house is situated at any other place;
- Actual house rent allowance received by the employee;
- Excess of rent paid over 10% of salary

Leave Encashment [S. 10(10AA)]

Encashment of earned leave while in service will be treated as income. S. 17(1)(v)(a). Encashment of earned leave on retirement would however, be exempt to the extent of least of:

- 10 months' salary calculated on the basis of last 10 months average salary or
- Rs. 3,00,000
- Amount equivalent to earned leave
- Actual amount paid by the employer

Entitlement of earned leave should not exceed 30 days for every year of actual service. Limits provided for aggregate maximum from any number of employers. Encashment of earned leave on retirement would be wholly exempt for employees of Central/State Government.

Special Allowances [S. 10(14)]

Following prescribed special allowances are exempt:

- Allowance, not in the nature of perquisite, granted to meet expenses wholly, necessarily and exclusively incurred in the performance of duties, to the extent to which actually incurred.
- Allowance granted to meet personal expense at the place where duties of his office are ordinarily performed or at the place where he ordinarily resides or to compensate for increased cost of living as may be prescribed in Rule 2BB.

Nature of allowance prescribed under Rule 2BB

- For cost of travel on tour or on transfer,
- For ordinary daily charges on account of absence from normal place of duty on tour orfor journey in connection with transfer,
- For conveyance in performance of duties, where free conveyance is not provided,
- For expenditure on helper engaged for performance of office duties,

- For encouraging academic, research and training pursuits in educational and researchinstitutions,
- For purchase or maintenance of uniform,
- Special Compensatory Allowance in specified areas to extent specified,
- Tribal Area Allowances in specified states up to Rs. 200 p.m.
- For meeting personal expenditure of employee of transport system running transport vehicle, up to 70% of allowance, maximum of Rs. 6,000 p.m., provided no daily allowance for the said duty is received.
- Children educational allowance @ Rs. 100 p.m. per child, maximum of two children,
- Children hostel allowance @ Rs. 300 p.m. per child, maximum of two children,
- Compensatory Field Area Allowance in specified areas, @ Rs. 2,600 p.m.
- Compensatory modified field area allowance @ Rs. 1,000 p.m.
- Counter insurgency allowance @ Rs. 3,900 p.m. to members of armed forces.
- Transport allowance (TA) granted to meet expenses for commuting between place of residence and place of duty is exempt up to Rs. 800 per month and TA received by blind or orthopedically handicapped is exempt up to Rs. 1,600 per month.
- Underground allowance granted to employee of underground coal mines: Rs. 800 per month.
- Special allowance in the nature of high altitude to members of armed forces: Rs. 1,060 per month for altitude of 9,000 to 15,000 ft. or Rs. 1,600 per month for altitude above 15,000 ft.
- Special compensatory highly active field area allowance to members of armed forces Rs. 4,200 per month.
- Island (duty) allowance to members of armed forces – Rs. 3,250/- per month.
- Perquisites
- Perquisites are benefits such as rent free accommodation, company's car, etc
- Perquisites may be provided in cash or in kind.
- Reimbursement of expenses incurred during office work is not a part of perquisites.
- Unauthorized benefits obtained do not form part of Perquisites
- Perquisites may be fully taxable, partially taxable or fully exempt.
- Fully and Partially Taxable Perquisites

Perquisites not taxable in all cases

The following perquisites are not taxable under CBDT instructions or by virtue of the Act/Rules:

- The provision of medical facilities as per Para 4(i).
- Free meals provided to all employees in office up to Rs. 50 per employee provided bythe employer through paid vouchers usable at eating joints.
- Telephone including mobile phone provided to the employee.
- Perquisites allowed outside India by the Government to a citizen of India for renderingservices outside India.
- Sum payable by an employer to pension or deferred annuity scheme.
- Employer's contribution to staff group insurance scheme.
- Actual travelling expenses paid/reimbursed for journeys undertaken for business purposes.
- Payment of annual premium on personal accident policy, if such policy is taken to safeguard the employer's interest. See *CIT vs. Lala Shri Dhar* (1922) 84 ITR 192 (Delhi).
- Rent-free official residence to a High Court or Supreme Court Judge.

- Rent-free furnished residence to official of Parliament.
- Conveyance facility to High Court/Supreme Court Judges.

Perquisites taxable in hands of all employees:

- Value of rent-free accommodation.
- Value of concession in rent.
- Amount paid by employer in respect of any obligation which otherwise would have been payable by employee.
- Value of any security or sweat equity shares allotted or transferred by employer/former employer as free or concessional cost.
- An amount of contribution to an approved superannuation fund by the employer, to an extent it excess Rs. 1, 00,000/-.
- Any sum payable either directly or through a fund by employer (other than recognized PF, approved superannuation fund etc.) to effect an assurance on the life of the employee or to affect a contract for an annuity.

Determination of the value of prescribed fringe benefit or amenityInterest free or concessional loan

Value of perquisite w.e.f. 1-4-2000, of the loan given to the employee or any member of his household shall be at the rates charged by State Bank of India in respect of the loans for the same purpose advanced by the employer, on the maximum outstanding monthly balance as reduced by interest actually paid by employee – However, perquisite value for loans (net of amount reimbursed under medical insurance scheme) given for medical treatment of specified disease or petty loans up to Rs. 20,000 is not taxable.

Use of movable assets

Value of benefit shall be 10% p.a. of the actual cost of asset or the rent charges paid bythe employer as reduced by amount paid by the employee.

Transfer of movable assets

Value of benefit on transfer of movable asset shall be the actual cost of the asset to the employer as reduced by the amount calculated at 10% of such cost for each completed year of use by the employer and further reduced by the payments made by the employee. The normal wear and tear would be computed at 50% in case of computers and electronic items, and 20% in case of motor cars on the reducing balance method.

Perquisites taxable only in hands of specified employees

Other perquisites are taxable only in the hands of the following specified employees; i.e.,

- Director-employee
- Employee having substantial interest in employer-company
- Employee drawing salary in excess of Rs. 50,000

Rent free accommodation:

The rent free accommodation provided to employees by their employer is taxable. Since the employees are provided rent free accommodation, the amount of income accruing to them cannot be determined by them. Accordingly, there is prescribed manner for calculating income chargeable to tax as perquisite. The manner of calculating income chargeable to tax as perquisite for rent free accommodation is as follows:

Category of Employees	Income	
	Unfurnished Accommodation	**Furnished Accommodatio n**
1) Provided to a Judge ofHigh Court, Supreme Court2) Provided to an Officer of Parliament	In case of Rent free Official Residence:Nil	In case of Rent Free Official Residence: Nil
Provided to Central/ StateGovernment employees	(a) License fees determined by theCentral/ State Government	(a) Same as Unfurnished Accommodation (b) 10% p.a. Of the cost offurniture If such furniture is hired,then hire charges payable.
Provided to any other employee		
1) Where the accommodation is ownedby the employer	(i) 15% of salary in cities having population exceeding 25,00,000(ii) 10% of salary in cities having population between 10,00,000 and 25,00,000(iii) 7.5% of salary in otherareas	(a) Same as Unfurnished Accommodation (b) 10% p.a. Of the cost offurniture If such furniture is hired,then hire charges payable.
2) Where the accommodation is takenon rent by the employer	Lower of the following:(i) RentPayable Or(ii) 15% of salary	(a) Same as Unfurnished Accommodation (b) 10% p.a. Of the cost offurniture If such furniture is hired,then hire charges payable.
Accommodation providedin a hotel	Not Applicable since Hotel ispresumed to be furnished.	Lower of the following:(i)24% of salary (ii) Rent (Room Fare/ Charges) Payable

Concession in rent:

Some employers provide the employees with accommodation at rates lower thannormal market rates. This reduction in rates is known as concession in rent.

Payment by the employer in respect of an obligation of employee:

In this case, the amount is liable to be paid by the employee and the employer pays the same.

Example: Self Assessment Tax of the employee is paid by the Employer.

Note: If the employer pays taxes on behalf of employees on non-monetary perquisites provided to them, then such taxes are exempt in the hands of the employee.

Valuation of benefit of provision of domestic servants

If the employee or any member of his household is provided with domestic servants such as sweeper, gardener, watchman or personal assistant then the benefits so received by the employee are taxable as perquisites in the hands of the employee.

Utility such as gas, electricity or water supplied by employer

If the employer pays to the utility provider on behalf of the employee or if the employer himself provides such utilities then the benefits so received by the employee are taxable as perquisites in the hands of the employee.

Free or concessional educational facilities

If the employer provides free or concessional educational facilities from the educational institutions maintained and owned by the employer or if free educational facilities are allowed in any other educational institution then the benefits so received by the employee are taxable as perquisites in the hands of the employee.

However, if the educational institution is maintained and owned by the employer and the employer provides free or concessional education facilities to the employee himself or his children and the benefits so received by the employee does not exceed Rs. 1,000/- per month then such amount shall not be taxable in the hands of the employee as perquisite.

Interest-free or concessional loan

The value of the benefit to the employee as a result of interest-free loan or concessionalloan for any purpose provided to the employee or any member of his household is a taxable perquisite.

However, this perquisite will be not being chargeable to tax in any of the following cases:

- If such loan is provided for the purpose of treatment of diseases such as cancer, tuberculosis, etc. However, out of the amount of loan provided, if the employee receives reimbursement from any medical insurance scheme, then such amount shall not be exempt.
- Amount of loans made to an employee does not exceed Rs. 20,000/-.

Free or concessional food and non-alcoholic beverages

If the employer provides free or concessional food and/ or beverages such as tea, coffee etc., then the benefits so received by the employee are taxable as perquisites in the hands of the employee. However, if the following are provided by the employer then they are not taxable in the hands of employees as perquisites:

- Free food and beverages such as tea, coffee etc. provided by the employer to an employee during working hours at office or business premises less than Rs. 50/- per meal.
- Vouchers provided having value less than Rs. 50/- per meal
- Tea or Snacks provided during working hours
- Free food and beverages such as tea, coffee etc. provided during working hours provided in a remote area or an offshore installation.

Gifts or Vouchers

Gift or vouchers received by employees or by member of his household on ceremonies or occasions are taxable perquisites in the hands of the employees. However, if the value of such gifts in totality does not exceed Rs. 5,000/- then such gifts are not taxable as perquisite in the hands of the employees.

Reimbursement of credit card expenses

If the employer reimburses expenses incurred by the employee or any member of his household using a Credit card then the benefits so received by the employee are taxable as perquisites in the hands of the employee.

However, if such expenses are made by the employee exclusively for official purposes and the employer has documented the expenses incurred using the credit card then such reimbursements are not taxable as perquisite in the hands of the employees.

Club expenditure

If the employer pays or reimburses for the periodic subscription of a club for the employee or any member of his household then the benefits so received by the employee are taxable as perquisites in the hands of the employee.

However, if the following are provided by the employer then they are not taxable in the hands of employees as perquisites:

- If the use of health club, sports and such facilities are provided uniformly to all employees by the employer.
- Such expenditure is incurred wholly and exclusively for business purposes and if the expenditure is properly documented by the employer.

Gratuity

Gratuity is a payment received by an employee by his employer as a gratitude for the employee's services to the organization. It is over & above normal salary & other retirement benefits received by an employee.

Taxability of Gratuity

Pension

Pension means the employer provides to the employee a fixed monthly amount after his retirement in consideration of past services. Pension can also be called as annuity.

There are 2 types of pension:

Uncommuted Pension:

The employer provides the employee with monthly pension till the lifetime of the employee starting post retirement.

Example: Manish worked for a company for past 20 years. After retirement the company pays him Rs. 5,000/- per month in appreciation of his past services to the company.

Commuted Pension:

The employee may request his employer to pay him a lump sum amount of money on retirement rather than providing a monthly amount. The employee can even request that out of the monthly pension, a certain part lets say 50% be given to him on retirement as a lump sum amount and receive the balance part monthly post retirement. This is known as commuted pension.

Example: Manish worked for a company for past 20 years. After retirement the company pays him Rs. 5,000/- per month in appreciation of his past services to the company. Now, Manish request the Company that instead of Rs. 5,000/- per month, he requires the entire amount post his retirement itself. This is a case of commuted pension.

Provident Fund

It is a savings scheme wherein a person saves a certain amount of money every year and receives the cumulative amount of money on retirement. There are various types of Provident Funds. They are as follows:

Public Provident Fund (PPF):

It is an account which may be opened from a nationalized bank. Only individual can open such PPF Accounts with annual contributions as low as Rs. 500/-.

Statutory Provident Fund:

This is applicable only to individuals employed with the Government, railways or all recognized educational institutions. The Government and the employee contribute a certain portion of the employee's salary to this fund monthly.

Recognized Provident Fund:

If the Provident Fund is approved by the Commissioner of Income-tax, it is known as Recognized Provident Fund. In recognized provident fund the employer and the employee contribute a certain portion of the salary of the employee to the fund.

Unrecognized Provident Fund:

A fund, which is not recognized by Income Tax Authorities, in which the employer and the employee contribute a certain portion of the salary of the employee, is an Unrecognized Provident Fund.

Taxability of Provident Fund

Public Provident Fund:

The amount of Contribution made to PPF in a Financial Year is allowed as Deduction U/s 80C subject to specified conditions. The amount of interest accrued is exempt from tax. If the amounts are withdrawn from PPF in specified manner then such withdrawals are also exempt from tax.

Statutory Provident Fund:

The amount of Contribution made by the Government is exempt from tax. Employee's contribution to Statutory Provident Fund is allowed as Deduction U/s 80C subject to specified conditions. The amount of interest accrued is exempt from tax. The amount received on retirement out of such fund is exempt from tax.

Recognized Provident Fund:

It is a fund, which is recognized by the commissioner of income tax. This type of fund is maintained by business houses, industrial undertakings and banks. Under this fund both employee and employer will contribute. Employee's contribution qualifies for deduction u/s 80C. Employer's contribution over 12% of mentioned salary is taxable. Interest is exempted up to 9.5%

Unrecognized Provident Fund:

The amount of contribution made by the employer is not taxable in the hands of the employee during the years when such amounts are being contributed. Employee's contribution to Unrecognized Provident Fund is not allowed as deduction. The amount of interest accrued is not taxable in the year of accrual. The amount received on retirement out of such fund is required to be bifurcated in 4 categories in order to understand its taxability.

SIMPLE FORMAT TO COMPUTE SALARY INCOME

Basic items 1. Basic salary/wages/remuneration/pay 2. Special pay 3. Bonus 4. Fees 5. Commission 6. Advance salary 7. Arrear salary		*** *** *** *** *** *** *** ***
Allowances 1. Fully taxable allowance 2. Partly taxable/partly exempted allowances 3. Fully exempted allowances		*** *** Nil
Perquisites 1. Taxable for all (specified and unspecified) 2. Taxable for specified employees only 3. Exempted for all (specified and unspecified)		*** *** Nil
Special items 1. Gratuity 2. Pension 3. Leave encashment		*** *** ***

4. Provident fund		
Gross salary		***
Deduction u/s 16 (i) Standard deduction-(limit 40,000) (ii) Entertainment allowance (iii) Professional/employment tax	*** *** ***	***
Income from salary		***

INCOME FROM HOUSE PROPERTY

Basic of charge

Annual value of any property is assessable under this head it,

- Assessee is the owner of the property.
- Property is building and attached land.
- Property should not be used by the owner for his business or profession.

Incomes - Exempted from 'House Property Income'

Under section 10 of the Income-tax Act 1961 following incomes from house property are exempted from tax. These incomes are not to be included in the total income of assessee.Hence no tax is payable on such incomes. These incomes are:

Agricultural House Property [Section 2(1)(c)].

Income from such house property which is situated on or in the immediate vicinity ofagricultural land which is used for agricultural purposes by cultivator is exempted from tax.

Income from Property held under Trust Wholly for Charitable or Religious Purposes [Section11(1)(a)]:

Income derived from property held under trust, wholly for charitable and religious purposes, shall be exempt. To the extent such income is applied in India for such purposes; andwhere any such income is accumulated or set apart for application to such purposes in India, to the extent to which the income so accumulated or set apart is not in excess of 15% of the income from such property.

Income from Property held under trust which is applied in part only for Charitable orReligious purposes [Section 11(1)(b)]:

Income derived from property held under trust in part only for such purpose, shall be exempt:To the extent such income is applied in India for such purposes, provided, the trust in question is created before the commencement of Income-tax Act, 1961 i.e. before 1.4.1962; andWhere any such income is finally set apart for application to such purposes in India, to the extent to which the income so accumulated or set apart is not in excess of 15% of the income from such property.

Income from Property held under trust which is applied for Charitable Purposes outside India[Section 11(1)(c)]:

Income derived from property held under trust, created on or after 1.4.1952 for charitable purpose which tends to promote international welfare in which India is interested, shall be exempt to the extent to which such income is applied to such purpose outside India. Religious trusts are not covered here.

Income derived from property held under a trust for charitable or religious purposes, created before 1.4.1952, shall be exempt to the extent to which such income is applied to such purposes outside India.

In the above two cases, it is necessary that the Board, by general or special order, has directedin either case that it shall not be included in the total income of the person in receipt of such income.

Self-Occupied but Vacant House [Section 23(3)]

In case an assesse keeps one of his own houses reserved for self-occupation but is living in a rented house elsewhere due to his employment or profession the income from such houseis taken to be NIL.

The annual value of self-occupied house shall not be NIL:

If such house or part of the house is actually let during the whole or any part of theprevious year; or
Any other benefit there from is derived by the owner from such house.

In the above cases, the annual value shall be determined as per provisions applicable forlet out properties i.e. under clause (a), (b) or (c) of section 23(1).

House used for Own Business or Profession.

There is no income chargeable to tax under this head from such house property.

Property held by Registered Trade Union [Section 10(24)].

Income from a house property owned by a registered trade union is not to be included in itsG.T.I.

Income from House Property held by following shall be exempted:

- House property held by a local authority.
- House property held by a scientific research institution.
- House property held at a political party.
- House property held by a university and any other educational institutionworking for spreading education and not to earn profit.
- House property held by a hospital or medical institution working for the spreading of medical services to people and is not meant for earning profit.
- It is income from a farmhouse.

One House Property (a palace) owned by a former ruler of Indian states.

Ex-rulers of Indian states may own many palaces but only one palace of their choice shall be treated as a self-occupied house and shall be exempted.

One Self-Occupied House

In case assessed owns one residential house, the net annual value of the same shall be taken as nil but in case he owns more than one house, then only one of his choice but normally of higher value shall be treated as a self-occupied one and other/others are treated as deemed to be let out.

Income from house property specimen / important provisions

For self-occupied:

Gross Annual Value(GAV)/ Annual Rental Value(ARV) **Less:** Municipal tax paid during the year by the owner		**Nil** **Nil**
Net Annual Value(NAV)		**Nil**
Less: Deduction u/s 24 (i) Standard deduction-not applicable (ii) Interest on loan of pre-construction	***	***
Loss from house property		***

Overall chart for computation of house property incomeFor letout property:

(i) Municipal value (or) Fair Rent (whichever is higher) (ii) Expected Rent (or) Standard Rent (whichever is lower) (iii) Expected Rent (or) Actual Rent (whichever is higher)	***	
Gross Annual Value		***
Less: (iv) Local taxes (or) Municipal taxes paid by the Owner duringthe previous year (v) Unrealized rent conditions of rule 4 are satisfied	*** ***	***
Annual value		***
Less: Deduction u/s 24 (i) 30% of Annual value (ii) Interest on borrowed capital-paid or due	*** ***	***
Income from House Property		***

INCOME FROM BUSINESS OR PROFESSION

Introduction

Provision regarding calculation of profits and gains of business or profession is dealt under section 28 to 44 of income tax act 1961. This head of the act is a major source of revenueto the government.

Business [section 2(13)]

Definition of "Business" includes any trade, commerce or manufacture or any venture or concern in the nature of trade, commerce or manufacture.

Profession [section 2(36)]

Profession involves an exercise of intellect and skill based on learning and experience. Vocation refers to any work performed on the strength of one's natural ability for the work. Regularity and profit motive are not necessary for an activity to be called a vocation.

OVER ALL CHAT FOR CALCULATION OF INCOME FROM BUSINESS

Particulars	**Amount**	**Amount**
Net profit as per P & L A/c		****
Add:		
1.Disallowed Expenses		****
2.Business Income not credited in P & L A/c		****
3.Under valuation of closing stock		****
4.Over valuation of opening stock		****
Less:		
1.Non business income credited in P & L A/c	****	
2.Allowed expenses not debited in P & L A/c	****	
3.Over valuation of closing stock	****	
4.Under valuation of opening stock	****	****
Income From Business		****

OVER ALL FORMAT FOR PROFESSIONALS LIKE DOCTORS, LAWYERS, ACCOUNTANTS, TAXCONSULTANTS

Particulars	**Amount**	**Amount**
PROFESSIONAL INCOMES:		
1.Fees [for all professional]		****
2.Operation fees, Visiting fees [for doctors]		****
3.Institute fees [for accountants]		****
4.Legal fee, practicing fees [for lawyers]		****

5.Gift from clients [for all professionals] 6.Gift from patients [for doctors] 7.Examiner fees [for all professional] 8.All other professional receipts		**** **** **** ****
Less: **PROFESSIONAL EXPENSES:** 1.Office and administrative expenses[for all professionals] 2.Clinic expenses and dispensary expenses[for doctors] 3. Cost of books for professional purposes.[for all professionals] 4. Subscription for journals.[for all professionals] 5.Depreciation a) For office equipments (for all professional) b) For surgical equipments (for doctors) 6.Any membership fee (for all professionals)7.Cost of medicine [for doctors] [opening stock +purchases-closing stock] 8.All other professional payments	**** **** **** **** **** **** **** ****	****
Income From Profession		****

Income from 'Capital Gains'

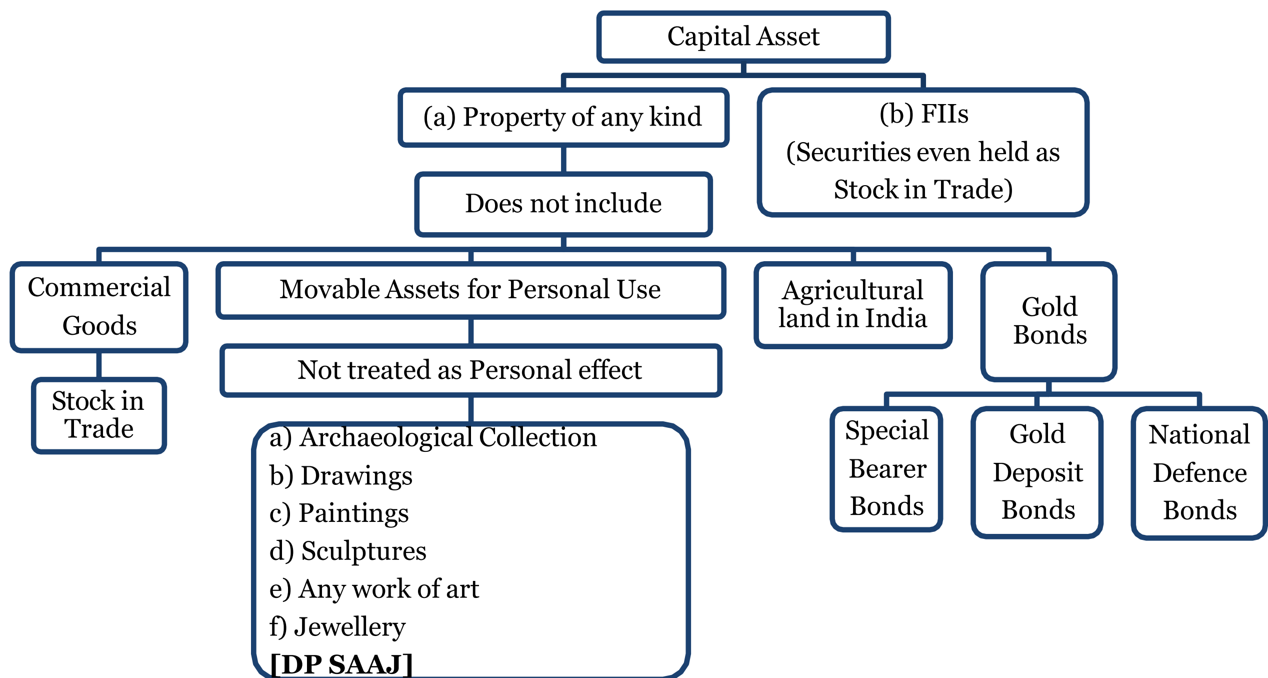
(Sec. 45 to 54)

Sec. 45(1) : Basis of Charge :

Any **profit or gain** arising from **transfer** of **capital asset** shall be charged to tax under the head capital gain in the same previous year in which **transfer took place**.

[Capital Asset + Transfer = Capital Gain / Loss (Accrual basis)]Sec. 2(14) : Capital Asset :

Capital asset means : a) Any kind of property held by an assessee, whether or not connected with business or profession of the assessee. b) Any securities held by a FII which has invested in such securities in accordance with the regulations made under the SEBI Act, 1992.



Jewellery :

a) Ornaments made of gold, silver, platinum or any other precious metal, whether or not worked or sewn into any wearing apparel.

b) Precious or semi precious stones, whether or not set in any furniture, utensil (home appliances) or other article or worked or sewn into any wearing apparel.

Agricultural Land :

The land in India, which is not situated within the limits of municipality or cantonmentboard:

Population of the municipality or cantonment board according to last preceding census	Distance from the limits of municipality or cantonment board
More than 10,000 upto 1 lakh	2 kms.
More than 1 lakh upto 10 lakhs	6 kms.

More than 10 lakhs	8 kms.

a) Property of any kind held by an assessee, whether connected with his business, profession or not.

[Capital asset may be movable or immovable, tangible or intangible, fixed or floating. It includes land, building, plant, machinery, investments, goodwill, leasehold, jewellery, shares, a manufacturing licence, etc.]

b) Any securities held by a Foreign Institutional Investor which has invested in such securities in accordance with the regulations made under SEBI Act, 1992.

Securities as Stock in Trade – transfer – Taxable u/h PGBP.

Securities as an Asset – transfer – Taxable u/h Capital Gain.

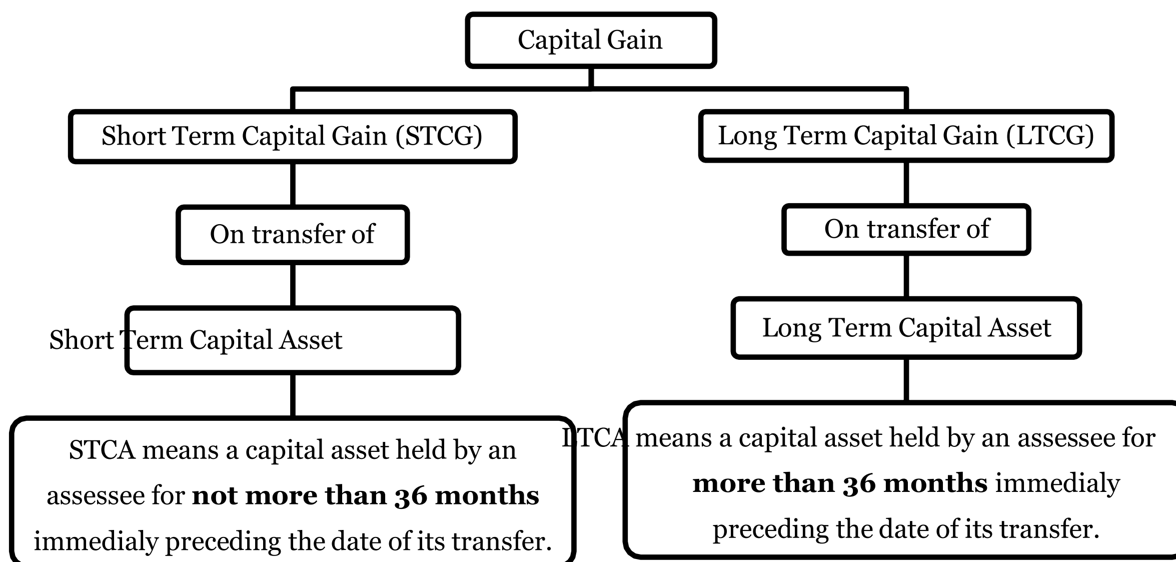
Both are taxable u/h Capital gain in the hands of FIIs.

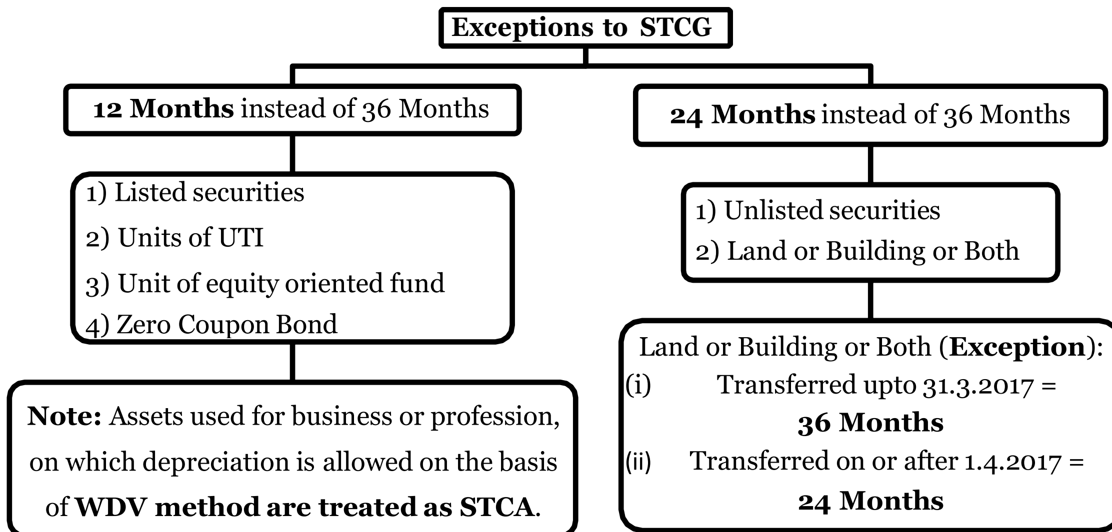
Sec. 2(47) : Transfer of Capital Asset :

Transfer includes –

a) Sale, exchange or relinquishment (give up) of the asset.
b) The extinguishment of any right.
c) Compulsory acquisition under any law.
d) Asset converted into stock in trade.
e) Conversion of business into limited co.
f) Allowing of the possession of any immovable property
g) Maturity of Zero Coupon Bond
h) Any transaction which effects the enjoyment of any immovable property.

Kinds of Capital Assets :





Sec. 47 : Certain Transactions not regarded as transfer

1) Transfer of **Capital Asset** under partition (Full or Partial) of HUF.

2) Gift or Will or an irrevocable (Unconditional transfer for long time of the beneficiary) trust.

Exceptions : Shares allotted to its employees under the scheme Employees Stock Option Plan (ESOP) is treated as transfer.

3) Holding Company Subsidiary Company.

Conditions :

i) Holding Company holds 100% shares of Subsidiary Company.

ii) Subsidiary Company is an Indian Company

4) Subsidiary Company Holding Company.

Conditions :

i) Holding Company holds 100% shares of Subsidiary Company.

ii) Holding Company is an Indian Company

5) Amalgamating Company Amalgamated Company.

Conditions : Amalgamated Company is an Indian Company.

6) Demerged Company Resulting Company.

Conditions : Resulting Company is an Indian Company.

7) Banking Company Banking Institution (Brought into force by the Central Government).

8) Foreign Amalgamating Company Foreign Amalgamated Company.

Conditions : i) At least 25% of **shareholders** remain shareholder of amalgamated foreign company.

ii) Such transfer does not attract tax in that country.

9) Foreign Demerged Company Foreign Resulting Company.

Conditions : i) Shareholders holding not less than 75% in value of shares.

ii) Such transfer does not attract tax in that country.

10) Any work of art, Archeological, Book, Manuscript, drawing, photograph Government / University / National Art Gallery / National Museum.

11) Conversion of debentures Shares / debentures of the same company.

12) **Transfer of Land** of Sick Industrial Company. (Exemption is allowed for the sickness period).

Sec. 48 : a) Computation of Short-term Capital Gains :

Short Term Capital Gain

Full value of consideration	xxx
(-) Selling expenses / Cost of Transfer	(xxx)
Net Value of Consideration	**xxx**
(-) Cost of acquisition	(xxx)
(-) Cost of Improvement	(xxx)
Short Term Capital Gain	**xxx**

Capital Gain Exempt From Tax :

1) Sec. 54 : Capital gains arising on the transfer of property used for residence.

Condition :

a) The building is owned by **individual or HUF**.

b) Such property was being used as **residential house**.

c) The income of such house property is chargeable u/h '**House Property**'.

d) The exemption will be available **only LTCA** (Period of holding is exceeding 24 months).

e) Within a period of **one year before** or **two year after** the date of transfer purchased **one residential house in India.**

f) Within a period of **three years after the date of transfer constructed** one residential house in India.

Exemption :

1. LTCG or amount invested, whichever is lower.
2. If he deposited the amount before the due date of furnishing the return under the **Capital Gains Account Scheme, 1988**, with specified bank authorized by the Central Government.

Withdrawal of exemption and tax on sale of new house :

If he sold new house (Purchased or constructed) is transferred within a period of **3 years** then the given exemption will be withdrawn. The old exempted capital gain and new capital gain shall be treated as STCG and chargeable to tax in that previous year in which the new residential house is transferred.

Tax on unutilized amount :

If the deposited amount is not utilized fully within 3 years, then the amount not utilized shall be treated as LTCG of the previous year in which the period is expires.

Effect of Capital Gains Account Scheme :

If the assessee cannot utilize the capital gain for acquisition of new house on or before the due date in order to avail this exemption. After such deposit he must utilize the deposit for acquiring the new house within 3 years from the date of transfer of the old house.

[Example No. 15, 16, 17, 18]

Sec. 54B : Capital gain arising from the transfer of agricultural land :

Condition :

a) The building is owned by **individual or HUF**.

b) Agricultural land is situated in an urban area.

c) New asset should be agricultural land (Urban or Rural)

d) The exemption will be available **on STCA / LTCA.**

e) New land should be purchased within **two year after** the date of transfer of land.

f) This land was used at least **2 years** immediately preceding the date of transfer for agricultural purposes by individua1l, parent or HUF as owner.

Exemption :

1. Capital gain or amount invested in new agricultural land, whichever is lower.
2. If assessee deposited the amount on or before the due date of furnishing the return under the **Capital Gains Account Scheme, 1988**.

Withdrawal of exemption and tax on sale of new house :

If this new land is transferred within a period of **3 years** then the given exemption will be withdrawn. The old exempted capital gain and new capital gain shall be treated as STCG and chargeable to tax in that previous year in which the new land is transferred.

Tax on unutilized amount :

If the deposited amount is not utilized fully within 2 years, then the amount not utilized shall be treated as STCG/LTCG of the previous year in which the period is expires.

Effect of Capital Gains Account Scheme :

Such deposit must utilize for the acquiring new agricultural land within 2 years from the date of transfer of the old agricultural land.

[Illustration 19]

Sec. 54D : Capital gain on compulsory acquisition of lands or buildings :Condition :

a) The land or building should be used by the assessee for the purpose of an industrial undertaking.

b) This land or building was used atleast 2 years immediately preceding the date of transfer being used for business of industrial undertaking.

c) New land or building should be purchased or construct within **three years after** the date of transfer for the purpose of shifting or reestablishing the industrial undertaking or setting up another industrial undertaking in that building.

Exemption :

1. Capital gain or amount invested in new land or building for acquisition or construction, whichever is lower.
2. If assessee deposited the amount on or before the due date of furnishing the return under the **Capital Gains Account Scheme, 1988**.

Withdrawal of exemption and tax on sale of new house :

If this new asset is transferred within a period of **3 years** then the given exemption will be withdrawn. The old exempted capital gain and new capital gain shall be treated as STCG and chargeable to tax in that previous year in which the new land is transferred.

Tax on unutilized amount :

If the deposited amount is not utilized fully **within 3 years,** then the amount not utilized shall be treated as STCG of the previous year in which the period is expires.

Effect of Capital Gains Account Scheme :

Such deposit must utilize for the acquiring new land or building **within 3 years** from the date of transfer of the old agricultural land.

Goods and Services Tax (GST): An Overview

I. Introduction

Introduction of GST would be a significant step in the field of indirect taxreforms in India. By amalgamating a large number of Central and State taxes into a single tax and allowing set-off of prior-stage taxes, it would mitigate theill effects of cascading and pave the way for a common national market. For the consumers, the biggest gain would be in terms of a reduction in the overall tax burden on goods, which is currently estimated at 25%-30%. Introduction of GST would also make our products competitive in the domestic and international markets. Studies show that this would instantly spur economic growth.There may also be revenue gain for the Centre and the States due to widening of tax base, increase in trade volumes and improved tax compliance. Last but not the least, this tax, because of its transparent character, would be easier to administer.

II. Genesis

2. The idea of moving towards the GST was first mooted in the Budget for 2006-07. The Empowered Committee of State Finance Ministers (EC) which had formulated the design of State VAT was requested to come up with a roadmap and structure for the GST. Joint Working Groups of officials having representation of the States as well as the Centre were set up to examine variousaspects of the GST and draw up reports specifically on exemptions and thresholds, taxation of services and taxation of inter-State supplies. Based on discussions within and between it and the Central Government, the Empowered Committee released its First Discussion Paper on the GST in November, 2009. This spells out the features of the proposed GST and has formed the basis for discussion between the Centre and the States so far.

III. Salient Features of GST

3. The salient features of GST are as under:

(i) The GST would be applicable on the supply of goods or services as against the present concept of tax on the manufacture and sale of goods or provision of services. It would be a destination based consumption tax.

(ii) It would be a dual GST with the Centre and States simultaneously levying it on a common tax base. The GST to be levied by the Centre on intra- State supply of goods and / or services would be called Central GST (CGST) and that to be levied by the States would be called State GST (SGST).

(iii) The GST would apply to all goods other than alcoholic liquor for human consumption and five petroleum products, viz. petroleum crude, motor spirit (petrol), high speed diesel, natural gas and aviation turbine fuel. It would apply to all services barring a few to be specified.

(iv) Tobacco and tobacco products would be subject to GST. In addition, the Centre could levy Central Excise duty on these products.

(v) The GST would replace the following taxes currently levied and collected by the Centre:

a. Central Excise duty
b. Duties of Excise (Medicinal and Toilet Preparations)
c. Additional Duties of Excise (Goods of Special Importance)
d. Additional Duties of Excise (Textiles and Textile Products)
e. Additional Duties of Customs (commonly known as CVD)
f. Special Additional Duty of Customs (SAD)
g. Service Tax

(vi) State taxes that would be subsumed under the GST are:

a. State VAT
b. Central Sales Tax
c. Luxury Tax
d. Entry Tax in lieu of octroi
e. Entertainment Tax (not levied by the local bodies)
f. Taxes on advertisements
g. Purchase Tax
h. Taxes on lotteries, betting and gambling
i. State cesses and surcharges insofar as they relate to supply ofgoods and services

(vii) An Integrated GST (IGST) would be levied and collected by the Centre on inter-State supply of goods and services. Accounts would be settled periodically between the Centre and the States to ensure that the SGST portion of IGST is transferred to the destination State where the goods or services are eventually consumed.

(viii) Tax payers shall be allowed to take credit of taxes paid on inputs (input tax credit) and utilize the same for payment of output tax.However, no input tax credit on account of CGST shall be utilized towards payment of SGST and vice versa. The credit of IGST would be permitted to be utilized for payment of IGST, CGST and SGST in that order.

(ix) HSN (Harmonised System of Nomenclature) code shall be used for classifying the goods under the GST regime. Taxpayers whose turnover isabove Rs. 1.5 croresbut below Rs. 5 crores shall use 2 digit code and the taxpayers whose turnover isRs. 5 croresand above shall use 4 digit code.

(x) Exports shall be treated as zero-rated supply. No tax is payable on export goods but credit of the input tax related to the supply shall be admissible to exporters.

(xi) Import of goods and services would be treated as inter-State supplies and would be subject to IGST in addition to the applicable customs duties.

(xii) The laws, regulations and procedures for levy and collection of CGST and SGST would be harmonized to the extent possible.

IV. GST and Centre-State Financial Relations

4. Currently, the fiscal powers between the Centre and the States are clearly demarcated in the Constitution with almost no overlap between the respective domains. The Centre has the powers to levy tax on the manufacture of goods (except alcoholic liquor for human consumption, opium, narcotics etc.) whilethe States have the powers to levy tax on the sale of goods. In the case of inter- State sales, the Centre has the power to levy a tax (the Central Sales Tax) but, the tax is collected and retained entirely by the States. As for services, it is the Centre alone that is empowered to levy service tax.

Introduction of the GST would require amendments in the Constitution so as to simultaneously empower the Centre and the States to levy and collect this tax. The assignment of simultaneous jurisdiction to the Centre and the States forthe levy of GST would require a unique institutional mechanism that would ensure that decisions about the structure, design and operation of GST are taken jointly by the two. For it to be effective, such a mechanism also needs to have Constitutional force.

V. Amendment of the Constitution and Other Legislative Requirements

(a) Constitution (One Hundred and Twenty Second) Amendment Bill, 2014

5. To address all these and other issues, aConstitution Amendment Bill was introduced in the LokSabha and the Bill (122nd Amendment Bill) has since beenpassed by the LokSabha (May, 2015). The Bill is currently under consideration of the RajyaSabha.The salient features of the Bill are as under:

(i) The GST shall be levied on all goods and services except alcoholic liquor forhuman consumption.

(ii) The tax shall be levied as dual GST separately by the Union and the States.

(iii) Parliament will have power to make laws with respect to GST imposed by the Union (CGST) and the State Legislatureswill have power to make laws with respect to GST imposed by the States (SGST).

(iv) Parliament will have exclusive power to make laws with respect to GST where the supply of goods and/or services takes place in the course of inter- State trade or commerce (IGST).

(v) The Government of India (GoI) will have exclusive power to levy and collect GST on inter-State trade or commerce.This tax shall be apportioned between the Union and States on the recommendations of the GST Council by Parliament by law.

(vi) Petroleum& petroleum products would be subject to GST. [However, it has been decided that these products would be kept out of the purview of GST in the initial years of implementation]. In the case of tobacco and tobacco products, the Centre alone would have the power to levy excise duty in addition to the GST.

(vii) Taxes on entertainments and amusements to the extent levied and collected by a Panchayat or a Municipality or a Regional Council or a District Council shall not be subsumed under GST.

(viii) Parliament may, by law, provide for compensation to States for revenue loss arising out of the implementation of the GST, based on the recommendations of the GST Council. Such compensation would be for aperiod of 5 years.

(ix) A GST Council would be constituted comprising the Union Finance Minister (who will be the Chairman of the Council), the Minister of State (Revenue) and the State Finance/Taxation Ministers to recommend on

(a) thetaxes, cesses and surcharges to be subsumed under GST;

(b) the goods and services that may be subjected to or exempted from the GST;

(c) the date from which the specified petroleum products would be subject to GST;

(d) model GST laws, principles of levy, apportionment of IGST and the principles that govern the place of supply;

(e) the threshold limit of turnover below which the goods and services may be exempted from GST;

(f) the rates including floor rates with bands of GST;

(g) any special rate or rates for a specified period to raise additional resources during any natural calamity or disaster; and

(h) special provision with respect to the North-East States, J&K, Himachal Pradesh and Uttarkhand.

The mechanism of GST Council would ensure some degree ofharmonization on different aspects of GST between the Centre and the States as well as among States. It is being specifically provided that the GST Council, in its discharge of various functions, shall be guided by the need for a harmonized structure of GST and for the development of a harmonized national market for goods and services.

5.3 The GST Council may decide about the modalities to resolve disputes arising out of its recommendation.

6. The Constitution Amendment Bill is expected to be passed by the RajyaSabha in the ensuing monsoonsession of Parliament. After ratification of the amendment bill by 50% of State legislatures and receipt of assent by the President, the process of enactment would be complete.

(b) Other Legislative Requirements

7. Suitable legislation for the levy of GST (Central GST Bill, Integrated GST Bill and State GST Bills) drawing powers from the Constitution can be introduced in Parliament or the State Legislaturesonly after the enactment of the Constitution Amendment Bill.Unlike the Constitutional Amendment which requires 2/3rd majority, the GST Bills would need to be passed by a simple majority. Obviously, the levy of the tax can commence only after the GST law has been enacted by the respective legislatures. Also, unlike the State VAT, the date of commencement of this levy would need to be synchronized across the Centre and the States. This is because the IGST model cannot function effectively unless the Centre and all the States participate simultaneously.

VI.Work on the Various Aspects of GST: Recent Developments and WorkAhead

(a) Model GST Law

8. The Model GST Law, jointly drafted by the tax officials of the Centre and States, has been placed on the website of the Ministry of Finance for suggestions/comments.The model CGST/SGST legislation contains 162 sections spread over 25 Chapters and 4 Schedules. The draft sets out the provisions of taxable event, taxable person, time of supply, valuation of supply and input tax credit. The draft also deals with the various administrative and procedural aspects of levy, such as, registration, filing of returns, assessment, payment of tax, maintenance of accounts, refunds, audit, demands and recovery, inspection, search, seizure and arrest, offences and penalties, prosecution, appeals and revision, advance ruling and transitional provisions.

9. Under the GST regime, tax is payable by the taxable person on the supplyof goods and/or services. Liability to pay tax arises when the taxable person crosses the threshold exemption, i.e. Rs.10 lakhs. The CGST / SGST is payable on all intra-State supply of goods and/or services and IGST is payable on all inter-State supply of goods and/or services. Intra-State supply of goods and/or services refers to those transactions where the location of the supplier and the place of supply are in the same State. Inter-State supply of goods and/or services refers to those transactions where the location of the supplier and the place of supply are in different States.The CGST /SGST and IGST are payableat the rates specified in the Schedules to the respective Acts.

10. The draft IGST law contains 33 sections divided into 11 Chapters. The draft, inter alia, sets out the rules for determination of the place of supply of

goods.Where the supply involves movement of goods, the place of supply shall be the location of goods at the time at which the movement of goods terminates for delivery to the recipient.Where the supply does not involve movement of goods, the place of supply shall be the location of such goods at the time of delivery to the recipient.Where the goods are assembled or installed at site, the place of supply shall be the place of such installation or assembly.Where the goods are supplied on board a conveyance the place of supply shall be the location at which such goods are taken on board.

The draft also sets out in detail the rules for determination of the place of supply of services. As per the draft, the place of supply of services (other than somespecified exceptions)made to a registered person shall be the location of such person and thatmade to a person other than a registered person shall be the location of the recipient where the address on record exists. In other cases, i.e. where the address on record is not available, the place of supply shall be the location of the supplier of service.The draft law has also set out rules for determining the place of supply of certain services like immovable property, restaurant and catering, training and performance appraisal, admission to a cultural, scientific or educational event, organization of a fair, exhibition etc., transportation of goods, passengers, telecommunications, banking, insurance and financial services.

The draft IGST law deals with cross utilization of IGST credit. It hasbeen provided that on utilization of IGST credit for payment of CGST, the Central Government shall transfer an amount equal to the credit so utilized from the IGST account to CGST account.Likewise, on utilization of IGST credit for payment of SGST, the Central Government shall transfer an amount equal to the credit so utilized from the IGST account to SGST account.The draft provides for apportionment of tax collected under this Act and settlement of funds.It has also been provided that certain provisions of the CGST Act such as registration, valuation, time of supply, exemption, ITC, audit, assessment, demands, adjudication, refund, search, seizure and arrest, prosecution, appeals, shall apply*mutatis mutandis*to this Act.

11. The Model Law has been drafted keeping in view certain policy objectives, such as, clarity in tax laws, tax laws which are easy to administer,tax laws which are non-adversarial and tax payer-friendly, and which improves “ease of doing business”. An attempt has been made to provide a fair dispute

resolution mechanism for tax payers under GST.The highlights of the ModelLaw are as under:

Minimal interface

The physical interface between the tax payer and the tax authorities would be minimal under GST. Certain important provisions in this regard are:

(i) Registration will be granted on line and shall be deemed to have been granted if no deficiency is communicated to the applicant within 3 common working days.

(ii) Taxable person shall himself assess the taxes payable (self-assessment) and credit it to the account of the Government.

(iii) Payment of tax shall be made electronically through internet banking. Smaller taxpayers shall be allowed to use the systems generated challanand pay tax at the bank counter.

(iv) The tax payer shall furnish the details of sales and purchases electronically without any physical interface with the tax authorities.

(v) Tax payers shall file, electronically, monthly returns of sales and purchases, ITC availed, tax payable, tax paid and other prescribed particulars.Composition tax payers shall file, electronically, quarterly returns. Omission/incorrect particulars can be self-rectifiedbefore the filing of annual return.

(vi) Matching, reversal and reclaim of input tax credit shall be done electronically on the GSTN portal without any tax payer contact. [This would prevent, *inter alia*, input tax credit being taken on the basis of fake invoices or twice on the same invoice.]

(vii) Tax payers shall be allowed to keep and maintain accounts and other records in electronic form.

Input tax credit

The provisions of input tax credit have been prone to litigation. The Model GST law provides an elaborate mechanism for availment and utilization of ITC and seeks to impart clarity so as to minimize disputes. The important provisions of the law are:

(i) Tax payer is allowed to take credit of taxes paid on inputs (input tax credit), as self-assessed, in his return.

(ii) Taxpayer can take credit of taxes paid on all goods and services, other than a few in the negative list, and utilize the same for payment of output tax.

(iii) Credit of taxes paid on inputs shall be allowed where the inputs are used for business purposes or making taxable supplies.

(iv) Full input tax credit shall be allowed on capital goods on its receipt as against the current Central Government practice of staggering the credit in two equal instalments.

(v) Unutilized input tax credit can be carried forward.

(vi) The facility of distribution of input tax credit amongst group companies has been provided for.

Refund

Refund provisions have been simplified and made more taxpayer friendly. Some of the important provisions of the Model GST law are:

(i) Time limit for claiming refund has been increased from one year to two years.

(ii) Refund claim along with documentary evidence is to be filed online without any physical interface and the tax refund will be directly credited to the nominated bank account of the applicant.

(iii) Refund shall be granted within 90 days from the date of receipt of application. Interest is payable if refund is not sanctioned within the stipulated period of 90 days.

(iv)If the refund claim is less than Rs. 5 lakhs, there is no need for the claimant to furnish any documentary evidence that he has not passed on the incidence of tax to any other person. Only a self-certification to this effect would suffice.

(v) Refund of input tax credit shall be allowed in case of exports or where the credit accumulation is on account of inverted duty structure (i.e. where the tax rate on output is higher than that on inputs).

(vi) In case of refund claim on account of exports, 80% of the claim shall be paid immediately on a provisional basis without verification of documentary evidence.

Demands

Keeping in mind complaints of long delays in issuance of adjudication orders, a new concept of sunset clause for tax disputes has been introduced. The important provisions in this regard are:

(i) Adjudication order shall be issued within 3 years of filing of annual return in normal cases.

(ii) The time limit is 5 years (of filing of annual return) in fraud/suppression cases.

(iii) There are no separate time lines for issue of SCN and adjudication order, asat present under Central Laws.

(iv) Provisions for settlement of cases have been made available to taxpayers at every stage, right from audit/investigation to the stage of passing of adjudicationorder and even thereafter.

(v) Penalty is minimal if the tax short paid / non-paid is deposited along with interest at the stage of audit/investigation.

(vi) The officer shall in his order set out the relevant facts and the basis of his decision.

(vii) The amount of tax, interest and penalty demanded in the order shall not be in excess of the amount specified in the notice.

(viii) No demand shall be confirmed on grounds other than the grounds specified in the notice.

Audit

The manner of conducting audit has been a sore point with the taxpayers. In the Model GST law, certain disciplines have been brought in, as enumerated below, to streamline the process of audit.

(i) It is not necessary that in all cases the tax authorities would have to visit the place of business of the taxpayer for conducting audit. The audit can even be conducted at the office of the tax authorities.

(ii) Tax payer shall be informed sufficiently in advance, not less than 15 working days, prior to the conduct of audit.

(iii) The audit shall be carried out in a transparent manner and completed generally within a period of 3 months from the date of commencement of audit.

(iv) On conclusion of audit, the proper officer shall without delay notify the taxable person of the findings, the taxable person's rights and obligations and reasons for the findings.

Penalty disciplines

Another area of dissatisfaction of the taxpayers has been the propensity of the tax authorities to impose disproportionately high penalties for breaches of law which may not be that serious. In order to address this concern, certain general disciplines, as mentioned below, have been incorporated in the Model GST Law.

(i) No substantial penalties shall be imposed for minor breaches of tax regulations or procedural requirements.

(ii) No penalty shall be imposed in respect of any omission or mistake in documentation which is easily rectifiable and obviously made without fraudulent intent or gross negligence.

(iii) Penalty shall be commensurate with the degree and severity of the breach.

(iv) No penalty shall be imposed without issue of Show Cause Notice and without giving personal hearing.

(v) Reasoning is to be given in the order, specifying the nature of the breach and the applicable laws or procedure.

(vi) In case of voluntary disclosure of breach, the tax authorities may consider this fact as a potential mitigating factor when establishing a penalty for that person.

Alternate dispute resolution mechanism

The various modes of dispute resolution like advance ruling and Settlement Commission have been continued under GST law.

(i) Advance ruling can be sought in respect of more subjects than allowed at present. The subjects are: classification of goods/or services, method of valuation, rate of tax, admissibility of input tax credit, liability to pay tax, liability to take registration and whether a particular transaction amounts to a supply under GST law.

(ii) The facility of appeal, which is not there under the Central law, has been provided in the Model GST Law. The applicants, if aggrieved by the advance ruling, would henceforth get the opportunityto file an appeal before the Appellate Authority for revision of the ruling.

(iii) The provision of Settlement Commissionhas been included in IGST Law only.

Transitional provisions

In the Model GST law, elaborate transitional provisions have been made to enable smooth migration of tax payers from the present regime to GST. The important provisions in this regard are:

(i) The existing taxpayers shall be issued a certificate of registration valid for 6 months. Upon furnishing of prescribed information, registration shall be grantedon a final basis.

(ii) The amount of Cenvat credit / VAT carried forward in a return shall be allowed to be taken as input tax credit subject to certain conditions. Un-availed Cenvat credit on capital goods, not carried forward in a return, shall also be allowed to be taken as ITC subject to certain conditions.

(iii) Credit of eligible duties and taxes in respect of inputs held in stock shall be allowed to a registered taxable person subject to fulfilment of certain conditions.

(iv) Credit of eligible duties and taxes in respect of inputs held in stock shall be allowed to a taxable person switching over from the composition scheme to the normal scheme.

(v) No tax is payable on the goods removed/despatched earlier but returned to the place of business after the introduction of GST. This is subject to the

condition that the goods are returned within a period of 6 months after the introduction of GST.

(vi) Likewise, no tax shall be payable on the inputs, semi-finished goods and finished goods removed/despatched earlier for job work or for carrying out certain processes and returned to the place of business after the introduction of GST.This is subject to the condition that the inputs / goods are returned within a period of 6 months after the introduction of GST.

(vii) Pending refund claims shall be disposed of in accordance with the provisions of earlier law and the amount of refund shall be paid to the claimant in cash, subject to certain conditions.

(viii) Pending claim of Cenvat credit /input tax credit shall be disposed of in accordance with the provisions of earlier law and the amount of refund shall be paid to the claimant in cash, subject to certain conditions.

(ix) No tax shall be payable on the supply of goods and /or services made before the introduction of GST where a part of consideration for the said supply is received on or after the introduction of GST, but the full duty or tax payable on such supply has already been paid under the earlier law.

(x) No tax shall be payable on the goods sent on approval basis before the introduction of GST but are rejected and returned to the seller on or after the introduction of GST if such goods are returned within 6 months from the introduction of GST.

Other provisions of Model GST Law

The Model Law contains several other provisions which are taxpayer friendly and are meant for facilitating trade. The provisions worth mentioning here are:

(i) Valuation of goods shall be done on the basis of transaction value i.e. the invoice price, which is the current practice under the Central Excise and Customs Laws.

(ii) Tax payments for all months shall be made in the succeeding month. Tax dues of March are thus to be paid in April and not March, as at present in the Central Government. Composition taxpayers filing quarterly returns and thereby

paying tax on a quarterly basis will be required to pay tax in the monthsucceeding the quarter-end.

(iii) Taxpayers are allowed to issue supplementary or revised invoice in respect of a supply made earlier.

(iv) Taxpayers are allowed to file the details of sales and purchases, and the various returns through Tax Return Preparers.

(v) The facility of provisional assessment to tax payers in cases where he is unable to determine the value or rate of tax has been allowed.

(vi) New modes of payment of tax are being introduced, viz. through credit and debit cards, National Electronic Fund Transfer (NEFT) and Real Time Gross Settlement (RTGS).

(vii) The Commissioner has been empowered to grant extension of time for payment of certain tax dues or allow payment of such amount in monthly instalments to the tax payer.

(viii) The facility of job work has been continued under the GST regime.

(ix) E-Commerce companies shall collect tax at source in relation to any supplies made through their online platforms at the rate notified by the Government. This would eliminate the issues around the levy of entry tax on e- commerce transactions.

(x) Exports shall be treated as zero rated supply. No tax is payable on exports but credit of the input tax related to that supply is admissible.

(xi)Provision has been made for the Government to provide remission of tax onsupplies which are found to be deficient in quantity due to any natural causes.

(xii) A separate schedule (schedule II) has been provided to clarify certain typesof supply as either supply of goods or of services. For example,supply ofintangibles, works contract supplies, lease transactions and restaurant supplies are categorised as supply of services. Hopefully, this would put an end to the prevailing confusion on their tax treatment.

(b) GST Rules and Regulations

12. Preparation of GST Rules and Regulations is another major area of work which needs to be completed well in advance before the implementation of

GST.This is to be jointly drafted by the officials of the Central Government andState Governments. The CBEC has set up a Working Group for this purpose.

(c) IT preparedness

13. Putting in place a robust IT network is an absolute must for implementation of GST. A Special Purpose Vehicle called the GSTN has been set up to cater to the needs of GST.The GSTN shall provide a shared ITinfrastructure and services to Central and State Governments, tax payers and other stakeholders for implementation of GST. The functions of the GSTN would, *inter alia,* include: (i) facilitating registration; (ii) forwarding the returns to Central and State authorities; (iii) computation and settlement of IGST; (iv) matching of tax payment details with banking network; (v) providing various MIS reports to the Central and the State Governments based on the tax payer return information; (vi) providing analysis of tax payers' profile; and (vii)running the matching engine for matching, reversal and reclaim of input tax credit.

The GSTN is developing a common GST portal and applications for registration, payment, return and MIS/reports. The GSTN would also be integrating the common GST portal with the existing tax administration IT systems and would be building interfaces for tax payers. Further, the GSTN is developing back-end modules like assessment, audit, refund, appeal etc. for 19 States and UTs (Model II States). The CBEC and Model I States (15 States) are themselves developing their GST back-end systems. Integration of GST front- end system with back-end systems will have to be completed and tested well in advance for making the transition smooth.

(e) Training and Workshops

14. A detailed calendar has since been drawn up for training the Central and State Government officers and staff on GST law, regulations and procedure. Some 10 officers from the Central Government and 15 officers from the State Governments have been identified as Source Trainers who would be training a pool of some 300 Master Trainers of the Central Government/State Governments who, in turn, would be training some 1600 Trainers drawn from the Central Government and State Governments. The Trainers would then train some 70,000 Central/State Government tax officials at the field level. Presentations and training materials are being prepared for this purpose. Training courses would be held at the various locations of the country.

Training of trade and industry on GST law and procedure is equally important. It has been decided to hold seminars/workshops in 50 cities spread across the country to prepare the trade and industry on GST law, rules, regulations and procedure. Sectoral seminars/workshops for specific sectors such as IT, E-commerce, telecommunications and financial services are proposed to be organised at New Delhi, Bangalore and Mumbai. Further, the GSTN would be imparting training to the officials and trade & industry on GST IT systems. Creating consumer awareness about the benefits of GST is also part of the work plan to be completed before the introduction of GST.

15. The target date for introduction of GST is 1st April 2017. Introduction of this transformational tax reform is expected to broaden the tax base, increase tax compliance and reduce economic distortions caused by inter-State variations in taxes. GST will boost economic activity and will benefit everyone. It will streamline the tax administration, avoid harassment of the business and result in higher revenue collection for the Centre and States. Compliance costs for the industry will go down.Last but not the least, it will create more jobs.

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MBA II SEM IV

Subject :- International Finance

Chapter No. 1 International Business Environment

Nature and Scope of International Financial Management

International finance-the finance function of a multinational firm has two functions-treasury and control. The treasurer is responsible for financial planning analysis, fund acquisition, investment financing, cash management, investment decision and risk management. Controller deals with the functions related to external reporting, tax planning and management, management information system, financial and management accounting, budget planning and control, and accounts receivables etc. Multinational finance is multidisciplinary in nature. While an understanding of economic theories and principles is necessary to estimate and model financial decisions, financial accounting and management accounting help in decision making in financial management at multinational level. Because of changing nature of environment at international level, the knowledge of latest changes in forex rates, volatility in capital market, interest rate fluctuations, macro level changes, micro level economic indicators, savings, consumption pattern, interest preference, investment behavior of investors, export and import trends, competition, banking sector performance, inflationary trends, demand and supply conditions etc. is required by the practitioners of international financial management.

Nature of the financial Management

1. IFM is concerned with financial decisions taken in international business.
2. IFM is an extension of corporate finance at international level.
3. IFM set the standard for international tax planning and international accounting
4. IFM includes management of exchange rate risk.

Scope of the financial Management:

1. IFM includes working capital management of multinational enterprises.
2. Foreign exchange markets, international accounting, exchange rate risk management etc.
3. It also includes management of finance functions of international business.

4. IFM sorts out the issues relating to FDI and foreign portfolio investment.
5. It manages various risks such as inflation risk, interest rate risks, credit risk and exchange rate risk.
6. It manages the changes in the foreign exchange market.
7. It deals with balance of payments in global transactions of nations.

Meaning & Introduction of International Finance

The international business activity has been in existence for hundreds of years. Adam Smith
in his book "Wealth of Nations" wrote that if a foreign country can supply us with a commodity cheaper than ourselves can make it, it is better to buy it, of them with some part of the produce of our own, in which, we have some advantage.
As human societies and economies evolved, production was increasingly for exchange, not
for consumption by the producer as in an earlier era; exchange with local communities and
villages then within reasons and across countries and finally cross border.
So, the systematic effort to facilitates the free flow of goods and services, across national
boundaries, is called international finance.
Rapid economic growth in the Western countries joined, in the process, and growth of international trade continues unabated. Despite the difficulties and road blocks, integration of the world economy is moving forward. Fast means of communication have made the world a small village. No single nation can remain aloof today, without having to transact with others. Exchange of goods/services, financial resources, technology development and skilled manpower is the reality of today's international finance.
The world trade has in fact grown at a pace much faster than the world output. For several countries, the growth has been described as EXPORT ORIENTED GROWTH, since the share of exports in their GDP is significantly high.
Though it is very difficult to define the term international finance, because the domain of
it, are very large and infinite. Since international finance involves MNCs, national government's rules and regulations, regarding flow of capital, across the borders of the country, the international finance discipline is vivid and complex.

The term international finance is defined on the basis of various parameters:

(*a*) It is a discipline of financing the international economic and commercial relations between countries.
(*b*) It includes international markets (such as international banking, euro currency market,
eurobond, international stock exchanges, American Depository Receipts, GDRs, international institutions *viz.,* IMF, World Bank, Asian Development Bank, Brics Bank, China, WTO, UNCTAD, Letters of Credit, Bill of Lading, factoring and the like, international financial instruments foreign exchange markets, Balance of Payments and International risk management.
(*c*) It is related to management, economic, commercial and accounting activities of MNCs,
governments and private individuals.
(*d*) It involves conversion of one currency into another.
(*e*) It coordinates all financial and non-financial operations with the objectives of of the shareholders' wealth.
In case of India, the period after 1991 has been one of liberalisation and integration with
the world economy. Now India has got the policy of "export and prosper".

Importance of International Finance

India and other developing countries feel the need for increasing their share in international
exchange of goods, services, capital and technology. Some of the important steps taken over
during the last 25 years can be summarised as below —

(*i*) establishment of unified market determined exchange-rate.
(*ii*) introduction of current account convertibility and introduction of capital account convertibility in a phased or later period.
(*iii*) reduction in import duties.
(*iv*) liberalisation of portfolio and FDI.

Over a period of time, large size business houses, *i.e.,* Multinational Corporations have
production and sales activities spread in many countries.
The process of integration of world economy has witnessed the creation of very dynamic

international financial market. A new field of finance *viz.*, financial engineering has come into existence. The market of present day offers a large variety of financial products for investment, speculation and risk management. The financial market with innovative products present vast opportunities as well as unprecedented risks. Now, more and more companies are venturing into international operations in one form or another. Some companies, may be doing only exports, others may be doing both exports and imports while some may be doing exports, imports and investments.

Scope of International Finance

Traditionally, international finance has been viewed as management of MNCs that engage
in some form of international business. (A business firm is considered an international player
according to Fortune Magazine, when its international sales exceed 20% of total). These MNCs continuously devise strategies to improve their cash flows and enhance shareholder wealth. Penetration of foreign market creates opportunities for improving the company's cash flows. The dismantlingof barriers to entry encourage companies to pursue international business. Liberal trade is the principal driver of internationalisation which encompasses unimpeded flows of capital labour and technology across national boundaries. Free trade is always beneficial because it encourages nations to specialise in the products they are best at and import those they are less good at. This results in efficient allocation of resources and maximisation of welfare. Corporates go through different stages in this pursuit, export products or import supplies from foreign manufacturerinitially to establishing subsidiaries in foreign countries.

The extent, pattern and modes of international companies' activity have been greatly influenced by the political, technological and economic events in the last three decades. The mobility aidedby computer technologies and wireless is offering international companies' wider options in respect of both the creation and use of these assets and products.

The data on stock of outward foreign direct investment by large companies and inbound
foreign investments by major host countries, show that foreign based activities of international companies, is the method for serving foreign markets. In all major economies, *viz.,* USA, Germany, U.K., Japan and European countries, the role of domestic and/or foreign based companies is increasing. Inwards FDI in 2004 was, 3.4% of GDP in India and 1.4% of outward FDIs of GDP.

While the world as a whole, the percentage share in 2004 was 7.5% of inward FDI as against
8.7% of outward FDIs Outward direct investment has been influenced by the opening up of
erstwhile communist countries especially China.

Globalisation & India's financial sector reforms

Global finance has assumed greater relevance in the new economic world order. The phenomenal changes that have occurred drastically after the advent of international institutions, international markets, currency convertibility, the balance of payments position reversed to Northward journey of many economies gave a rigorous boost to international finance.
The modern way of penetrating into the new markets by hitherto restricted markets catapultedthe domain of international finance. The massive growth of multinational companies from internationalcompany to Global company, to transnational company, gave way to the renewed and necessarysignificance to international finance. Every country, on the growth path, transverse to financial aspects to a great extent to increase their economic growth and GDP. The main players in the
international finance are multinational corporations, who are, more stronger than the national governments. At the end of 2013 the world's largest 500 multinational corporations were situated in different countries as below:

Rank	Country	Companies
1	U.S.A	132 companies
2	China	89
3	Japan	62
4	U.K.	37
5	France	31
6	Germany	29
7	Netherlands	22
8	Switzerland	14
9	South Korea	14
10	Canada	09
11	Australia	08
12	Italy	08
13	Brazil	08
14	Spain	08
15	India	08
16	Russia	07
17	Taiwan	06

Out of 8 MNCs in India, five are in public sector and the remaining 3 are in the private
sector. These MNCs wield their powers, in such a manner that the things may go topsy-turvy
or rather the economies are made to bloom and blossom. International finance is the talk of thetown or nation or world because finance is the lifeblood of every organisations, the economyand the running of world-trade. International finance encompasses, other than MNCs, the foreignexchange markets, international methods of payments, international financial markets, exchangerates, international risk management and so on. The financial management globally necessitatesthe international movement of FDI and capital inflows through foreign institutional investors.

The world has entered an era of unprecedented internationalisation and globalisation of
economic activity. Each nation is economically related to the nations of the world through a
complex network of international traditions and financial relationships in this context; internationalfinance has also become increasingly important as it links world trade and foreign investments.Inflow of foreign investments in the world during 2012 was $ 1351 bn. as against outflows of$ 1391 bn. The largest recipient of foreign invesxtments was USA with $ 168 bn. in 2012 asagainst largest provider of foreign investments by USA in 2012 with $ 329 bn. As capital marketsof the world are becoming more integrated, a solid understanding of international finance hasbecome essential for intelligent corporate decision making. The liberalisation of internationaltrade has internationalise consumption patterns. The production of goods and services has alsobecome globalised on account of the efforts of international firms to source inputs and locateproduction anywhere in the world, where costs are lower and profits higher. This has given rise to outsourcing which is viewed as exporting jobs from advanced countries to countries, where costs are LOWER. In US globalisation is now seen as a phenomenon that makes rich countries poorer.

Financial markets around the globe are integrated US pension and mutual funds diversify
their investment portfolios internationally. The Japanese investors have been investing in US
and other financial markets in efforts to re-cycle their trade surpluses. Cross Listing of shares
(stock) on foreign stock exchanges has helped trading of shares and provides access to foreign capital as well. Financial globalisation which may give rise to higher capital inflows may not however lead to higher growth since it influences

capital labour ratios and not total factor productivity. International companies now force a world where consumption, production and investment decisions are globalised.
These trends especially of globalisation cannot be stopped. The hostility toward globalization arises from the uneven distribution of benefits and costs across countries.

Goals of International Finance

There are various goals of international finance. These are:

1. To achieve higher rate of profits: International companies search for foreign markets
that hold promise for higher rate of profits. Thus, the objective of profit affects and motivates
FUNDAMENTALS OF INTERNATIONAL FINANCE 5the business to expand its operations to foreign countries. For example, Hewlett Packard in US earned 86.2% of its profits from the foreign markets, compared to that of domestic markets, in 2007. Apple earned, US $ 730 million as net profit from the foreign markets and only US $ 620 mn. as net profit, from its domestic market, in 2007.

2. Expansion of production capacities: Some of the domestic companies expanded their
production capacities more than the demand for the product in the domestic countries. These
companies in such cases, are forced to sell their excess production in foreign developed countries.
Toyota of Japan is an example.

3. Severe competition in the home country: The weak companies which could not meet
the competition of the strong companies in the domestic country started entering the markets
of the developing countries.

4. Limited home market: When the size of the home market is limited due to the smaller
size of the population or due to lower purchasing power of the people or both, the companies

internalise their operations. For example, most of the Japanese automobile and electronic firms entered the U.S., Europe and even African markets due to the smaller size of the home market.
I.T.C. entered the European market due to the lower purchasing power of Indians with regard
to high quality cigarettes.
Similarly, the mere six million population of Switzerland, is the reason for Ciba-Geigy to
internationalise its operations. In fact, this company was forced to concentrate on global market and establish manufacturing facilities in foreign countries.

5. Political stability vs. political instability: Political stability does not simply mean that
continuation of the same party in power, but it does not mean that continuation of the same
policies of the Government for a quieter longer period. It is viewed that the U.S.A. is a politically stable country.
Similarly, UK, France, Germany, Italy and Japan are also politically stable countries. International companies prefer, to enter the politically stable countries and are restrained from locating their business operations in politically instable countries. In fact, business companies shift their operations from politically instable
countries to politically stable countries.

6. Availability of technology and skilled human resources: Availability of advanced technology and competent human resources, in some countries act as PULLING FACTORS for international companies. The developed countries due to these reasons attract companies from the developing world American and European companies, depended on Indian companies for software products and services through their BPOs. The cost of professionals in India is 10 to 15 times less compared to US and European markets. These factors helped Indian software industry to grow at a faster rate with world class standards. Added to this, satellite communications help Indian companies to serve the global business without going globally.

7. High cost of transportation: The major factor in lower profit margins to international
companies, is the cost of transportation of the products. Under such conditions, the foreign

companies are inclined to increase their profit margin by locating their manufacturing facilities in foreign countries, where there is enough demand either in one country or in a group of neighbouring countries. For example, Mobil, which was supplying the petroleum products to Ethiopia, Kenya, Eritrea, Sudan, etc. from its refineries, in Saudi Arabia, established its refinery facility in Eritrea, in order to reduce the cost of transportation.

8. Nearness to raw materials: The source of highly qualitative raw materials and bulk
raw materials is a major factor for attracting the companies from various foreign countries. Most of the US based and European based companies located their manufacturing facilities in Saudi Arabia, Bahrain, Qatar, Iran etc. due to availability of petroleum.

9. Availability of quality human resources: This is a major factor for software, high
technology and telecommunication companies to locate their operations in India. India is a major source for high quality and low cost human resources.

10. Liberalisation and globalisation: Most of the countries in the world, liberalised their
economies and opened their countries to the rest of the world.

11. Increased market share: Some of the large scale international companies like to enhance their market share in the world market by expanding and intensifying their operations in various foreign countries. Foe example, Ball Corporation, the third largest beverage cans manufacturer in the USA, bought the European Packaging operations of continental can company. Then it expanded its operations in Europe and met the Europe demand, which is 200 per cent more than that of USA. Thus, it increased its global market share of soft drink cans.

12. To achieve higher rate of economic development: International companies help the
governments to achieve higher growth rate of the economy, increase the total and per capita
GDP, industrial growth, employment and income levels.

13. Tariffs and import quotas: It was quite common before globalisation that governments

imposed tariffs or duty on imports to protect the domestic companies. Sometimes government also fixes import quotas to reduce the competition to the domestic companies from competent foreign companies. To avoid high tariffs and quotas companies prefer direct investments to go globally. For example, companies like Sony, Honda and Toyota preferred direct foreign investment in various countries by establishing subsidiaries or through joint ventures.

1. Investment and financing across the nations widen the scope of IFM to international accounting standards.
2. It widens the scope of tax laws and taxation strategy of both parent country and host country.
3. It helps in taking decisions related to international business.

Chapter No. 3 Foreign Exchange market

Function and Structure of the Forex markets, major participants, types of transactions and settlements dates, foreign exchange quotations. Process of arbitrage, speculation in the forward market.
Currency futures and options markets, overview of the other markets, Euro currency market, Euro credit market,Euro bond market, international stock market.

Foreign Exchange Market

Foreign exchange market is the market in which foreign currencies are bought and sold. The buyers and sellers include individuals, firms, foreign exchange brokers, commercial banks and the central bank. Like any other market, foreign exchange market is a system in which the transactions are not confined to only one or few foreign currencies. There are a large number of foreign currencies which are traded, converted and exchanged in the foreign exchange market. The foreign exchange market assists international trade and investment by enabling currency conversion. For example, it permits a business in the United States to import goods from the European Union member states especially Euro zone members and pay Euros, even though its income is in United States dollars. The foreign exchange market (forex, FX, or currency market) is a form of exchange for the global decentralized trading of international currencies.

Characteristics of foreign exchange market

1. Electronic market

2. Geographical Dispersal
3. Transfer of purchasing power
4.Intermediary Volume
5. Provision of credit
6. Minimizing Risk.

Structure of the Foreign Exchange Market

Retail Market

Transactions are exchange of current, bank draft, bank notes ordinary and traveller's cheques etc. Retail banking consists of a large number of small customers who consume personal banking and small business services. Retail banking is largely intra-bank: the bank itself.

1. **Wholesale markets**

The wholesale market comprises of commercial banks and investment banks. This is broadly classified as inter-bank market and central bank market. Wholesale banking typically involves a small number of very large customers such as large corporate and governments, Wholesale banking is largely interbank: banks use the inter -bank markets to borrow from or lend to other banks, to participate in large bond issues, and to engage in syndicated lending.

2. **Inter-bank**

The interbank network consists of a global network of financial institutions that trade currencies between each other to manage exchange rate and interest rate risk. The largest participants in this network are private banks. Most transactions within the interbank network are for a short duration, anywhere between overnight to six months. The interbank market is not regulated.

a) Spot market

Spot market refers to the transactions involving sale and purchase of currencies for immediate delivery. In practice, it may take one or two days to settle transactions. Transactions are affected at prevailing rate of exchange at that point of time and delivery of foreign exchange is affected instantly. The exchange rate that prevails in the spot market for foreign exchange is called Spot Rate.

b) Forward Market

A market in which foreign exchange is bought and sold for future delivery is known as Forward Market. It deals with transactions (sale and purchase of foreign exchange) which are contracted today but implemented sometimes in future. Exchange rate that prevails in a forward contract for purchase or sale of foreign exchange is called Forward Rate. Thus, forward rate is the rate at which a future contract for foreign currency is made.

c) Derivatives

Within the fields of trading and finance, a derivative is considered to be an instrument used for investment via a contract. Its value is "derived" from (or based upon) that of another asset, typically referred to as the underlying asset or simply "the underlying." In other words, a derivative contract is an agreement that allows for the possibility to purchase or sell some other type of financial instrument or

non-financial asset. Common types of derivative contracts include options, forwards, futures and swaps.

 Future Market: Standardized forward contracts are called futures contracts and traded on a futures exchange. A futures contract (more colloquially, futures) is a standardized contract between two parties to buy or sell a specified asset of standardized quantity and quality for a price agreed upon today (the futures price or strike price) with delivery and payment occurring at a specified future date.

 Option Market: A currency option gives an investor the right, but not the obligation, to buy or sell a quantity of currency at a pre-established price on or before the date that the option expires. The right to sell a currency is known as a "call option" and the right to buy is known as a "put option." Options can be understood as a type of insurance where buyers or sellers can take advantage of more favourable prices should market conditions change after the option is purchased.

 Swap Market: The idea of a swap by definition normally refers to a simple exchange of property or assets between parties. A currency swap also involves the conditions determining the relative value of the assets involved. That includes the exchange rate value of each currency and the interest rate environment of the countries that have issued them. A foreign exchange swap, forex swap, or FX swap is a simultaneous purchase and sale of identical amounts of one currency for another with two different value dates (normally spot to forward)

Types of transactions & settlements in FOREX Market

The Foreign Exchange Transactions refers to the sale and purchase of foreign currencies. Simply, the foreign exchange transaction is an agreement of exchange of currencies of one country for another at an agreed exchange rate on a definite date.

1 Spot Transaction

The spot transaction is when the buyer and seller of different currencies settle their payments within the two days of the deal. It is the fastest way to exchange the currencies. Here, the currencies are exchanged over a two-day period, which means no contract is signed between the countries. The exchange rate at which the currencies are exchanged is called the Spot Exchange Rate. This rate is often the

prevailing exchange rate. The market in which the spot sale and purchase of currencies is facilitated is called as a Spot Market.

2 Forward Transaction

A forward transaction is a future transaction where the buyer and seller enter into an agreement of sale and purchase of currency after 90 days of the deal at a fixed exchange rate on a definite date in the future. The rate at which the currency is exchanged is called a ‗Forward Exchange Rate'. The market in which the deals for the sale and purchase of currency at some future date are made is called a ‗Forward Market'. **Future Transaction:** The future transactions are also the forward transactions and deals with the contracts in the same manner as that of normal forward transactions. But however, the transactions made in a future contract differ from the transaction made in the forward contract on the following grounds:

 The forward contracts can be customized on the client's request, while the future contracts are standardized such as the features, date, and the size of the contracts is standardized.

 The future contracts can only be traded on the organized exchanges, while the forward contracts can be traded anywhere depending on the client's convenience.

 No margin is required in case of the forward contracts, while the margins are required of all the participants and an initial margin is kept as collateral so as to establish the future position.

3 Swap Transactions

The Swap Transactions involve a simultaneous borrowing and lending of two different currencies between two investors. Here one investor borrows the currency and lends another currency to the second investor. The obligation to repay the currencies is used as collateral, and the amount is repaid at a forward rate. The swap contracts allow the investors to utilize the funds in the currency held by him/her to pay off the obligations denominated in a different currency without suffering a foreign exchange risk. **Option Transactions:** The foreign exchange option gives an investor the right, but not the obligation to exchange the currency in one denomination to another at an agreed exchange rate on a pre-defined date. An option to buy the currency is called as a ‗Call Option' while the option to sell the currency is called as a ‗Put Option'. Thus, the Foreign exchange transaction involves the conversion of a currency of one country into the currency of another country for the settlement of payments.

4. Settlement dates

Settlement date, as the name implies refers to the date on which the transaction is settled by the transferor of deposits, with reference to foreign exchange transactions. In a Spot exchange transaction, though the word "Spot" implies "immediate", it usually takes two business days for the transaction to get settled. Though the spot rate is the rate of the day on which the transaction has taken place, the execution of the transaction occurs within a maximum of two working days. But in certain cases of countries currencies, the settlement may take place the very next business day, an example being currency settlement between

US Dollars and Canadian Dollars. There are two aspects involved in settlement dates: the settlement location and dealing location. Settlement location refers to the country in which the transaction has to be settled or paid and dealing location refers to the country in which the bank dealing with the foreign exchange transaction is located. Forward exchange rates are applicable for the delivery of foreign exchange at some future date, which may be specified. There are two options in forward exchange transactions. Let us assume that Emirates in UAE is purchasing aircrafts from the United States. Obviously, the settlement has to be made in US dollars. Suppose if the agreement between the two countries is to settle the payment after 2 months time, there are now two options available for Emirates, UAE: one, to remain silent now and after 2 months period, buy the US Dollars at the spot market at the then prevailing spot rate and settle the payment to the United States. In this case, the settlement date will be as per the Spot Exchange transaction. Secondly, the country can buy US dollars at the forward exchange market at the agreed prevailing forward exchange rate, which would be valid for settlement after two months period, irrespective of the spot rate prevailing at the time of settlement after two months. The second option avoids uncertainty and risk and the settlement takes place at the maturity of the forward exchange contract.

Exchange rate quotations

These can be quoted in two ways-**Direct** quotation and **Indirect** quotation. Direct quotation is when the one unit of foreign currency is expressed in terms of domestic currency. Similarly, the indirect quotation is when one unit of domestic currency us expressed in terms of foreign currency.

Since the US dollar (USD) is the most dominant currency, usually, the exchange rates are expressed against the US dollar. However, the exchange rates can also be quoted against other countries' currency, which is called as cross currency.

Now, a lower exchange rate in a direct quote implies that the domestic currency is appreciating in value. Whereas, a lower exchange rate in an indirect quote indicates that the domestic currency is depreciating in value as it is worth a smaller amount of foreign currency

Currency futures and options markets

1. **Exchange-traded derivative**

option, the arithmetic average of the Exchange-traded derivative contract are standardized derivative contracts such as futures and options contracts that are transacted on an organized futures exchange. They are standardized and require payment of an initial deposit or margin settled through a house. Since the contracts are standardized, accurate pricing models are often available. To understand which derivative is being traded a standardized naming convention has been developed by

the exchanges, that shows the expiry month and strike price using special letter codes.

2. **Over the Counter derivatives**

Over the Counter (OTC) derivatives are traded between two parties (bilateral negotiation) without going through an exchange or any other intermediaries. OTC is the term used to refer stocks that trade via dealer network and not any centralized exchange. These are also known as unlisted stocks where the securities are traded by broker-dealers through direct negotiations.

3. **Options** Currency option (also known as a forex option) is a contract that gives the buyer the right, but not the obligation, to buy or sell a certain currency at a specified exchange rate on or before a specified date. For this right, a premium is paid to the seller.

Currency options are one of the most common ways for corporations, individuals or financial institutions to hedge against adverse movements in exchange rates.

 Call options provide the holder the right (but not the obligation) to purchase an underlying asset at a specified price (the strike price), for a certain period of time. If the stock fails to meet the strike price before the expiration date, the option expires and becomes worthless. Investors buy calls when they think the share price of the underlying security will rise or sell a call if they think it will fall. Selling an option is also referred to as "writing" an option.

 Put options give the holder the right to sell an underlying asset at a specified price (the strike price). The seller (or writer) of the put option is obligated to buy the stock at the strike price. Put options can be exercised at any time before the option expires. Investors buy puts if they think the share price of the underlying stock will fall, or sell one if they think it will rise. Put buyers - those who hold a "long" - put are either speculative buyers looking for leverage or "insurance" buyers who want to protect their long positions in a stock for the period of time covered by the option.

 American option is a version of an options contract that allows holders to exercise the option rights at any time before and including the day of expiration. An American style option allows investors to capture profit as soon as the stock price moves favorably.

 European Option is a version of an options contract that limits execution to its expiration date. In other words, if the underlying security such as a stock has moved in price an investor would not be able to exercise the option early and take delivery of or sell the shares. Instead, the call or put action will only take place on the date of option maturity.

 Asian option (also known as average price option) is an option whose payoff is determined with respect to the (arithmetic or geometric) average price of the underlying asset over the term of the option.

 While the payoff of a standard (American and European) option depends on the price of the underlying asset at a specific point of time i.e. the exercise date, the payoff of an Asian option depends on the average price of the underlying asset that prevailed over a period of time i.e. the term of the option.

 There are two types of Asian options with respect to the method of averaging: in arithmetic Asian price of the underlying is used in payoff calculations; while in geometric Asian options, geometric average is used.
 Asian options have relatively low volatility due to the averaging mechanism. They are used by traders who are exposed to the underlying asset over a period of time such as consumers and suppliers of commodities, etc.

Relation between inflation, interest rates and exchange rates

While exchange rates can be subject to myriad factors in intraday trading-from market sentiment, breaking economic news, and cross-border trade and investment flows -inflation and interest rate policy are often important indicators for exchange rate trends-they can help traders gain an idea of what is likely to be a profitable trade for foreign exchange positions taken over longer periods. Inflation is commonly thought of as the pace at which prices increase in a given economy and determines the "worth" of money in relation to goods and services offered. If more money is perceived to be circulating at a given time, suppliers of goods and services typically react by adjusting their prices upward, meaning less can be purchased with a given unit of currency. Conversely, if the offer of money by consumers appears to be scarce, suppliers often react by lowering prices to attract buyers, meaning inflation will decelerate and money in that economy will gain relative value.

Measures of Inflation Inflation is normally measured by governments using groups of price levels for goods in varying sectors known as price indices. These include measures such as a producer price index (PPI), which measures wholesale inflation, and a consumer price index (CPI), which measures inflation for consumers. Governments and central banks frequently use these indices to help determine their economic measures through instruments such as inflation-targeting strategies. Inflation in the economies of currencies being traded is an important factor to consider because it affects the relative value of those currencies internationally and because it can determine future policy adjustments by governments and central banks.

Interest Rates
Through use of monetary policy, national central banks attempt to adjust their base **interest rates** and available banking money reserves to control the rate of lending

by banks within their economies. The theory is that when there is more, or cheaper, money perceived to be available in the economy through bank loans and other types of credit, consumers and businesses will spend more, sellers of goods and services will adjust prices upward, and inflation can accelerate. Conversely, when there is less, or more expensive, money available, consumers and businesses will restrict their spending, prices will fall, and inflation will decelerate. Thus, if central banks want to curb inflation, they will raise interest rates; and if they want to induce spending and economic activity, they will lower interest rates.

Interest Rate Parity While directly related to inflation control policy, interest rates are also considered to have their own particular relevance for foreign exchange trading because of what is known as interest rate parity. This theory posits that the real interest rates (interest rates less inflation) across borders tend to move toward equilibrium, and that currencies in economies with higher interest rates tend to weaken over time.
However, where capital is allowed to move freely across borders, investors will seek to put their money in countries where they can get the highest returns. Thus, if one country has a higher interest rate than another, money will tend to flow to the country with the higher interest rate, causing that country's weaker currency to once again appreciate over time. When the currency has risen to an equilibrium price level .

Chapter No. 4 Exchange Rate Mechanism

Exchange rate quotations

These can be quoted in two ways-**Direct** quotation and **Indirect** quotation. Direct quotation is when the one unit of foreign currency is expressed in terms of domestic currency. Similarly, the indirect quotation is when one unit of domestic currency us expressed in terms of foreign currency.
Since the US dollar (USD) is the most dominant currency, usually, the exchange rates are expressed against the US dollar. However, the exchange rates can also be quoted against other countries‘ currency, which is called as cross currency.
Now, a lower exchange rate in a direct quote implies that the domestic currency is appreciating in value. Whereas, a lower exchange rate in an indirect quote indicates that the domestic currency is depreciating in value as it is worth a smaller amount of foreign currency

International arbitrage and interest rate parity

Arbitrage can be defined as capitalizing on a discrepancy in quoted prices. The funds invested are not tied up and no risk is involved. In response to the imbalance in demand and supply resulting from arbitrage activity, prices will realign very quickly, such that no further risk-free profits can be made. Locational arbitrage is the process of buying a currency at the location where it is priced cheap and immediately selling it at another location where it is priced higher. Locational arbitrage is possible when a bank‘s buying price (bid) is higher than another bank‘s selling price (ask) for the same currency. Triangular Arbitrage in which currency transactions are conducted in the spot market to capitalize on a discrepancy in the cross exchange rate between two currencies. This is possible, if quoted cross exchange rate differs from the appropriate cross exchange rate. When the exchange rates of the currencies are not in equilibrium, triangular arbitrage will force them back into equilibrium. Covered Interest Arbitrage is the process of capitalizing on the interest rate differential between two countries, while covering for exchange rate risk. Covered interest arbitrage tends to force a relationship between forward rate premiums and interest rate differentials. As many investors capitalize on covered interest arbitrage, there is Upward pressure on the spot rate and Downward pressure on the 90-day forward rate. Once the forward rate has a discount from the spot rate that is about equal to the interest rate advantage, covered interest arbitrage will no longer be feasible. **Interest Rate Parity (IRP)** Sometimes market forces cause the forward rate to differ from the spot rate by an amount that is sufficient to offset the interest rate differential between the two currencies. Then, covered interest arbitrage is no longer feasible, and the equilibrium state achieved is referred to as interest rate parity (IRP).

When IRP exists, it does not mean that both local and foreign investors will earn the same returns. What it means is that investors cannot use covered interest arbitrage to achieve higher returns than those achievable in their respective home countries.

where its cost is no longer offset by gains from its higher interest rate, it reaches interest rate parity and further investment flows from abroad come to a halt. Currency traders, then, hope to predict future exchange rate movements by paying attention to the relative levels of inflation in the countries of their target currency pairs in addition to where each country is in its monetary policy cycle, and the size and pace of currency flows moving into and out of each country.

Purchasing Power Parity Theory

Under the theory of Purchasing Power Parity, the change in the exchange rate between two countries' currencies is determined by the change in their relative price levels locally that are affected by inflation. It is generally agreed that this theory mostly holds true over the long run, but economists have found that it can suffer distortions over the short term because of trade and investment barriers, local taxation, and other factors. As a result of this relationship, one can expect the currencies of countries with higher inflation rates to weaken over time versus their peers, whereas currencies of countries with lower inflation rates tend to strengthen. In economies with weak production of local goods and services, the depreciation of the local currency can at times even be accelerated by the "pass-through effect" of importing foreign goods with relatively higher prices. When a country‘s inflation rate rises relative to that of another country, decreased exports and increased imports depress the high-inflation country‘s currency because of worsening trade and current account balances. Purchasing Power Parity (PPP) theory attempts to quantify this inflation-exchange rate relationship.

Interpretations of PPP

- The absolute form of PPP is an extension of the law of one price. It suggests that the prices of the same products in different countries should be equal when measured in a common currency.
- The relative form of PPP accounts for market distortions like transportation costs, labor costs, tariffs, taxes, and quotas. It states that the rate of price changes should be similar.

Rationale behind PPP Theory

Suppose U.S. inflation > U.K. inflation.

- U.S. imports from U.K.
- U.S. exports to U.K., and U.S. current account

 Downward pressure (depreciation) is placed on the $. This shift in consumption and the $'s depreciation will continue until
in the U.S.: price U.K. goods ≥price U.S. goods and
in the U.K.: price U.S. goods ≤ price U.K. goods

Derivation of PPP
Assume that PPP holds. Over time, as inflation occurs exchange rates adjusts to maintain PPP: $Ph1 \rightarrow Ph0\ (1 + Ih)$
Where $Ph1$=home country's price index, year-1 end
Ih =home country's inflation rate for the year
$Pf1 \rightarrow Pf0\ (1 + If)(1 + ef)$
where Pf = foreign country's price index
If = foreign country's inflation rate
ef = foreign currency's % in value
If PPP holds $Ph1 = Pf1$ and $Ph0\ (1 + Ih) = Pf0\ (1 + If)\ (1 + ef)$

Solving for $ef = (1 + Ih) / (1 + If) - 1$
$Ih > If$ $ef > 0$ i.e. foreign currency appreciates
$Ih < If$ $ef < 0$ i.e. foreign currency depreciates
Example: Suppose $IU.S. = 9\%$ and $IU.K. = 5\%$.
Then $e £ =\{ (1 + 0.09) / (1+0.05)\} – 1 = 3.81\%$
When the inflation differential is small, the PPP relationship can be simplified as
ef $Ih – If$

Testing the PPP Theory

Conceptual Test Plot actual inflation differentials and spot exchange rate changes for two or more countries on a graph. If the points deviate significantly from the PPP line over time, then PPP does not hold.

Statistical Test Apply regression analysis to historical exchange rates and inflation differentials:
$ef = a0 + a1\ [(1+ Ih)/(1+ If) – 1] +$
Then apply t-tests to the regression coefficients (Test for $a\ 0 = 0$ and $a\ 1 = 1$.) .If any coefficient differs significantly from what was expected, PPP does not hold.
Empirical studies indicate that the relationship between inflation differentials and exchange rates is not perfect even in the long run. However, the use of inflation differentials to forecast long-run movements in exchange rates is supported. A limitation in the tests is that the choice of the base period will affect the result.

PPP does not hold. Empirical studies indicate that the relationship between inflation differentials and exchange rates is not perfect even in the long run. However, the use of inflation differentials to forecast long-run movements in exchange rates is supported. A limitation in the tests is that the choice of the base period will affect the result. PPP does not occur consistently due to confounding effects, a lack of substitutes for some traded goods**.** Exchange rates are also affected by differences in inflation, interest rates, income levels, government controls and expectations of future rates. PPP can be tested by assessing a ―real‖ exchange rate over time (e.g., crawling pegs). The real exchange rate is the actual exchange rate adjusted for inflationary effects in the two countries of concern. If the real exchange rate follows a random walk, it cannot be viewed as being a constant in the long run. Then PPP does not hold.

Factors influencing Exchange rates

Foreign Exchange rate (ForEx rate) is one of the most important means through which a country‘s relative level of economic health is determined. A country's foreign exchange rate provides a window to its economic stability, which is why it is constantly watched and analyzed. While sending or receiving money from overseas, there‘s a need to keep a keen eye on the currency exchange rates. The exchange rate is defined as "the rate at which one country's currency may be converted into another." It may fluctuate daily with the changing market forces of supply and demand of currencies from one country to another. For these reasons; when sending or receiving money internationally, it is important to understand what determines exchange rates.

i) **Inflation Rates** Changes in market inflation cause changes in currency exchange rates. A country with a lower inflation rate than another‘s will see an appreciation in the value of its currency. The prices of goods and services increase at a slower rate where the inflation is low. A country with a consistently lower inflation rate exhibits a rising currency value while a country with higher inflation typically sees depreciation in its currency and is usually accompanied by higher interest rates

ii) **Interest Rates** Changes in interest rate affect currency value and dollar exchange rate. Forex rates, interest rates, and inflation are all correlated. Increases in interest rates cause a country's currency to appreciate because higher interest rates provide higher rates to lenders, thereby attracting more foreign capital, which causes a rise in exchange rates

iii) **Country’s Current Account / Balance of Payments** A country‘s current account reflects balance of trade and earnings on foreign investment. It consists of total number of transactions including its exports, imports, debt,

etc. A deficit in current account due to spending more of its currency on importing products than it is earning through sale of exports causes depreciation. Balance of payments fluctuates exchange rate of its domestic currency.

iv) **Government Debt** Government debt is public debt or national debt owned by the central government. A country with government debt is less likely to acquire foreign capital, leading to inflation. Foreign investors will sell their bonds in the open market if the market predicts government debt within a certain country. As a result, a decrease in the value of its exchange rate will follow.

v) **Terms of Trade** Related to current accounts and balance of payments, the terms of trade is the ratio of export prices to import prices. A country's terms of trade improves if its exports prices raise at a greater rate than its imports prices. This results in higher revenue, which causes a higher demand for the country's currency and an increase in its currency's value. This results in an appreciation of exchange rate.

vi) **Political Stability & Performance**

A country's political state and economic performance can affect its currency strength.

A country with less risk for political turmoil is more attractive to foreign investors, as a result, drawing investment away from other countries with more political and economic stability. Increase in foreign capital, in turn, leads to an appreciation in the value of its domestic currency.

A country with sound financial and trade policy does not give any room for uncertainty in value of its currency. But, a country prone to political confusions may see depreciation in exchange rates.

vii) **Recession** When a country experiences a recession, its interest rates are likely to fall, decreasing its chances to acquire foreign capital. As a result, its currency weakens in comparison to that of other countries, therefore lowering the exchange rate.

viii) **Speculation** If a country's currency value is expected to rise, investors will demand more of that currency in order to make a profit in the near future. As a result, the value of the currency will rise due to the increase in demand. With this increase in currency value comes a rise in the exchange rate as well. All of these factors determine the foreign exchange rate fluctuations. If you send or receive money frequently, being up-to-date on these factors will help you better evaluate the optimal time for international money transfer. To avoid any potential falls in currency exchange rates, opt for a locked-in exchange rate service, which will guarantee that your currency is exchanged

at the same rate despite any factors that influence an unfavorable fluctuation.

Chapter No. 5 Risk in International operations

Foreign exchange risk

Foreign exchange risk refers to the losses that an international financial transaction may incur due to currency fluctuations. Also known as currency risk, FX risk and exchange-rate risk, it describes the possibility that an investment‘s value may decrease due to changes in the relative value of the involved currencies. Investors may experience jurisdiction risk in the form of foreign exchange risk.

Understanding Foreign Exchange Risk Foreign exchange risk arises when a company engages in financial transactions denominated in a currency other than the currency where that company is based. Any appreciation / depreciation of the base currency or the depreciation / appreciation of the denominated currency will affect the cash flows emanating from that transaction. Foreign exchange risk can also affect investors, who trade in international markets, and businesses engaged in the import / export of products or services to multiple countries.
The proceeds of a closed trade, whether its a profit or loss, will be denominated in the foreign currency and will need to be converted back to the investor's base currency. Fluctuations in the exchange rate could adversely affect this conversion resulting in a lower than expected amount.
An import/export business exposes itself to foreign exchange risk by having account payables and receivables affected by currency exchange rates. This risk originates when a contract between two parties specifies exact prices for goods or services, as well as delivery dates. If a currency‘s value fluctuates between when the contract is signed and the delivery date, it could cause a loss for one of the parties.

Types of Foreign Exchange Risk

There are three types of foreign exchange risk:
Transaction risk: This is the risk that a company faces when it's buying a product from a company located in another country. The price of the product will be denominated in the selling company's currency. If the selling company's currency were to appreciate versus the buying company's currency then the company doing

the buying will have to make a larger payment in its base currency to meet the contracted price.

Translation risk: A parent company owning a subsidiary in another country could face losses when the subsidiary's financial statements, which will be denominated in that country's currency, have to be translated back to the parent company's currency.

Economic risk: Also called forecast risk, refers to when a company‘s market value is continuously impacted by an unavoidable exposure to currency fluctuations. Companies that are subject to FX risk can implement hedging strategies to mitigate that risk. This usually involves forward contracts, options, and other exotic financial products and, if done properly, can protect the company from unwanted foreign exchange moves.

Capital risk management-Different types

Sometimes referred to as investment risk, capital market risk is a term that refers to one of the risks associated with investing. Capital markets such as the stock, bond, foreign currency and derivatives markets are considered risky because of the constantly changing prices of the securities that are traded. In other words, security prices are volatile. Securities prices are not influenced just by their fundamentals, but also by broader market influences such as economic news, political developments, currency movements, or even ―black-swan‖ unexpected events such as a massive earthquake, tsunami or general market panic. While debatable, some consider price volatility to be a proxy for risk. The risk of financial loss associated with either choosing to or being forced to sell a security when prices have declined is what is meant by **capital market risk.**

Types of Capital risk

i. Market risk

Market risk is the possibility of an investor experiencing losses due to factors that affect the overall performance of the financial markets in which he or she is involved. Market risk, also called "systematic risk," cannot be eliminated through diversification, though it can be hedged against in other ways.

ii. Industry risk

Industry Risk refers to the impact that the state's industrial policy can have on the performance of a specific industry.

iii. Regulatory Risk

Regulatory risk is the risk that a change in regulations or legislation will affect a security, company, or industry. Companies must abide by regulations set by governing bodies that oversee their industry. Therefore, any change in regulations can cause a rippling effect across an industry. Regulations can increase costs of operations, introduce legal and administrative hurdles, and sometimes even restrict a company from doing business.

iv. Business Risk

Business risk can be defined as uncertainties or unexpected events, which are beyond control. In simple words, we can say business risk means a chance of incurring losses or less profit than expected. These factors cannot be controlled by the businessmen and these can result in a decline in profit or can also lead to a loss. Business risk is the possibilities a company will have lower than anticipated profits or experience a loss rather than taking a profit. Business risk is influenced by numerous factors, including sales volume, per-unit price, input costs, competition, and the overall economic climate and government regulations.

v. Interest rate risk

Interest rate risk is the danger that the value of a bond or other fixed-income investment will suffer as the result of a change in interest rates. Investors can reduce interest rate risk by buying bonds that mature at different dates. They also may allay the risk by hedging fixed-income investments with interest rate swaps and other instruments. A long-term bond generally offers a maturity risk premium in the form of a higher built-in rate of return to compensate for the added risk of interest rate changes over time.

vi. Liquidity Risk

Liquidity risk is the **risk** that a company or bank may be unable to meet short term financial demands. This usually occurs due to the inability to convert a security or hard asset to cash without a loss of capital and/or income in the process

vii. Product Risk

Product risk is the **risk** that you may not actually be able to deliver the **product** to **market** within the resources (time, money) that you have available to you. And if you do deliver the **product**, the **risk** is also in that the **product** may not work exactly as well as hoped or promised or envisioned. Types of product market risks are:

1. Credit/Default risk
2. Basis risk
3. Settlement risk
4. Currency risk
5. Foreign exchange risk
6. Commodity risk

i. Credit/Default risk

A **credit risk** is the **risk** of **default** on a debt that may arise from a borrower failing to make required payments. In the first resort, the **risk** is that of the lender and includes lost principal and interest, disruption to cash flows, and increased collection costs. The loss may be complete or partial. Default risk can be gauged using standard measurement tools, including FICO scores for consumer credit, and credit ratings for corporate and government debt issues. Credit ratings for debt issues are provided by nationally recognized statistical rating organizations (NRSROs), such as Standard & Poor's (S&P), Moody's, and Fitch Ratings. Default risk can change as a result of broader economic changes or changes in a company's financial situation. Economic recession can impact the revenues and earnings of

many companies, influencing their ability to make interest payments on debt and, ultimately, repay the debt itself. Companies may face factors such as increased competition and lower pricing power, resulting in a similar financial impact. Entities need to generate sufficient net income and cash flow to mitigate default risk.

ii. Basis risk

Basis risk is the financial **risk** that offsetting investments in a hedging strategy will not experience price changes in entirely opposite directions from each other.

iii. Settlement risk

Settlement risk-also often called **delivery risk** - is the risk that one party will fail to deliver the terms of a contract with another party at the time of settlement. Settlement risk can also be the risk associated with **default**, along with any timing differences in a settlement between the two parties. Default risk can also be associated with principal risk.

iv. Currency risk

Currency Risk, sometimes referred to as exchange rate risk, is the possibility that currency depreciation will negatively affect the value of one's assets, investments, and their related interest and dividend payment streams, especially those securities denominated in foreign currency.

v. Foreign exchange risk

Foreign exchange risk refers to the losses that an international financial transaction may incur due to **currency** fluctuations. **Foreign exchange risk** can also affect investors, who trade in international markets, and businesses engaged in the import / export of products or services to multiple countries. They are classified into three types:

1. Transaction risks
2. Translation risks
3. Economic risks

vi. Commodity risk

Commodity risk refers to the uncertainties of future market values and of the size of the future income, caused by the fluctuation in the prices of **commodities**. These **commodities** may be grains, metals, gas, electricity etc. Commodity price risk to buyers stems from unexpected increases in commodity prices, which can reduce a buyer's **profit margin** and make budgeting difficult. For example, automobile manufacturers face commodity price risk because they use commodities like steel and rubber to produce cars. In the first half of 2016, steel prices jumped 36%, while natural rubber prices rebounded by 25% after declining for more than three years. This led many Wall Street financial analysts to conclude that auto manufacturers and auto parts makers could see a negative impact on their profit margins.

Interest Rate Risk

Interest rate risk is the probability of a decline in the value of an asset resulting from unexpected fluctuations in interest rates. Interest rate risk is mostly

associated with fixed-income assets (e.g., bonds) rather than with equity investments. The interest rate is one of the primary drivers of a bond's price.

The current interest rate and the price of a bond demonstrate an inverse relationship. In other words, when the interest rate increases, the price of a bond decreases.

The inverse relationship between the interest rate and bond prices can be explained by opportunity risk. By purchasing bonds, an investor assumes that if the interest rate increases, he or she will give up the opportunity of purchasing the bonds with more attractive returns. Whenever the interest rate increases, the demand for existing bonds with lower returns declines as new investment opportunities arise (e.g., new bonds with higher return rates are issued).

Although the prices of all bonds are affected by interest rate fluctuations, the magnitude of the change varies among bonds. Different bonds show different price sensitivities to interest rate fluctuations. Thus, it is imperative to evaluate a bond's duration while assessing the interest rate risk.

Generally, bonds with a shorter time to maturity carry a smaller interest rate risk compared to bonds with longer maturities. Long-term bonds imply a higher probability of interest rate changes. Therefore, they carry a higher interest rate risk.

How to Mitigate Interest Rate Risk?

Similar to other types of risks, the interest rate risk can be mitigated. The most common tools for interest rate mitigation include:

1. Diversification

If a bondholder is afraid of interest rate risk that can negatively affect the value of his portfolio, he can diversify his existing portfolio by adding securities whose value is less prone to the interest rate fluctuations (e.g., equity). If the investor has a "bonds only" portfolio, he can diversify the portfolio by including a mix of short-term and long-term bonds.

2. Hedging

The interest rate risk can also be mitigated through various hedging strategies. These strategies generally include the purchase of different types of derivatives.

The most common examples include interest rate swaps, options, futures, and forward rate agreements (FRAs).

Chapter No. 6 Balance of Payment

Balance of Payments (BOP), fundamentals of BOP, Accounting components of BOP, factors affecting international trade flows, agencies that facilitate international flows. Indian BOP trends. International Monetary System: Evolution, gold standard, Bretton Woods_s system, the flexible exchange rate regime, evaluation of floating rates, the current exchange rate arrangements, the economic and monetary union (EMU).

Balance Of Payments:
Fundamentals, Accounting Components

Balance of payments **(BOP)** accounts are an accounting record of all monetary transactions between a country and the rest of the world. These transactions include payments for the country's exports and imports of goods, services, financial capital, and financial transfers. The Bop is a collection of accounts conventionally grouped into three main categories with subdivisions in each. The three main categories are:

(a) **The Current Account:** Under this are included imports and exports of goods and services and uni-lateral transfers of goods and services.

(b**) The Capital Account**: Under this are grouped transactions leading to changes in foreign financial assets and liabilities of the country.

(c) **The Reserve Account**: In principle this is no different from the capital account in as much as it also relates to financial assets and liabilities. However, in this category only ―reserve assets‖ are included.

The IMF definition: The International Monetary Fund (IMF) use a particular set of definitions for the BOP accounts, which is also used by the Organization for Economic Cooperation and Development (OECD), and the United Nations System of National Accounts (SNA). The main difference in the IMF's terminology is that it uses the term "financial account" to capture transactions that would under

alternative definitions be recorded in the capital account. The IMF uses the term capital account to designate a subset of transactions that, according to other usage, form a small part of the overall capital account.[6] The IMF separates these transactions out to form an additional top level division of the BOP accounts. Expressed with the IMF definition, the BOP identity can be written: Current account financial account capital account balancing item=0. The IMF uses the term current account with the same meaning as that used by other organizations, although it has its own names for its three leading subdivisions, which are: The goods and services account (the overall trade balance) The primary income account (factor income such as from loans and investments) The secondary income account (transfer payments)

Current account of balance of Payment
1 Current Account transactions
The Current accounts records the transaction in merchandise and invisibles with the rest of the world. Merchandise covers imports and exports and invisibles include travel transportation insurance, investment and other services. The current account mainly consists of 4 types of transactions.
i) Exports and imports of goods: Exports of goods are credits (+) to the current account. Imports of goods are debits (-) to the current account.

ii) Exports and imports of services: Exports of services are credits (+) to the current account. Imports of services are debits (-) to the current account.

Interest payments on international investments
Interest, dividends and other income received on U.S. assets held abroad are credits (+). Interest, dividends and payments made on foreign assets held in the U.S. are debits (-). Since 1994, the U.S. has run a net debit in the investment income account: more payments are made to foreigners than foreigners make to U.S. investors.
Current transfers Remittances by Americans working abroad, pensions paid by foreign countries to their citizens living in the U.S., aid offered by foreigners to the U.S. count as credits (+). Remittances by foreigners working in the U.S., pensions paid by the United States to its citizens living abroad, aid offered to foreigners by the U.S. count as debits (-) As expected the U.S. runs a deficit in current transfers. The sum of these components is known as the current account balance. A negative number is called a current account deficit and a positive number called a current account surplus. As expected, given that it runs a surplus only in the services component of the current account, the U.S. runs a substantial current account deficit.

2 Capital account of Balance of payment

In the case of the capital account an increase (decrease) in the county foreign financial assets are debit (credit) whereas any increase (decrease) in the country foreign financial liabilities are credits (debits). The transaction under the Capital account is classified as:

- Foreign Investment
- Loans
- Banking Capital
- Rupee debt services
- Other debt capital

Loans include the concessional loans received by the government‘ or public sector bodies , long term loan and medium term borrowings from the commercial capital market in the form of loans Bond issue and short term credits. Disbursement received by Indian resident entities is the credit Items while payment and loans made by the Indians are the credit items All inflow of the foreign capital comes credit item of the Balance of payment/Banking capital covers the changes in the foreign assets and liabilities of commercial banks whether privately owned or the comparative and government owned. An decrease in assets and increase in liability is a credit item. The item Rupee debt services defined as the cost of meeting inters payments and regular contractual repayments of the principal of a loan along with the any administrate charges in rupee by India.

Factors affecting the components of BOP account

Exports of goods and services affected by following factors

1. The prevailing rate of domestic currency
2. Inflation rate
3. Income of foreigners
4. World price of the commodity

5. Trade barriers.

Imports of Goods and services

1. Level of Domestic Income
2. International prices
3. Inflation rate
4. Value of Domestic Currency
5. Trade Barriers

IMPORTANCE OF BALANCE OF PAYMENTS

A country's balance of payments is a quantitative synopsis of a nation's global exchanges over some undefined time frame. It uncovers different parts of the nation's worldwide financial position. It illuminates the legislature about the universal money related situation of a nation. It likewise helps the legislature in taking choices on money related and monetary approaches from one viewpoint and outside exchange and payments issues on the other. Balance of payments is likewise used to decide the impact of outside exchanges on the degree of national salary. On account of an immature nation balance of payments shows the degree of reliance of a nation's monetary advancement in budgetary help given by the created capital loaning nation. The best significance of the investigation of balance of payments lies in its filling in as a pointer of the changing worldwide monetary situation of a nation. The balance of payments is a monetary indicator which if appropriately took care of by financial examination can be utilized to evaluate a country's present moment global possibilities to assess the level of its universal dissolvability and to decide the propriety of the conversion scale of a nation's cash.
Be that as it may, a shortfall or surplus in balance of installment fundamentally ought not be taken as a record of financial chapter 11 or flourishing of the nation on the grounds that a shortage is good with monetary success and gives no reason to national alert while a surplus doesn't generally demonstrate the sound financial state of a nation.

AN OVERVIEW OF INDIA’S STRATEGY WITH RESPECT TO BALANCE OFPAYMENTS

At the hour of autonomy, India was an overwhelmingly rural economy utilizing crude creation strategies and totally broke by hundreds of years of frontier loot.. There was a requirement for arranged improvement with the state assuming a main job. With the end goal of monetary improvement India received Mahalanobis Model of Economic Planning bolstered by Nehru's vision. The Government bolstered and embraced 'import substitution 'or internal

arranged procedure. This import substitution methodology was upheld by utilization of money related and financial arrangements, levies, charges, and loan fee strategies and physical interventionist approaches, for example, authorizing, portion, levy and non – tax boundaries of import limitations. For around forty years or so India tried different things with the import substitution system by building up "Permit – Quota Raj" and making a controlled and prohibitive condition. During the period, the Indian economy was developing at a rate called as "Hindu Rate of Growth ".

The advancement theory and system looked over time to time in the post – freedom period, consistently stayed a matter of worry for affecting the outer segment and BOP. India's internal situated strategy prompted different BOP issues like - steady shortage in BOP, developing outside obligation, slow development rate, and so forth.

As pointed out fundamentally - "A striking reality about India's economy in the, post freedom period is the perseverance of balance of payments issues, independent of the progressions that have occurred in India's advancement system or financial strategy."

In late 1980's the Indian Government revalued its import substitution procedure and began offering significance to send out advancement quantifies and received a proper conversion scale approach in order to make trades profitable. Along these lines, it received a 'trade advancement or outward arranged methodology.

The time of 1990 is set apart with a total U turn as India received a way of financial progression. It pursued the arrangement of Liberalization, Privatization and Globalization (LPG) to tackle its BOP and related issues. A progression of monetary changes were acquainted in different parts with handle the BOP and different issues. The Indian economy which was a shut economy for very nearly forty years presently turned out to be moderately progressively open presenting difficulties for macroeconomic administration.

Chapter No. 7 Financial Mgt. of the Multinational Firm

Foreign direct investment, international capital budgeting, international capital structure and cost of capital. International portfolio management. International financing: Equity, Bond financing, parallel loans, international cash management, accounts receivable management, inventory management. Payment methods of international trade, trade finance methods, export and import bank of India, and recent amendments in EXIM policy, regulations and guidelines.

5.1 Foreign Direct Investment

A foreign direct investment (FDI) is an investment made by a firm or individual in one country into business interests located in another country. Generally, FDI takes place when an investor establishes foreign business operations or acquires foreign business assets in a foreign company. However, FDIs are distinguished from portfolio investments in which an investor merely purchases equities of foreign-based companies. Foreign direct investments are commonly made in open economies that offer a skilled workforce and above-average growth prospects for the investor, as opposed to tightly regulated economies. Foreign direct investment frequently involves more than just a capital investment. It may include provisions of management or technology as well. The key feature of foreign direct investment is that it establishes either effective control of or at least substantial influence over the decision-making of a foreign business.

5.1.1 Types of Foreign Direct Investment

1. **FDI**: It is the investment done by a company or organization which practices all the tasks and activities done at the investing company, back at its own country of operation. Therefore, basically such investors are from the same industry where investments are done but operating in two different countries. For e.g., a car manufacture in Australia invests in a car manufacturing company of India.

2. **Vertical FDI**: The industry of the investor and the company where investments are done are related to each other. This type of FDI is further classified as:

a) **Forward Vertical FDI**: In such investments, foreign investments are done in organizations which can take the products forward towards the customers. For e.g., a car manufacturing company in Australia invests in a wholesale Car Dealer company in India.

b) **Backward Vertical FDI**: In such investments, foreign investments are done in an organization which is involved in sourcing of products for the particular

industry. For e.g., the car manufacturer of Australia invests in a tyre manufacturing plant in India.

c) **Conglomerate FDI**: Such investments are done to gain control in unrelated business segments and industries in a foreign land. For e.g., the car manufacturer of Australia invests in a consumer durable good manufacturer in India. Here the investing company ideally manages two challenges, first being gaining operational control in a foreign land, and the second being starting operations in a new industry segment.

d) **Greenfield Entry**: In this special type of FDI, the investing company refers to an investing organization starting assembling from scratch just like Honda did in United Kingdom

e) **Foreign Takeover**: This type of FDI takes the form of a foreign merger

5.2 Theories Of FDI

5.2.1 Mac Dougall -Kemp Hypothesis

FDI moves from capital abundant economy to capital scarce economy till the marginal production is equal in both countries. This leads to improvement in efficiency in utilization of resources in which leads to ultimate increase in welfare. According to this theory, foreign direct investment is a result of differences in capital abundance between economies. This theory was developed by MacDougal (1958) and was later elaborated by Kemp (1964)

5.2.2 Industrial Organization Theory

According to this theory, MNC with superior technology moves to different countries to supply innovated products making in turn ample gains. Krugman (1989) points out that it was technological advantage possessed by European countries which led to massive investment in USA .According to this theory, technological superiority is the main driving force for foreign direct investment rather that capital abundance.

5.2.3 Currency Based Approaches

A firm moves from strong currency country to weak currency country. Aliber (1971) postulates that firms from strong currency countries move out to weak currency countries. Froot and Stain (1989) holds that, depreciation in real value of currency of a country lowers the wealth of a domestic residents visa avis the wealth of the foreign residents, thus being cheaper for foreign firms to acquire assets in such countries. Therefore, foreign direct investments will move from countries with strong currencies to those with weak or depreciating currencies.

5.2.4 Location-Specific Theory

Hood and Young (1979) stress on the location factor. According to them, FDI moves to a countries with abundant raw materials and cheap labor force. Since real wage cost varies among countries, firms with low-cost technology move to low wage countries. Abundance of raw materials and cheap labor force are the main factors for FDI. Countries with cheap labor and abundant raw material will tend to attract FDI.

5.2.5 Product Cycle Theory

FDI takes place only when the product in question achieves specific stage in its life cycle-introduction, growth, maturity and decline stage. At maturity stage, the demand for new product in developed countries grow substantially and rival firms begin to emerge producing similar products at lower price. So in order to compete with rivals, innovators decide to set up production in the host country so as to beat up the cost of transportation and tariffs.

5.2.6 Political-Economic Theories

They concentrate on the political risks. Political stability in the host country leads to FDI(Fatehi-Sedah and Safizeha 1989).Similarly, political instability in the home country encourages FDI in other countries(Tallman 1988).

5.3 Strategy for FDI

5.3.1 Firm-Specific Strategy

It means offering new kind of product or differentiated product. When product innovation fails to work, a firm may adopt product differentiation strategy. This is done through putting trade mark on the product or branding. Sometimes a firm may adopt different brands for different markets to make them suitable for local markets. Bata for example, operates in 92 countries under the same trade mark, while Uniliver‘s low - leather fabric washing product is marketed is market under five different brands in Western Europe. 69

5.3.2 Cost-Economic Strategy

This strategy is done through lowering cost by moving the firm to the places where there are cheap factors of production (eg. labour and raw materials).The cheapness of these factors of production reduces the cost of production and maintains an edge over other firm

5.3.3 Joint Venture with a Rival Firm

Sometimes when a rival firm in a host country is so powerful that it is not easy for MNC to compete, the later prefer to join hands with the host country firm for a joint venture agreement and the MNC is able to operate the host country market.

5.3.4 Investment Mode Strategy

This strategy depends on the move of investment favored by the host country. It depends also on the political and economic environment of the host country. If the host government does not favor a particular mode, an investing company cannot adopt it even if it is the most suitable.

5.4 Costs And Benefits Of FDI

A cost-benefit analysis is a process by which business decisions are analyzed. The benefits of a given situation or business related action are summed, and then the costs associated with taking that action are subtracted. • Prior to erecting a new plant or taking on a new project, prudent managers conduct a cost-benefit analysis as a means of evaluating all the potential costs and revenues that may be generated if the project is completed. The outcome of the analysis will determine whether the project is financially feasible or if another project should be pursued. Cost and benefits of FDI can be classified as two

- Cost and Benefits of the Host Country
- Cost and Benefits of the investing MNC

a) Benefits of Host Country

- **Improving the balance of payments**

Inward investment will usually help a country's balance of payments situation. The investment itself will be a direct flow of capital into the country and the investment is also likely to result in import substitution and export promotion. Export promotion comes due to the multinational using their production facility as a basis for exporting, while import substitution means that products previously imported may now be bought domestically.

- **Providing employment**

FDI will usually result in employment benefits for the host country as most employees will be locally recruited. These benefits may be relatively greater given

that governments will usually try to attract firms to areas where there is relatively high unemployment or a good labour supply

- **Source of tax revenue**

Profits of multinationals will be subject to local taxes in most cases, which will provide a valuable source of revenue for the domestic government.

- **Technology transfer**

Multinationals will bring with them technology and production methods that are probably new to the host country and a lot can therefore be learnt from these techniques. Workers will be trained to use the new technology and production techniques and domestic firms will see the benefits of the new technology. This process is known as technology transfer

• Building of economic and social infrastructure.

• Strengthening of the government budget. Stimulation of national economy

• The presence of one multinational may improve the reputation of the host country and other large corporations may follow suite and locate as well

Costs of the Host Country

• Cultural and political interference.

• Unhealthy competition to Domestic players

• Over utilization of local resources (both natural and human resources)

• Violation of human rights (child labor eg. the case of NIKE in Vietnam, APPLE in China etc)

• Threat to indigenous technology.

• Threat to local products.

b) Benefits of Investing MNCs

• **Access to markets** FDI can be an effective way for you to enter into a foreign market. Some countries may extremely limit foreign company access to their domestic markets. Acquiring or starting a business in the market is a means for you to gain access • **Access to resources** FDI is also an effective way for you to acquire important natural resources, such as precious metals and fossil fuels. Oil companies, for example, often make tremendous FDIs to develop oil fields. • **Reduces cost of production** FDI is a means for you to reduce your cost of production if the labor market is cheaper and the regulations are less restrictive in the target foreign market. For example, it's a well-known fact that the shoe and clothing industries have been able to drastically reduce their costs of production by moving operations to developing countries. • Its also likely that Investors may get investment incentives, promotion, social amenities. **Costs to Investing MNCs • Risk from Political Changes**. Because political issues in other countries can instantly change, foreign direct Investment is very risky. Plus, most of the risk factors that you are going to experience are extremely high. • **Hindrance to Domestic Investment**. As it focuses its resources elsewhere other than the investor‘s home Country, foreign direct investment can sometimes hinder domestic investment • **Economic Non-Viability**. Considering that foreign direct investments may be capital-intensive from the point of view of the investor, it can sometimes be very risky or economically non-viable. • measured in terms of cash flows. The estimation of the cash inflows and cash outflows mainly depends on future uncertainties. The risk associated with each project must be carefully analyzed and sufficient provision must be made for covering the different types of risks. **Expropriation**. Remember that political changes can also lead to expropriation,

which is a scenario where the government will have control over your property and assets. Investment abroad takes away employment opportunities of the people in the home country.

5.5 International capital budgeting
The process through which different projects are evaluated is known as capital budgeting. Capital budgeting is defined ―as the firm‘s formal process for the acquisition and investment of capital. It involves firm‘s decisions to invest its current funds for addition, disposition, modification and replacement of fixed assets‖. ―Capital budgeting is long term planning for making and financing proposed capital outlays‖ ―Capital budgeting consists in planning development of available capital for the purpose of maximizing the long term profitability of the concern‖- Lynch .The main features of capital budgeting are a. potentially large anticipated benefits b. a relatively high degree of risk c. relatively long time period between the initial outlay and the anticipated return. **Significance of capital budgeting**

 The success and failure of business mainly depends on how the available resources are being utilized.

 It‘s a main tool of financial management.

 All types of capital budgeting decisions are exposed to risk and uncertainty.

 They are irreversible in nature

 Capital rationing gives sufficient scope for the financial manager to evaluate different proposals and only viable

 project must be taken up for investments.

 Capital budgeting offers effective control on cost of capital expenditure projects. It helps the management to avoid

 over investment and under investments.

Capital budgeting process involves the following **i) Project generation**: Generating the proposals for investment is the first step.

• The investment proposal may fall into one of the following categories:

• Proposals to add new product to the product line,

• proposals to expand production capacity in existing lines

• proposals to reduce the costs of the output of the existing products without altering the scale of operation.

No standard administrative procedure can be laid down for approving the investment proposal. The screening and selection procedures are different from firm to firm **ii) Project Evaluation:** It involves two steps **Estimation of benefits and costs:** the benefits and costs are Once the proposal for capital expenditure is finalized, it is the duty of the finance manager to explore the different alternatives available for acquiring the funds. He has to prepare capital budget. Sufficient care

must be taken to reduce the average cost of funds. He has to prepare periodical reports and must seek prior permission from the top management. Systematic procedure should be developed to review the performance of projects during their lifetime and after completion. The follow up, comparison of actual performance with original estimates not only ensures better forecasting but also helps in sharpening the techniques for improving future forecasts.

Selection of appropriate criteria to judge the desirability of the project: It must be consistent with the firm's objective of maximizing its market value. The technique of time value of money may come as a handy tool in evaluation such proposals.

5.5.1 Factors influencing capital budgeting

• Availability of funds

• Structure of capital

• Taxation policy

• Government policy

• Lending policies of financial institutions

• Immediate need of the project

• Earnings

• Capital return

• Economical value of the project

• Working capital

• Accounting practice

• Trend of earnings

5.5.2 Methods of capital budgeting

Traditional methods

• Payback period

• Accounting rate of return method

Discounted cash flow methods

• Net present value method

• Profitability index method

• Internal rate of return method (IRR)

Merits of IRR 'It considers the time value of money. Calculation of cost of capital is not a prerequisite for adopting IRR. IRR attempts to find the maximum rate of interest at which funds invested in the project could be repaid out of the cash inflows arising from the project. It is not in conflict with the concept of maximizing the welfare of the equity shareholders. It considers cash inflows throughout the life of the project. **Cons**

• Computation of IRR is tedious and difficult to understand

• Both NPV and IRR assume that the cash inflows can be reinvested at the discounting rate in the new projects. However, reinvestment of funds at the cut off rate is more appropriate than at the IRR.

• IT may give results inconsistent with NPV method.

• This is especially true in case of mutually exclusive project

Step 1: Calculation of cash outflow Cost of project/asset xxxx Transportation/installation charges xxxx Working capital xxxx Cash outflow xxxx **Step 2: Calculation of cash inflow** Sales xxxx Less: Cash expenses xxxx 73

PBDT xxxx Less: Depreciation xxxx PBT xxxx Less: Tax xxxx PAT xxxx Add: Depreciation xxxx Cash inflow p.a xxxx

5.6 International capital structure and cost of capital

The **capital structure** is the particular combination of debt and equity used by a company to finance its overall operations and growth. Debt comes in the form of bond issues or loans, while equity may come in the form of common stock, preferred stock, or retained earnings. Short-term debt such as working capital requirements is also considered to be part of the capital structure.

Many major firms throughout the world have begun to internationalize their capital structure by raising funds from foreign as well as domestic sources. As a result, these corporations are becoming multinational not only in the scope of their business activities but also in their capital structure.

By internationalizing its corporate ownership structure, a firm can generally increase its share price and lower its cost of capital. This trend reflects the ongoing liberalization and deregulation of international financial markets that make them accessible for many firms.

Cost of capital is the required return necessary to make a capital budgeting project, such as building a new factory, worthwhile. When analysts and investors discuss the cost of capital, they typically mean the weighted average of a firm's cost of debt and cost of equity blended together.

The cost of capital metric is used by companies internally to judge whether a capital project is worth the expenditure of resources, and by investors who use it to determine whether an investment is worth the risk compared to the return. The cost of capital depends on the mode of financing used. It refers to the cost of equity if the business is financed solely through equity, or to the cost of debt if it is financed solely through debt.

Many companies use a combination of debt and equity to finance their businesses and, for such companies, the overall cost of capital is derived from the weighted average cost of all capital sources, widely known as the weighted average cost of capital (WACC).

holding or security. The art of selecting the right investment policy for the individuals in terms of minimum risk and maximum return is called as portfolio management. Portfolio management refers to managing an individual‘s investments in the form of bonds, shares, cash, mutual funds etc so that he earns the maximum profits within the stipulated time frame.

International Cash Management

Cash has been defined in the Government Financial Statistics (GFS) manual.2 - cash on hand refers to notes, coins, and deposits held on demand by government

institutional units with a bank or another financial institution. Cash equivalents are defined to be highly liquid investments that are readily convertible to cash on hand. **Cash management** is necessary because there are mismatches between the timing of payments and the availability of cash. Even if the annual budget is balanced, with realistic revenue and expenditure estimates, in-year budget execution will not be smooth, since both the timing and seasonality of cash inflows (which depend in turn on tax and nontax flows, and timing of grant or loan disbursements) and of expenditures can result in conditions of temporary cash surpluses or temporary cash shortfalls. For example, if taxes are paid quarterly, there can be large temporary cash surpluses around the time taxes are due, and temporary deficits in other time periods

Storkey (2003) provides the following definition: ―cash management is having the right amount of money in the right place and time to meet the government‘s obligations in the most cost-effective way.‖ Other definitions emphasize active cash management of temporary cash surpluses and temporary deficits. Moderrn cash management has four major **objectives**:

• To ensure that adequate cash is available to pay for expenditures when they are due. Pooling revenues in a treasury single account (TSA) facilitates this.

• To borrow only when needed and to minimize government borrowing costs.

• To maximize returns on idle cash, i.e., to avoid the accumulation of unremunerated or low yielding government deposits in the central bank or in commercial banks.

• To manage risks, by investing temporary surpluses productively, against adequate collateral. Effective cash management contributes to the smooth implementation of the operational targets of fiscal policy, the public debt management strategy, and monetary policy.

5.10.1 Approaches of Centralized Cash Management

a) Netting

In a typical multinational family of companies, there are a large number of intra-corporate transactions between subsidiaries and between subsidiaries and the parent. If all the resulting cash flows are executed on a bilateral, pair wise basis, a large number of currency conversions would be involved with substantial transaction costs. With a centralized system, netting is possible whereby the **cash management center (CMC)** nets out receivables against payables, and only the net cash flows are settled among different units of the corporate family. Payments

among affiliates go back and forth, whereas only a netted amount need be transferred. For example, the German subsidiary of an MNC sells goods worth $1 million to its Italian affiliate that in turn sells goods worth $2 million to the German unit. The combined flows total $3 million. On the net basis, however, the German unit need remit only $1 million to the Italian unit. This is called bilateral netting. It is valuable, though only if subsidiaries sell back and forth to each other. But a large percentage of multinational transactions are internal – leading to a relatively large volume of inter-affiliate payments – the payoff from multilateral netting can be large, relative to he costs of such a system. The netting center will use a matrix of payables and receivables to determine the net payer or creditor position of each affiliate at the date of clearing.

b) Cash Pooling

The CMC act not only as a netting center but also the repository of all surplus funds. Under this system, all units are asked to transfer their surplus cash to the CMC, which transfers them among the units as needed and undertakes investment of surplus funds and short-term borrowing on behalf of the entire corporate family. The CMC can in fact function as a finance company which accepts loans from individual surplus units, makes loans to deficit units and also undertakes market borrowing and investment. By denominating the intra-corporate loans in the units' currencies, the responsibility for exposure management is entirely transferred to the finance company and the operating subsidiaries can concentrate on their main business, viz. production and selling of goods and services. Cash pooling will also reduce overall cash needs since cash requirements of individual units will not be synchronous.

c) Collection and Disbursement of Funds

Accelerating collections both within a foreign country and across borders is a key element of international cash management. Considering either national or international collections, accelerating the receipt of funds usually involves the following:

- defining and analyzing the different available payment channels,

- selecting the most efficient method (which can vary by country and customer),
- giving specific instructions regarding procedures to the firm‘s customers and banks.

Management of disbursements is a delicate balancing act of holding onto funds versus staying on good terms with suppliers. It requires a detailed knowledge of individual country and supplier policies, as well as the different payment instruments and banking services available around the world. A constant review on disbursements and auditing of payment instruments help international firms achieve better cash management.

2. Market Analysis: Segmentation: Meaning, Need, Factors influencing segmentation, Basis

- for segmentation, Segmentation of Consumer/ Industrial markets; Targeting: Basis for
- identifying target customers, Target Market Strategies; Positioning: Meaning, Product
- differentiation strategies, Marketing Research: Meaning and scope of marketing research;
- Marketing research process; Competition Analysis. **(8)**

Segmentation of Consumer Market

- **Market segmentation** is the process of dividing a **market** of potential customers into groups, or **segments**, based on different characteristics.

- Market Segmentation is a process of dividing the market of potential customers into different groups and segments on the basis of certain characteristics. The member of these groups share similar characteristics and usually have one or more than one aspect common among them.

- The **segments** created are composed of consumers who will respond similarly to **marketing** strategies and who share traits such as similar interests, needs, or locations

Nature of a market segment

- A market segment needs to be **homogeneous**. There should be something common among the individuals in the segment that the marketer can capitalise on.
- Marketers also need to check that different segments have different distinguishing features which make them **unique.**
- But segmenting requires more than just similar features. Marketers must also ensure that the individuals of the segment **respond in a similar way** to the stimulus.
- That is, the segment must have a similar type of reaction to the marketing activities being pitched.

Limitations of segmentation

- 1) Segments are too small – If the chosen segment is too small then you will not have the proper turnover which in turn will affect the total margins and the viability of the business.
- 2) Consumers are misinterpreted – The right product to the wrong customers. What if your market research says that your customers want a new soap and you come out with a new facial cream. The concept is same, cleanliness. But the concept is completely different.
- 3) Costing is not taken into consideration – Targeting a segment is ok but you also need to know how much you will have to spend to target a particular segment. If it is a Sec A segment and you do not have the budget to be present in the places the the Sec A customer visits, then your segmentation strategy is a failure.

- 4) There are too many brands – Along with segmentation, you also need to check out the competition offered in the same segment from other products. Getting into a segment already saturated will mean higher costs and lesser profit margins.
- 5) Consumer are confused – If the consumer himself doesn't know whether he will be interested in a particular product or not, than that's a sign that you need to get out of that segment / product.
- 6) Product is completely new – If a product is completely new than there is no market research to base your segmentation on. You need to market it to the masses and as acceptance increases, only then will you be able to focus on one particular segment.

GEOGRAPHIC SEGMENTATION
PSYCHOGRAPHIC SEGMENTATION
DEMOGRAPHIC SEGMENTATION
BEHAVIOURAL SEGMENTATION
MARKET SEGMENTATION
FEEDOUGH.COM
The entrepreneurs' guide

4 Types of Market Segmentation

Geographic

Target customers based on a predefined geographic boundary. Differences in interests, values, and preferences vary dramatically throughout cities, states, regions, and countries.

Demographic

The process of dividing a market through variables such as age, gender, education level, family size, occupation, income, and more. This is one of the most wildly used strategies amongst marketers.

Psychographic

Focus on the intrinsic traits the target customer has. Psychographic traits can range from values, personalities, interests, attitudes, conscious and subconscious motivators, lifestyles, and opinions.

Behavioral

Break down the way customers go through their decision making and buying processes. Attitudes towards the brand, the way they use it, and their knowledge base are all behavioral examples.

Demographic

- Eg. automobiles, beauty products, mobile phones, apparels, etc

- Demographic segmentation separates your audience by **who they are,**
- Age
- Gender --cosmetics, clothing, and jewellery industry, etc.
- Occupation
- Income-- High Income Group
  Mid Income Group
  Low Income Group
- Life style -- marital status, interests, hobbies, religion,values,
- Family status
- family size
- Education
- occupation,
- nationality

- Example
- A high-end jewellery store segments their audience by high household income. This focus ensures they don't waste valuable resources on targeting an audience that wouldn't be interested in their products.

Geographic

- Geographic segmentation splits your audience depending on where they are located.
- For example:
- Continent
- Country
- Region
- City
- Borough/District

Psychographic

- Psychographic segmentation separates your audience by their **personality.**
- Personality is the combination of characteristics that form an individual's distinctive character and includes
- habits,
- traits,
- attitude,
- temperament, etc.
- Lifestyle
- Interests
- Values

Behavioural

- The market is also segmented based on audience's behaviour, usage, preference, choices and decision making. The segments are usually divided based on their knowledge of the product and usage of the product. It is believed that the knowledge of the product and its use affect the buying decision of an individual. The audience can be segmented into –
- Those who know about the product,
- Those who don't know about the product,
- Ex-users,
- Potential users,
- Current Users,
- First time users, etc.

- Example
- A local restaurant segments its audience data by purchase patterns, specifically **when the purchase was made.** This allows it to investigate its **lunch-time audience** compared to its **dinner-time audience**.
- By comparing the difference in the type of meals purchased between each of these times, the restaurant is able to create a new lunch and dinner menu that better suits its individual groups of customers.

Eg Of segmentation

- Marketers will only waste their time and might end up making fun of themselves if they don't segment the market while marketing beauty products.
- A company that sells nutritious food might market the product to the older people while fast-food chains target the working demographic or teens.
-

Segmenting Industrial Market

- **1. Geographic Bases:**
- Company needs to perform tasks differently to treat customers residing in different geographical regions.
- **On the basis of geographical bases, industrial buyers can be segmented into following segments:**
  - **i. Distance:**

    Local market, regional, domestic (national) market, and International market.
  - **ii. Location of Industrial Unit:**

    Rural and Urban Customers.
- **iii. Area and Climate:**
- Area specific segmentation considers place-specific bases such as hilly, desert, valley, plains, etc., while climate-based classification includes segmenting market on the basis of level and intensity of humidity, heat, cold, rains, etc. Different buyers located at different places need to be treated differently. Separate marketing programme must be prepared for each of these groups.

- **2. Types of Industry:**
- Company's products are used in different industries. Relevant industries should be considered for segmenting market and, as per suitability, one or more industries can be selected as the target market to be served.
- **Possible segments include:**
- i. Auto Industry
- ii. IT Industry
- iii. Chemical industry
- iv. FMCG (Fast Moving Consumer Goods) Industry
- v. Textile industry
- vi. Iron and steel Industry
- vii. Cement Industry
- viii. Engineering Industry
- ix. Agro processing industry
- x. Service Industry, etc.

- **3. Type of Business Operation:**
- Industrial units perform different activities. Each of them differs in term of their nature of activities/operations and requirements.
- **On that base, we can classify industrial customers into several segments, such as:**
- i. Manufacturing Units
- ii. Assembling Units
- iii. Processing Units
- iv. Distributing units
- v. Retailing Business
- vi. Consultancies and Services Units, etc.

- **4. Consumption Rate/ Size:**
- On the basis of order size and/or annual consumption, industrial buyers can be segmented in certain distinct groups. A company can select suitable one or more customer groups as target market.
- **Sized-based segmentation includes:**
- i. Heavy Users
- ii. Medium Users
- iii. Light Users
- Particularly, price and promotion strategies must be designed differently to meet expectations of varied groups.

- **5. Ownership Factor:**
- Ownership exhibits different response. A firm needs to treat them differently. A company can select one or more customers to serve.
- **Ownership-based segmentation leads to following segments:**
- i. Sole Proprietary Firms and Partnership Firms
- ii. Private Companies
- iii. Pubic companies and Public Sector Units (PSUs)
- iv. Government as a Customer
- v. Corporations
- vi. Defence Department
- vii. Cooperative Societies
- viii. Community Organisations
- ix. Religious and Missionary Organisations.

- **6. Buying Methods:**
- Industrial buyers purchase products on different ways. Every method requires different treatment in terms of formality, timing of ordering and executing, profit margin, and overall procedures to be followed.
- **Based on methods, industrial markets can be segmented on following bases:**
- i. Tender/sealed-bid Buying Units
- ii. Service Contract Customers
- iii. Leasing Customers
- iv. Buying through Approved Agencies
- v. Direct Purchasing Units.

- **7. Ordering Time or Frequency:**
- **Taking ordering time and buying frequency as the bases, industrial markets can be classified into several segments, such as:**
- **i. Annual Customers:**
- They put a large order (once in a year) and buy all quality at a time.
- **ii. Regular Customers:**
- They buy regularly only from the particular firm. They are loyal customers.
- **iii. Occasional Customers:**
- They buy company’s products occasionally. They buy company’s products just to try; they buy for change; or they buy when required products are not available from other sources.
- **iv. Frequent and Infrequent Customers:**
- Frequent customers buy more frequently. They put repeated orders and are reasonably predictable. Infrequent customers are irregular in their buying pattern. They may or may not buy and are difficult to be predicted.

- **8. Payment Modes and Time:**
- Industrial customers follow different modes of payment. They also take short or long time to pay their bills.
- **Main segments are:**
- i. Cash Purchasing Buyers
- ii. Credit Purchasing Buyers
- iii. Partial Credit Purchasing Buyers
- iv. Fully Trusted v/s Partially Trusted Buyers
- v. Full (at a time) Paying Customers
- vi. Gradual or Installment Paying Customers
- vii. Short-term and Long-term Credit Buyers, etc.
- Suitable marketing programme should be prepared to deal with these groups of buyers. Particularly, pricing policies are more relevant for this segmentation.

- **9. Legal Aspects:**
- Legal or authenticity aspects can be relevant base to some companies for segmenting total market. The firm is directed to sell its products only to some agencies approved by the government. But, due to some reasons, it has to transact (willingly or unwillingly) with illegal customers, who have been restricted by the Law to buy, hold, or use some products. Company can earn more profits by dealing with unauthorized customers.
- In case of companies manufacturing some defence tools and devices (arms and ammunitions), or companies supplying products for national schemes for the BPL (Below Poverty Line) families or any other reserved categories, they may tempted to sell extra product to unauthorized customers. Sometimes, company is restricted to produce as per the fixed quota.
- **Marketing strategies for legal and illegal customers seems quite different:**
- **i. Legal Customers:**
- These customers are free to use any quantity without any restriction.
- **ii. Restricted (Partially Permitted) Customers:**
- There are permitted up to certain limit. They cannot buy more quantity beyond the specified limit.
- **iii. Illegal Customers:**
- The Law puts ban on these customers. They cannot legally buy, hold, use, or resell some products.

- **10. Other Bases:**
- Apart from these bases, some minor behavioural bases are also used for segmenting industrial markets.
- **Some of them include:**
- i. Occasions
- ii. User status
- iii. Loyalty Pattern,
- iv. Benefits Expected
- v. Attitudes, etc.

- 3. Marketing Research: Meaning and scope of marketing research; Marketing research process, Modern Marketing Information System. Introduction to Consumer behavior and its importance; factors influencing Consumer behavior - economic, socio-cultural and psychological factors; comparing industrial and Consumer buying behavior; Consumer decision making process.

Positioning

- This is the act of designing a company‘s offering and image to occupy a distinctive placI.e. The act of creating a difference between a company‘s offer from those of competitorse in the target market‘s mind.

- A difference is worth establishing to the extent that it satisfies the following criteria.
- 1) Important: - The difference delivers a highly valued benefit to a sufficient number of buyers.
- 2) Distinctive:- The difference is delivered in a distinctive way
- 3) Superior: The difference is superior to other ways of obtaining the benefit.
- 4) Pre-emptive: The difference cannot be easily copied by competitors.
- 5) Affordable - The buyer can afford to pay for the difference.
- 6) Profitable - The Company will find in profitable to introduce the difference.

- Positioning strategies:-
- 1) Attribute positioning -A company positions itself on an attribute e.g. size, number of years in existence.
- 2) Benefit positioning -The product is positioned as the leader in a certain benefit.
- 3) Use or application positioning -Positioning a product as the best for some use or application.
- 4) User positioning -Positioning a product the best for some user group e.g. Bic pen, food for consumption.
- 5) Competitor positioning -The product claims to be better in some way then a named competitor.
- 6) Product category positioning -The product is positioned as the leader in a certain product category
- 7) Quality or price positioning. -The product is positioned as offering the best value

- As companies increase their number of claims for their brands, they risk disbelief and loss of clear positioning. Companies must avoid four major positioning errors.
- 1. Under Positioning -When buyers have only a vague idea of the brand The brand is seen as just another entry in a crowded marketplace. E.g. When Pepsi introduced its clear crystal Pepsi in 1993 (U.S.A.) customers were distinctively unimpressed. They didn‘t see _clarity‘ as an important benefit of a soft drink.
- 2. Over Positioning -Buyers may have too narrow a image of the brand. These buyers might think that suits at Sir Henry‘s start at 15000/= when in fact it offers affordable suits started at 3000/= Prepared by Bharat Bhati, BRAUSS 3. Confused Positioning -Buyers might have a confused image of the brand resulting from the company making too many claims or changing the brands positioning too frequently e.g. Omo, Zain 4. Doubtful Positioning - Buyers might find it hard to believe the brand claims in view of the products features, price or manufacturers.

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Course MBA

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Chapter-1

1.1 Electronic Commerce:

- Electronic commerce, commonly known as E-commerce is trading in products or services using computer networks, such as the Internet.
- Electronic commerce draws on technologies such as mobile commerce, electronic funds transfer, supply chain management, Internet marketing, online transaction processing, electronic data interchange (EDI), inventory management systems, and automated data collection systems.
- Modern electronic commerce typically uses the World Wide Web for at least one part of the transaction's life cycle, although it may also use other technologies such as e-mail.

Definition of E-commerce:

Sharing business information, maintaining business relationships and conducting business transactions using computers connected to telecommunication network is called E-Commerce.

1.2 E-Commerce Categories:

1. Electronic Markets

Present a range of offerings available in a market segment so that the purchaser can compare the prices of the offerings and make a purchase decision.

Example: Airline Booking System

2. Electronic Data Interchange (EDI)

• It provides a standardized system

• Coding trade transactions

• Communicated from one computer to another without the need for printed orders and invoices & delays & errors in paper handling

• It is used by organizations that a make a large no. of regular transactions

Example: EDI is used in the large market chains for transactions with their suppliers

3. Internet Commerce

• It is use to advertise & make sales of wide range of goods & services.

• This application is for both business to business & business to consumer transactions.

Example: The purchase of goods that are then delivered by post or the booking of tickets that can be picked up by the clients when they arrive at the event.

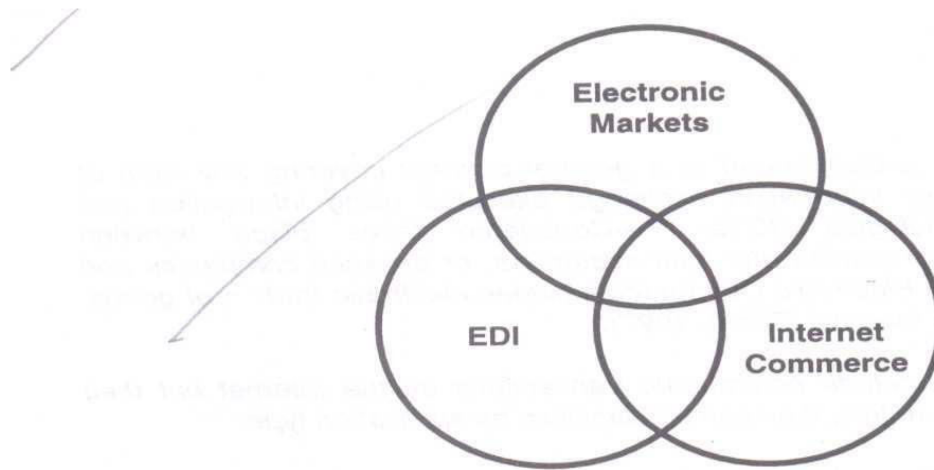


Fig. 1.1 The three categories of e-Commerce.

1.3 Advantages Of E-commerce:

- Buying/selling a variety of goods and services from one's home or business
- Anywhere, anytime transaction
- Can look for lowest cost for specific goods or service
- Businesses can reach out to worldwide clients - can establish business partnerships
- Order processing cost reduced
- Electronic funds transfer faster
- Supply chain management is simpler, faster, and cheaper using ecommerce
    - Can order from several vendors and monitor supplies.
    - Production schedule and inventory of an organization can be inspected by cooperating supplier who can in-turn schedule their work

1.4 Disadvantages Of E-commerce:

- Electronic data interchange using EDI is expensive for small businesses
- Security of internet is not very good - viruses, hacker attacks can paralise e-commerce
- Privacy of e-transactions is not guaranteed

- E-commerce de-personalises shopping

1.5 Threats of E-commerce:

- Hackers attempting to steal customer information or disrupt the site
- A server containing customer information is stolen.
- Imposters can mirror your ecommerce site to steal customer money
- Authorised administrators/users of an ecommerce website downloading hidden active content that attacks the ecommerce system.
- A disaffected employee disrupting the ecommerce system.
- It is also worth considering where potential threats to your ecommerce site might come from, as identifying potential threats will help you to protect your site. Consider:
- Who may want to access your ecommerce site to cause disruption or steal data; for example competitors, ex-employees, etc.
- What level of expertise a potential hacker may possess; if you are a small company that would not be likely to be considered a target for hackers then expensive, complex security may not be needed.

1.6 Features of E-Commerce:

- **Ubiquity**

  Internet/Web technology is The marketplace is extended beyond traditional available everywhere: at work, at home, and boundaries and is removed from a temporal and elsewhere via mobile devices, anytime. geographic location. ―Marketspace‖ is created; shopping can take place anywhere. Customer convenience is enhanced, and shopping costs are reduced.

- **Global reach**

  The technology reaches Commerce is enabled across cultural and across national boundaries, around the earth. national boundaries seamlessly and without modification. ―Marketspace‖ includes potentially billions of consumers and millions of businesses worldwide.

- **Universal standards**

  There is one set of There is one set of technical media standards technology standards, namely Internet across the globe.

- **Richness**

  Video, audio, and text messages Video, audio, and text marketing messages are are possible. integrated into a single marketing message and consuming experience.

- **Interactivity**

  The technology works Consumers are engaged in a dialog that through interaction with the user. dynamically adjusts the experience to the individual, and makes the consumer a co-participant in the process of delivering goods to the market.

- **Information density**

  The technology Information processing, storage, and reduces information costs and raises quality. communication costs drop dramatically, while currency, accuracy, and timeliness improve greatly. Information becomes plentiful, cheap, and accurate.

- **Personalization/Customization**

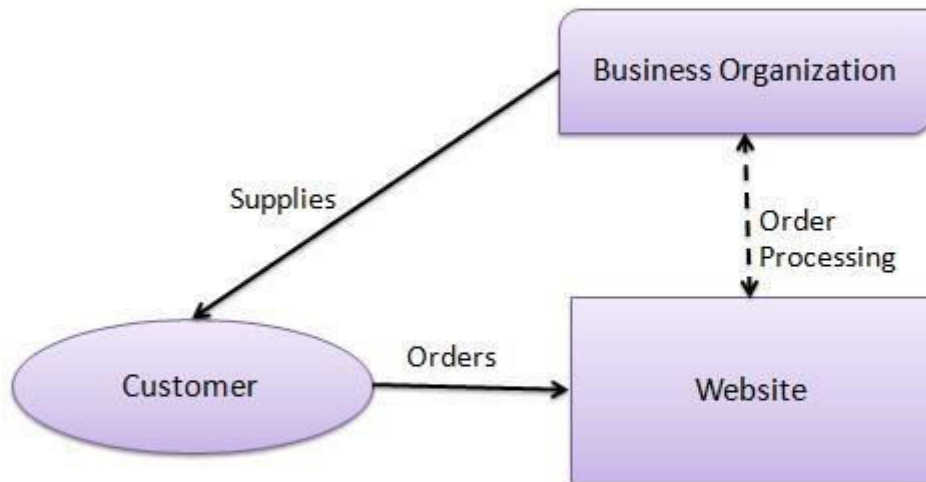
  The Personalization of marketing messages and technology allows personalized messages to customization of products and services are be delivered to individuals as well as groups. based on individual characteristics.

1.7 Business models of e-commerce:

There are mainly 4 types of business models based on transaction party.

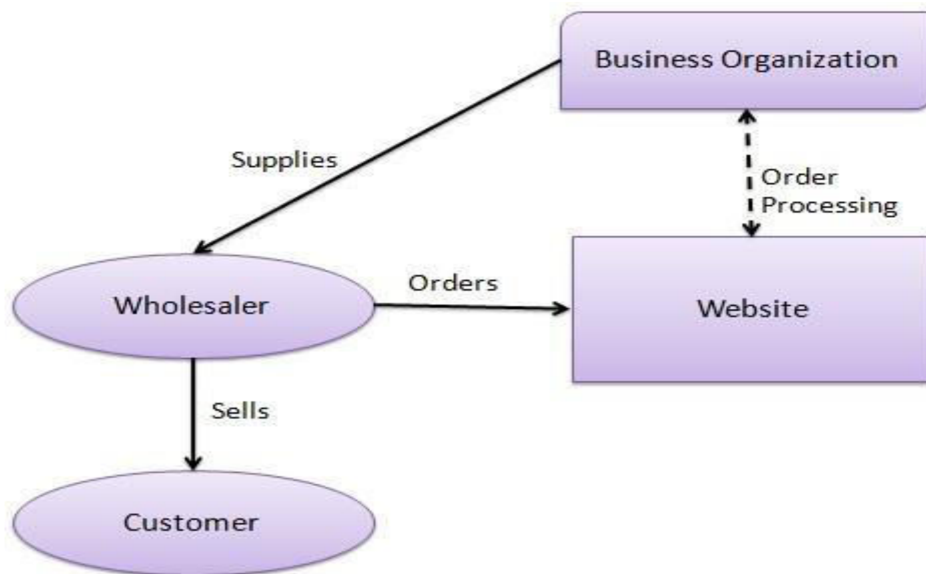
Business-to-Consumer (B2C)

In a Business-to-Consumer E-commerce environment, companies sell their online goods to consumers who are the end users of their products or services. Usually, B2C E-commerce web shops have an open access for any visitor, meaning that there is no need for a person to login in order to make any product related inquiry.



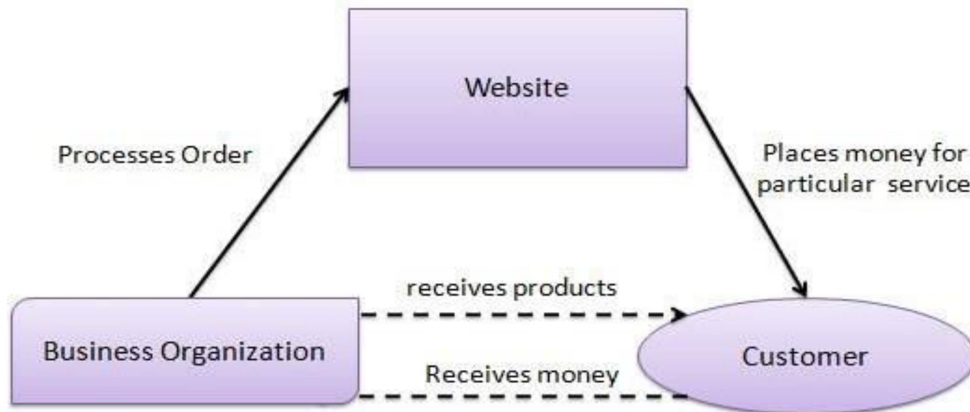
Business-to-Business (B2B)

In a Business-to-Business E-commerce environment, companies sell their online goods to other companies without being engaged in sales to consumers. In most B2B E-commerce environments entering the web shop will require a log in. B2B web shop usually contains customer-specific pricing, customer-specific assortments and customer-specific discounts.



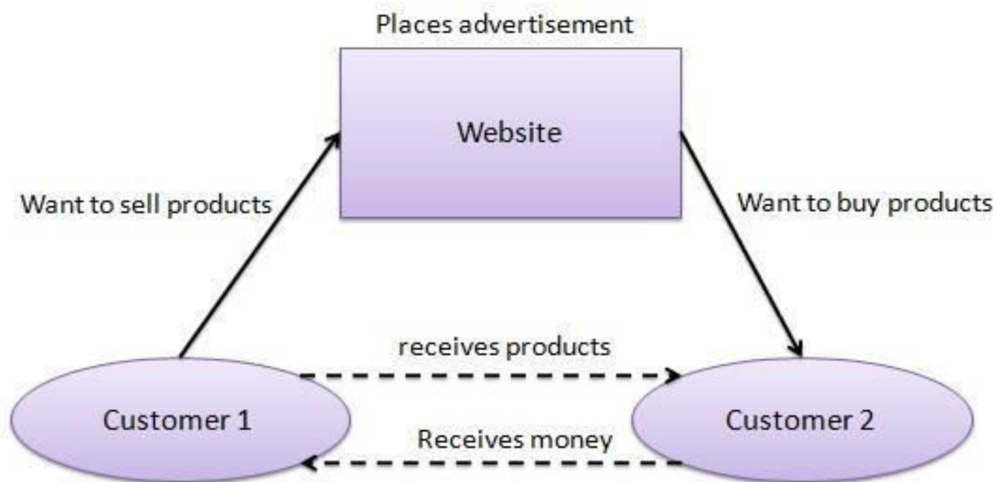
Consumer-to-Business (C2B)

In a Consumer-to-Business E-commerce environment, consumers usually post their products or services online on which companies can post their bids. A consumer reviews the bids and selects the company that meets his price expectations.



Consumer-to-Consumer (C2C)

In a Consumer-to-Consumer E-commerce environment consumers sell their online goods to other consumers. A well-known example is eBay.



1.8 E-Governance:

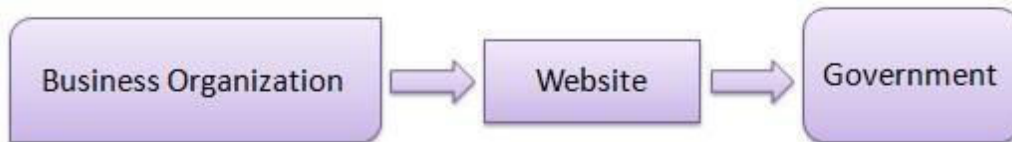
E-governance is the application of information and communication technology (ICT) for delivering government services, exchange of information communication transactions, integration of various stand-alone systems and services between government-to-customer (G2C), government-to-business (G2B), government-to-government (G2G) as well as back office processes and interactions within the entire government framework.

Through e-governance, government services will be made available to citizens in a convenient, efficient and transparent manner. The three main target groups that can be distinguished in

governance concepts are government, citizens and businesses/interest groups. In e-governance there are no distinct boundaries.

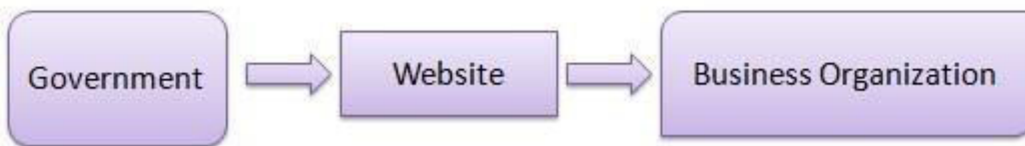
Business - to - Government (B2G)

B2G model is a variant of B2B model. Such websites are used by government to trade and exchange information with various business organizations. Such websites are accredited by the government and provide a medium to businesses to submit application forms to the government.



Government - to - Business (G2B)

Government uses B2G model website to approach business organizations. Such websites support auctions, tenders and application submission functionalities.



Government - to - Citizen (G2C)

Government uses G2C model website to approach citizen in general. Such websites support auctions of vehicles, machinery or any other material. Such website also provides services like registration for birth, marriage or death certificates. Main objectives of G2C website are to reduce average time for fulfilling people requests for various government services.

1.9 Different Types of Networking For E-Commerce:

Internet:

The Internet is a global network of computers that allows people to send email, view web sites, download files such as mp3 and images, chat, post messages on newsgroups and forums and much more.

The Internet was created by the Advanced Research Projects Agency (ARPA) of the U.S. government in 1960's and was first known as the ARPANet. At this stage the Internet's first computers were at academic and government institutions and were mainly used for accessing files and to send emails. From 1983 onwards the Internet as we know it today started to form with the introduction of the communication protocol TCP/IP to ARPANet. Since 1983 the Internet has accommodated a lot of changes and continues to keep developing.

The last two decades has seen the Internet accommodate such things as network LANs and ATM and frame switched services. The Internet continues to evolve with it becoming available on mobile phones and pagers and possibly on televisions in the future.

Advantages of internet:

There many advantages to using the internet such as:

E-mail

Email is now an essential communication tool in business. It is also excellent for keeping in touch with family and friends. The advantage to email is that it is free (no charge per use) when compared to telephone, fax and postal services.

Information

There is a huge amount of information available on the internet for just about every subject known to man, ranging from government law and services, trade fairs and conferences, market information, new ideas and technical support.

Services

Many services are now provided on the internet such as online banking, job seeking and applications, and hotel reservations. Often these services are not available off-line or cost more.

Buy or sell products.

The internet is a very effective way to buy and sell products all over the world.

Communities communities of all types have sprung up on the internet. Its a great way to meet up with people of similar interest and discuss common issues.

A Leading-Edge Image

Presenting your company or organization as leading-edge shows your customers and prospective customers that you are financially strong, technologically savvy, and ready for the 21st century. And that you care enough about your customers to take advantage of new technologies for their benefit. And finally that you have the resources to support your clients in the most beneficial manner possible.

More and more advertisers on television, radio, magazines, and newspapers are including a Web address. Now is the time to avoid playing catch-up later.

Improved Customer Service

The companies are available to their customers 24 hours a day, 7 days a week. The Internet never sleeps. Whenever customer needs information about any company, products or services, they can access the company's Web Page.

Market Expansion

The Internet is a global system. Latest estimates are that there are about 40 million people with access to the Internet, and this number is growing every day. By simply posting a Web Page you are also addressing International markets.

Low Cost Marketing

Imagine developing a full color brochure without having to incur the costs of proofs, printers, wasted paper, long lead times between revisions, and more. Then imagine a full color product or services brochure that is interactive and which incorporates text, graphics, audio, and/or video. One that can be immediately updated without incurring the usual costs of product material updates.

Low Cost Selling

Without the cost of direct selling potential customers can get detailed information about your products or services at any time. And they can easily order your products over the Internet, or request additional information be sent to them via a request form on your Web page.

Lower Communication Costs

Your time, and your employees time, is valuable. Most businesses and organizations spend time answering the same questions over and over again. With a Web page you can make the answers

available to everyone immediately. You can also update your Wed page with new information quickly and easily.

Intranet:

- An intranet is a computer network that uses Internet Protocol technology to share information, operational systems, or computing services within an organization. This term is used in contrast to extranet, a network between organizations, and instead refers to a network within an organization.
- The objective is to organize each individual's desktop with minimal cost, time and effort to be more productive, cost efficient, timely, and competitive.
- An intranet may host multiple private websites and constitute an important component and focal point of internal communication and collaboration.
- Any of the well known Internet protocols may be found in an intranet, such as HTTP (web services), SMTP (e-mail), and FTP (file transfer protocol). Internet technologies are often deployed to provide modern interfaces to legacy information systems hosting corporate data.

Uses of Intranet:

- Increasingly, intranets are being used to deliver tools, e.g. collaboration (to facilitate working in groups and teleconferencing) or sophisticated corporate directories, sales and customer relationship management tools, project management etc., to advance productivity.
- Intranets are also being used as corporate culture-change platforms. For example, large numbers of employees discussing key issues in an intranet forum application could lead to new ideas in management, productivity, quality, and other corporate issues.
- In large intranets, website traffic is often similar to public website traffic and can be better understood by using web metrics software to track overall activity. User surveys also improve intranet website effectiveness. Larger businesses allow users within their intranet to access public internet through firewall servers. They have the ability to screen messages coming and going keeping security intact.
- When part of an intranet is made accessible to customers and others outside the business, that part becomes part of an extranet. Businesses can send private messages through the public

network, using special encryption/decryption and other security safeguards to connect one part of their intranet to another.

- Intranet user-experience, editorial, and technology teams work together to produce in-house sites. Most commonly, intranets are managed by the communications, HR or CIO departments of large organizations, or some combination of these.
- Because of the scope and variety of content and the number of system interfaces, intranets of many organizations are much more complex than their respective public websites. Intranets and their use are growing rapidly.

Advantages:

- **Workforce productivity**: Intranets can help users to locate and view information faster and use applications relevant to their roles and responsibilities. With the help of a web browser interface, users can access data held in any database the organization wants to make available, anytime and — subject to security provisions — from anywhere within the company workstations, increasing employees' ability to perform their jobs faster, more accurately, and with confidence that they have the right information.
- **Time**: Intranets allow organizations to distribute information to employees on an *as-needed* basis; Employees may link to relevant information at their convenience, rather than being distracted indiscriminately by email.
- **Communication**: Intranets can serve as powerful tools for communication within an organization, vertically strategic initiatives that have a global reach throughout the organization. By providing this information on the intranet, staff have the opportunity to keep up-to-date with the strategic focus of the organization. Some examples of communication would be chat, email, and/or blogs. A great real world example of where an intranet helped a company communicate is when Nestle had a number of food processing plants in Scandinavia. Their central support system had to deal with a number of queries every day.
- **Web publishing**: allows cumbersome corporate knowledge to be maintained and easily accessed throughout the company using hypermedia and Web technologies. Examples include: employee manuals, benefits documents, company policies, business standards, news feeds, and even training, can be accessed using common Internet standards (Acrobat files,

Flash files, CGI applications). Because each business unit can update the online copy of a document, the most recent version is usually available to employees using the intranet.

- **Business operations and management**: Intranets are also being used as a platform for developing and deploying applications to support business operations and decisions across the internetworked enterprise.
- **Cost-effective**: Users can view information and data via web-browser rather than maintaining physical documents such as procedure manuals, internal phone list and requisition forms. This can potentially save the business money on printing, duplicating documents, and the environment as well as document maintenance overhead.
- **Enhance collaboration**: Information is easily accessible by all authorised users, which enables teamwork.
- **Cross-platform capability**: Standards-compliant web browsers are available for Windows, Mac, and UNIX.
- **Built for one audience**: Many companies dictate computer specifications which, in turn, may allow Intranet developers to write applications that only have to work on one browser (no cross-browser compatibility issues).
- **Promote common corporate culture**: Every user has the ability to view the same information within the Intranet.
- **Immediate updates**: When dealing with the public in any capacity, laws, specifications, and parameters can change. Intranets make it possible to provide your audience with "live" changes so they are kept up-to-date, which can limit a company's liability.
- **Supports a distributed computing architecture:** The intranet can also be linked to a company‘s management information system, for example a time keeping system.

1.10 Wireless Application Protocol:

- WAP is a technical standard for accessing information over a mobile wireless network.
- A WAP browser is a web browser for mobile devices such as mobile phones that uses the protocol.
- WAP is a specification for a set of communication protocols to standardize the way that wireless devices, such as cellular telephones and radio transceivers, can be used for Internet access, including e-mail, the World Wide Web, newsgroups, and instant messaging.

The WAP layers are:

- Wireless Application Environment (WAE)
- Wireless Session Layer (WSL)
- Wireless Transport Layer Security(WTLS)
- Wireless Transport Layer (WTP)

Web security:

- It is a branch of Information Security that deals specifically with security of websites, web applications and web services.
- At a high level, Web application security draws on the principles of application security but applies them specifically to Internet and Web systems. Typically web applications are developed using programming languages such as PHP, Java EE, Java, Python, Ruby, ASP.NET, C#, VB.NET or Classic ASP.

Chapter-2

2.1 Technological convergence:

- Technological convergence is the tendency that as technology changes, different technological systems sometimes evolve toward performing similar tasks.
- Digital convergence refers to the convergence of four industries into one conglomerate, ITTCE (Information Technologies, Telecommunication, Consumer Electronics, and Entertainment).Previously separate technologies such as voice data and productivity applications, and video can now share resources and interact with each other synergistically.
- Telecommunications convergence, network convergence or simply convergence are broad terms used to describe emerging telecommunications technologies, and network architecture used to migrate multiple communications services into a single network.
- Convergence in this instance is defined as the interlinking of computing and other information technologies, media content, and communication networks that has arisen as the result of the evolution and popularization of the Internet as well as the activities, products and services that have emerged in the digital media space.
- Convergent services, such as VoIP, IPTV, Mobile TV, Smart TV, and others, tend to replace the older technologies and thus can disrupt markets. IP-based convergence is inevitable and will result in new service and new demand in the market.

2.2 Technology Implications:

Convergent solutions include both fixed-line and mobile technologies. Recent examples of new, convergent services include:

- Using the Internet for voice telephony
- Video on demand
- Fixed-mobile convergence
- Mobile-to-mobile convergence

- Location-based services
- Integrated products and bundles

Convergent technologies can integrate the fixed-line with mobile to deliver convergent solutions. Convergent technologies include:

- IP Multimedia Subsystem
- Session Initiation Protocol
- IPTV
- Voice over IP
- Voice call continuity
- Digital video broadcasting - handheld

2.3 Collaborative Product Development:

- CPD is a business strategy, work process and collection of software applications that facilitates different organizations to work together on the development of a product. It is also known as collaborative product definition management (cPDM).
- Collaborative Product Development helps individual users and companies manage, share and view your CAD projects without the cost and complexity of purchasing an entire PDM or PLM solution. CPD comes in the form of a Software as a service delivery model, which allows for rapid iterations and little or no downloads and installs.
- Exactly what technology comes under this title does vary depending on whom one asks; however, it usually consists of the Product Lifecycle Management (PLM) areas of: Product Data Management (PDM); Product visualization; team collaboration and conferencing tools; and supplier sourcing software. It is generally accepted as not including CAD geometry tools, but does include data translation technology.

Technologies and methods used:

Clearly general collaborative software such as email and chat (instant messaging) is used within the CPD process. One important technology is application and desktop sharing, allowing one person to view what another person is doing on a remote machine. For CAD and product visualization applications an ‗appshare' product that supports OpenGL graphics is required. Another common application is Data sharing via Web based portals.

Specific to product data

With product data an important addition is the handling of high volumes of geometry and metadata. Exactly what techniques and technology is required depends on the level of collaboration being carried out and the commonality (or lack thereof) of the partner sites' systems.

Specific to PLM and CAx collaboration

Collaboration using PLM and CAx tools requires technology to support the needs of:

1. People: Personnel of different disciplines and skill levels;
2. Organizations: Organizations throughout an enterprise or extended enterprise with different rules, processes and objectives;
3. Data: Data from different sources in different formats.

Appropriate technologies are required to support collaboration across these boundaries.

- **People**

  Effective PLM collaboration will typically require the participation of people who do not have high level CAD skills. This requires improved user interfaces including tailorable user interfaces that can be tailored to the skill level and specialty of the user.

  Improved visualization capabilities, especially those that provide a meaningful view of complex information such as the results of a fluid flow analysis will leverage the value of all participants in the collaboration process. Effective collaboration requires that a participant be freed from the burden of knowing the intent history typically imbedded within and constricting the use of parametric models.

- **Organizations**

  Community collaboration requires that companies, suppliers, and customers share information in a secure environment, ensure compliance with enterprise and regulatory rules and enforce the process management rules of the community as well as the individual organizations.

- **Data**

  The most basic collaboration data need is the ability to operate in a MultiCAD environment. That is, however, only the beginning. Models from multiple CAD sources must be assembled into an active digital mockup allowing change and/or design in context.

2.4 Content Management System:

- A content management system (CMS) is a computer application that allows publishing, editing and modifying content, organizing, deleting as well as maintenance from a central interface. Such systems of content management provide procedures to manage workflow in a collaborative environment.
- CMSs are often used to run websites containing blogs, news, and shopping. Many corporate and marketing websites use CMSs. CMSs typically aim to avoid the need for hand coding, but may support it for specific elements or entire pages.

Main features of CMS:

- The function and use of content management systems is to store and organize files, and provide version-controlled access to their data. CMS features vary widely. Simple systems showcase a handful of features, while other releases, notably enterprise systems, offer more complex and powerful functions. Most CMS include Web-based publishing, format management, revision control (version control), indexing, search, and retrieval. The CMS increments the version number when new updates are added to an already-existing file. Some content management systems also support the separation of content and presentation.
- A CMS may serve as a central repository containing documents, movies, pictures, phone numbers, scientific data. CMSs can be used for storing, controlling, revising, semantically enriching and publishing documentation.

The content management system (CMS) has two elements:

- Content management application (CMA) is the front-end user interface that allows a user, even with limited expertise, to add, modify and remove content from a Web site without the intervention of a Webmaster.
- Content delivery application (CDA) compiles that information and updates the Web site.

2.5 Web Traffic:

Web traffic is the amount of data sent and received by visitors to a web site.
Web traffic is measured to see the popularity of web sites and individual pages or sections within a site. This can be done by viewing the traffic statistics found in the web server log file, an automatically generated list of all the pages served. A *hit* is generated when any file is served.

The following types of information are often collated when monitoring web traffic:

- The number of visitors.
- The average number of page views per visitor – a high number would indicate that the average visitors go deep inside the site, possibly because they like it or find it useful.
- Average visit duration – the total length of a user's visit. As a rule the more time they spend the more they're interested in your company and are more prone to contact.
- Average page duration – how long a page is viewed for. The more pages viewed, the better it is for your company.
- Domain classes – all levels of the IP Addressing information required to deliver Webpages and content.
- Busy times – the most popular viewing time of the site would show when would be the best time to do promotional campaigns and when would be the most ideal to perform maintenance
- Most requested pages – the most popular pages
- Most requested entry pages – the entry page is the first page viewed by a visitor and shows which are the pages most attracting visitors
- Most requested exit pages – the most requested exit pages could help find bad pages, broken links or the exit pages may have a popular external link

- Top paths – a path is the sequence of pages viewed by visitors from entry to exit, with the top paths identifying the way most customers go through the site
- Referrers; The host can track the (apparent) source of the links and determine which sites are generating the most traffic for a particular page.

2.6 Content marketing:

- Content marketing is any marketing that involves the creation and sharing of media and publishing content in order to acquire and retain customers.
- It is a strategic marketing approach focused on creating and distributing valuable, relevant, and consistent content to attract and retain a clearly-defined audience — and, ultimately, to drive profitable customer action.
- Basically, content marketing is the art of communicating with your customers and prospects without selling.
- It is non-interruption marketing. Instead of pitching your products or services, you are delivering information that makes your buyer more intelligent.

2.7 Call centre:

- A call centre is a centralised office used for receiving or transmitting a large volume of requests by telephone.
- An inbound call centre is operated by a company to administer incoming product support or information inquiries from consumers.
- Outbound call centers are operated for telemarketing, solicitation of charitable or political donations, debt collection and market research.
- A contact centre is a location for centralised handling of individual communications, including letters, faxes, live support software, social media, instant message, and e-mail.
- A call centre has an open workspace for call centre agents, with work stations that include a computer for each agent, a telephone set/headset connected to a telecom switch, and one or more supervisor stations. It can be independently operated or networked with additional centres, often linked to a corporate computer network, including mainframes, microcomputers and LANs.
- The contact centre is a central point from which all customer contacts are managed. Through contact centres, valuable information about company are routed to appropriate

people, contacts to be tracked and data to be gathered. It is generally a part of company's customer relationship management.

2.8 Components of call centre:

There are 6 key components which should be integrated into the call centre operation:

- Location, building and facilities
- Customer
- Technology
- Process
- People
- Finance and business management

➢ **Location, building and facilities**

Where a centre is located is critical in terms of the cost of the building but more importantly the ability to recruit and retain employees to work in the centre. The ease and cost to get to a centre is important for those employed in the centre but also in the integration with the Head Office functions that the centre needs to work with. The facilities and working environment is more critical than for functional line departments because of the intensity with which the Agents have to sit at their desks and the need to manage resource patterns. Visiting a call centre and looking at how it might feel to work in it will be extremely telling as to how good the centres performance is, but also how the organisation view and treat their employees.

➢ **Customer**

Customers can be anyone, and the Agent needs to have the skills to be able to adapt their style and vocabulary to suit different customer types. The Agent talks to more customers in any one day that any other person in the organisation. If you want to know what is going on with customers, ask the Agents! With average call durations of less than 3 minutes, how do you form a relationship and build loyalty from a customer in that time. That is one of the biggest challenges that the Agents face, especially given many customers do not like the impersonal touch that call centres often provide.

➢ **Technology**

There are significant amounts of technology available and it is very easy to be bamboozled by it all! It very much depends on the size and nature of your business as to what you require. The basic equipment to handle calls is the Automated Call Distributor but these can range from basic to a Rolls Royce! Many centres do not fully utilise the technology that they have.

In addition there is usually a disjoint between what the technology can do and what it is actually used for.

- **Process**

Every centre has a multitude of processes, but the biggest challenge that it faces is to understand the end to end process from the customer perspective. The customer journey is what happens from the point in time when a customer decides to contact you through to the completion of that request or transaction. How long does this journey take and what does it feel like taking the steps along the way. How long is spent waiting? Does the agent have the customer details to hand? Can the agent answer the query first time? Does the fulfilment when expected? One very easy but critical way of looking at the customer journey is to mystery shop the centre and to see what it really feels like to be the customer. Put yourselves in the shoes of your key customer demographic type and call your own centre today.

- **People**

People are the most critical asset in a call centre as it is they who really deliver the business performance. Unfortunately the investment and perception of your staff may be rather poor. The people (Agents) often have to deal with difficult situations when things have gone wrong in your organisation and deal with a large volumes of calls that result, whilst not always having the necessary training or skills. However, the teams in Centres can be very resilient and are often very social, making the centre a great place to work. There are many different roles on offer and so they can a good environment to start and develop a career.

- **Finance and business management**

There will be more management information statistics in a call centre than in any other part of the organisation. The centre is measured from every different angle but unfortunately, this does not always give a complete picture!

One of the most challenging roles is the planning, measuring and reviewing of performance because so many centres are under pressure from calls and other expectations, that being able to step back and take an objective view maybe difficult. Most centres are run to very tight budgets so factors such as turnover of staff will have a huge impact.

2.9 Customer-Premises Equipment:

Customer-premises equipment or customer-provided equipment (CPE) is any terminal and associated equipment located at a subscriber's premises and connected with a carrier's telecommunication channel at the demarcation point . The demarc is a point established in a building or complex to separate customer equipment from the equipment located in either the distribution infrastructure or central office of the communications service provider.

CPE generally refers to devices such as telephones, routers, switches, residential gateways (RG), set-top boxes, fixed mobile convergence products, home networking adapters and Internet access gateways that enable consumers to access communications service providers' services and distribute them around their house via a local area network (LAN).

2.10 Supply Chain Management:

It is the process of planning, implementing, and controlling the operations of the supply chain with the purpose to satisfy customer requirements as efficiently as possible. Supply chain management spans all movement and storage of raw materials, work-in-process inventory, and finished goods from point-of-origin to point-of-consumption.

Supply chain management must address the following problems:

- Distribution Network Configuration: Number and location of suppliers, production facilities, distribution centers, warehouses and customers.
- Distribution Strategy: Centralized versus decentralized, direct shipment, cross docking, pull or push strategies, third party logistics.
- Information: Integrate systems and processes through the supply chain to share valuable information, including demand signals, forecasts, inventory and transportation.
- Inventory Management: Quantity and location of inventory including raw materials, work-in-process and finished goods.

2.11 Features Of Supply Chain Management:

In electronic commerce, supply chain management has the following features.

- An ability to source raw material or finished goods from anywhere in the world
- A centralized, global business and management strategy with flawless local execution

- On-line, real-time distributed information processing to the desktop, providing total supply chain information visibility
- The ability to manage information not only within a company but across industries and enterprises
- The seamless integration of all supply chain processes and measurements, including third-party suppliers, information systems, cost accounting standards, and measurement systems
- The development and implementation of accounting models such as activity based costing that link cost to performance are used as tools for cost reduction
- A reconfiguration of the supply chain organization into high-performance teams going from the shop floor to senior management.

2.12 Components Of Supply Chain Management:

The following are five basic components of SCM.

- **Plan:**

  This is the strategic portion of SCM. You need a strategy for managing all the resources that go toward meeting customer demand for your product or service. A big piece of planning is developing a set of metrics to monitor the supply chain so that it is efficient, costs less and delivers high quality and value to customers.

- **Source:**

  Choose the suppliers that will deliver the goods and services you need to create your product. Develop a set of pricing, delivery and payment processes with suppliers and create metrics for monitoring and improving the relationships. And put together processes for managing the inventory of goods and services you receive from suppliers, including receiving shipments, verifying them, transferring them to your manufacturing facilities and authorizing supplier payments.

- **Make:**

  This is the manufacturing step. Schedule the activities necessary for production, testing, packaging and preparation for delivery. As the most metric-intensive portion of the supply chain, measure quality levels, production output and worker productivity.

- **Deliver:**

  This is the part that many insiders refer to as logistics. Coordinate the receipt of orders from customers, develop a network of warehouses, pick carriers to get products to customers and set up an invoicing system to receive payments.

- **Return:**

  The problem part of the supply chain. Create a network for receiving defective and excess products back from customers and supporting customers who have problems with delivered products.

2.13 Measuring A Supply Chain's Performance:

The performance of a supply chain is evaluated by how it reduces cost or increases value. SCM performance monitoring is important; in many industries, the supply chain represents roughly 75 percent of the operating budget expense. Three common measures of performance are used when evaluating SCM performance:

- Efficiency focuses on minimizing cost by decreasing the inventory investment or value relative to the cost of goods sold. An efficient firm is therefore one with a higher inventory turnover or fewer weeks�ANTML_ESCAPE_PLACEHOLDER worth of inventory on hand.
- Responsiveness focuses on reduction in both inventory costs and missed sales that comes with a faster, more flexible supply chain. A responsive firm is proficient in an uncertain market environment, because it can quickly adjust production to meet demand.
- Effectiveness of the supply chain relates to the degree to which the supply chain creates value for the customer. Effectiveness-focused supply chains are called ―value chains‖ because they focus more on creating customer value than reducing costs and improving productivity.

To examine the effect of the Internet and electronic commerce on the supply chain is to examine the impact the Internet has on the efficiency, responsiveness, effectiveness, and overall performance of the supply chain.

2.14 Advantages of Internet/E-Commerce Integrated Supply Chain:

The primary advantages of Internet utilization in supply chain management are speed, decreased cost, flexibility, and the potential to shorten the supply chain.

- **Speed:**

  A competitive advantage accrues to those firms that can quickly respond to changing market conditions. Because the Internet allows near instantaneous transfer of information between various links in the supply chain, it is ideally suited to help firms keep pace with their environments. Many businesses have placed a priority upon real-time information regarding the status of orders and production from other members of the supply chain.

- **Cost decrease:**

  Internet-based electronic procurement helps reduce costs by decreasing the use of paper and labor, reducing errors, providing better tracking of purchase orders and goods delivery, streamlining ordering processes, and cutting acquisition cycle times.

- **Flexibility:**

  The Internet allows for custom interfaces between a company and its different clients, helping to cost-effectively establish mass customization. A manufacturer can easily create a custom template or Web site for a fellow supply chain member with pre-negotiated prices for various products listed on the site, making re-ordering only a mouse click away. The information regarding this transaction can be sent via the Internet to the selling firm‘s production floor and the purchasing firm‘s purchasing and accounting departments. The accuracy and reliability of the information is greater than the traditional paper and pencil transaction, personnel time and expense is reduced, and the real-time dissemination of the relevant information to interested parties improves responsiveness. These advantages can benefit both firms involved in the transaction.

- **Shortening the supply chain:**

  Dell computers has become a classic example of the power the Internet can have on a supply chain. Dell helped create one of the first fully Internet-enabled supply chains and revolutionized the personal-computer industry by selling directly to businesses and consumers, rather than through retailers and middlemen. In mid-1996, Dell began allowing consumers to configure and order computers online. By 1998, the company recorded

roughly $1 billion in ―pure‖ Internet orders. By reducing sales costs and attracting customers who spend more per transaction, Dell estimates that it yields 30 percent greater profit margins on Internet sales compared to telephone sales.

2.15 Disadvantages of Internet/E-Commerce Integrated Supply Chain:

- **Increased interdependence:**

  Increased commoditization, increased competition, and shrinking profit margins are forcing companies to increase outsourcing and subcontracting to minimize cost. By focusing on its core competencies, a firm should be able to maximize its economies of scale and its competitiveness. However, such a strategy requires increased reliance and information sharing between members of the supply chain. Increased dependency on various members of the supply chain can have disastrous consequences if these supply chain members are unable to handle the functions assigned to them.

- **The costs of implementation:**

  Implementation of a fully-integrated Internet-based supply chain is expensive. This expense includes hardware cost, software cost, reorganization cost, and training costs. While the Internet promises many advantages once it is fully integrated into a supply chain, a significant up front investment is needed for full deployment.

- **Keeping up with the change in expectations:**

  Expectations have increased as Internet use has become part of daily life. When customers send orders electronically, they expect to get a quick confirmation and delivery or denial if the order can not be met. Increasingly, in this and other ways, customers are dictating terms and conditions to suppliers. The introduction of Internet-based supply chains make possible the change to a ―pull‖ manufacturing strategy replacing the traditional ―push‖ strategy that has been the standard in most industries.

Chapter-3

3.1 E-Payment System:

Electronic payment systems are central to on-line business process as companies look for ways to serve customers faster and at lower cost. Emerging innovations in the payment for goods and services in electronic commerce promise to offer a wide range of new business opportunities.

Electronic payment systems and e-commerce are highly linked given that on-line consumers must pay for products and services. Clearly, payment is an integral part of the mercantile process and prompt payment is crucial. If the claims and debits of the various participants (consumers, companies and banks) are not balanced because of payment delay, then the entire business chain is disrupted. Hence an important aspect of e-commerce is prompt and secure payment, clearing, and settlement of credit or debit claims.

Electronic payment systems are becoming central to on-line business transactions nowadays as companies look for various methods to serve customers faster and more cost effectively. Electronic commerce brings a wide range of new worldwide business opportunities. There is no doubt that electronic payment systems are becoming more and more common and will play an important role in the business world. Electronic payment always involves a payer and a payee who exchange money for goods or services. At least one financial institution like a bank will act as the issuer (used by the payer) and the acquirer (used by the payee).

3.2 Types of Electronic Payment Systems:

Electronic payment systems are proliferating in banking, retail, health care, on-line markets, and even government—in fact, anywhere money needs to change hands.

- Organizations are motivated by the need to deliver products and services more cost effectively and to provide a higher quality of service to customers.
- The emerging electronic payment technology labeled electronic funds transfer (EFT).

- EFT is defined as –any transfer of funds initiated through an electronic terminal telephonic instrument, or computer or magnetic tape so as to order, instruct, or authorize a financial institution.

EFT can be segmented into three broad categories:

- **Banking and financial payments**
  - Large-scale or wholesale payments (e.g., bank-to-bank transfer)
  - Small-scale or retail payments (e.g., automated teller machines
  - Home banking (e.g., bill payment)
- **Retailing payments**
  - Credit Cards (e.g., VISA or MasterCard)
  - Private label credit/debit cards (e.g., J.C. Penney Card)
  - Charge Cards (e.g., American Express)
- **On-line electronic commerce payments**
  - **Token-based payment systems**
    - Electronic cash (e.g., DigiCash)
    - Electronic checks (e.g., NetCheque)
    - Smart cards or debit cards (e.g., Mondex Electronic Currency Card)
  - **Credit card-based payments systems**
    - Encrypted Credit Cards (e.g., World Wide Web form-based encryption)
    - Third-party authorization numbers (e.g., First Virtual)

3.3 E-Cash:

- There are many ways that exist for implementing an e-cash system, all must incorporate a few common features.
- Electronic Cash is based on cryptographic systems called –digital signatures‖.
- This method involves a pair of numeric keys: one for locking (encoding) and the other for unlocking (decoding).

E-cash must have the following four properties.

- Monetary value
- Interoperability
- Retrievability
- Security

• Electronic cash is a general term that describes the attempts of several companies to create value storage and exchange system that operates online in much the same way that government-issued currency operates in the physical world.

• Concerns about electronic payment methods include:

– Privacy

– Security

– Independence

– Portability

Electronic Cash Storage:

• Two methods

– **On-line**

• Individual does not have possession personally of electronic cash

• Trusted third party, e.g. e-banking, bank holds customers' cash accounts

– **Off-line**

• Customer holds cash on smart card or electronic wallet

• Fraud and double spending require tamper-proof encryption

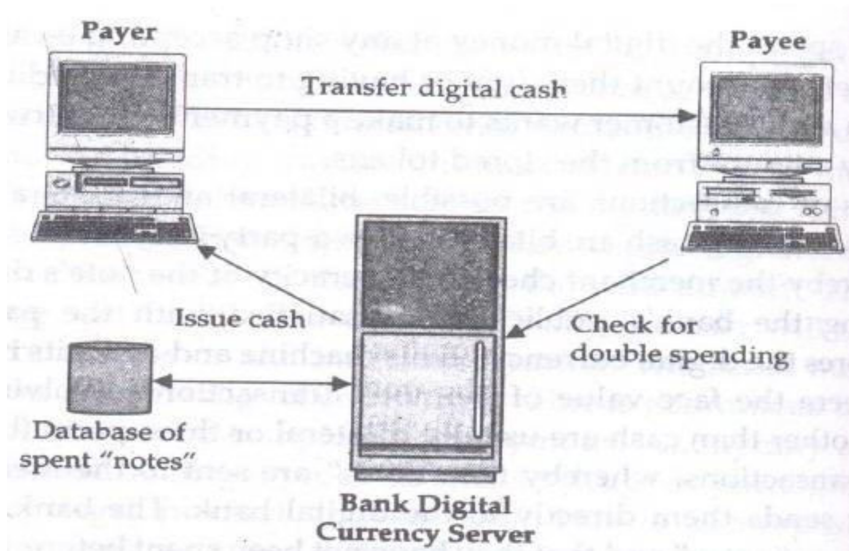
The purchase of e-cash from an on-line currency server (or bank) involves two steps:

- ➢ Establishment of an account
- ➢ Maintaining enough money in the account to bank the purchase.

- Once the tokens are purchased, the e-cash software on the customer's PC stores digital money undersigned by a bank.
- The users can spend the digital money at any shop accepting e-cash, without having to

open an account there or having to transmit credit card numbers.

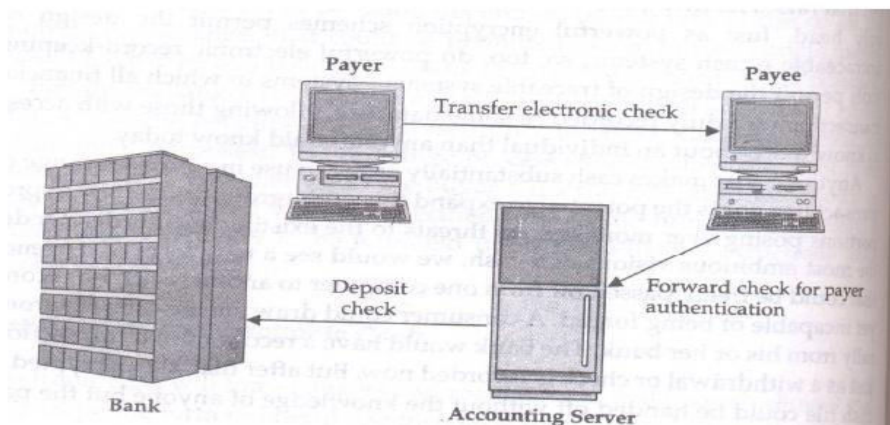
- As soon as the customer wants to make a payment, the software collects the necessary amount from the stored tokens



– Convenience

3.4 Electronic Checks:

- It is another form of electronic tokens.
- Buyers must register with third-party account server before they are able to write electronic checks.
- The account server acts as a billing service.



Advantages of Electronic Checks:

1. They work in the same way as traditional checks.
2. These are suited for clearing micropayments.
3. They create float & availability of float is an important for commerce.
4. Financial risk is assumed by the accounting server & may result in easier acceptance.

3.5 Smart Cards & Electronic Payment Systems:

- Smart cards have been in existence since the early 1980s and hold promise for secure transactions using existing infrastructure.
- Smart cards are credit and debit cards and other card products enhanced with microprocessors capable of holding more information than the traditional magnetic stripe.
- The smart card technology is widely used in countries such as France, Germany, Japan, and Singapore to pay for public phone calls, transportation, and shopper loyalty programs.

Types of Smart Cards:

- Relationship-Based Smart Credit Cards
- Electronic Purses also known as debit cards

➢ **Relationship-Based Smart Credit Cards:**

- It is an enhancement of existing cards services &/ or the addition of new services that a financial institution delivers to its customers via a chip-based card or other device.
- These services include access to multiple financial accounts, value-added marketing programs, or other information card holders may want to store on their card.
- It includes access to multiple accounts, such as debit, credit, cash access, bill payment & multiple access options at multiple locations.

➢ **Electronic Purses:**

To replace cash and place a financial instrument are racing to introduce electronic purses, wallet-sized smart cards embedded with programmable microchips that store sums of money for people to use instead of cash for everything.

The electronic purse works in the following manner:

- After purse is loaded with money at an ATM, it can be used to pay for candy in a vending machine with a card reader.
- It verifies card is authentic & it has enough money, the value is deducted from balance on the card & added to an e-cash & remaining balance is displayed by the vending machine.

Credit Card-Based Electronic Payment Systems:

Payment cards are all types of plastic cards that consumers use to make purchases:

– Credit cards

• Such as a Visa or a MasterCard, has a preset spending limit based on the user‘s credit limit.

– Debit cards

• Removes the amount of the charge from the cardholder‘s account and transfers it to the seller‘s bank.

– Charge cards

• Such as one from American Express, carries no preset spending limit.

Advantages:

– Payment cards provide fraud protection.

– They have worldwide acceptance.

– They are good for online transactions.

Disadvantages:

Payment card service companies charge merchants per-transaction fees and monthly processing fees.

3.6 Risks in Electronic Payment systems:

- Customer's risks
  - – Stolen credentials or password
  - – Dishonest merchant
  - – Disputes over transaction
  - – Inappropriate use of transaction details
- Merchant‘s risk
  - – Forged or copied instruments

– Disputed charges

– Insufficient funds in customer‘s account

– Unauthorized redistribution of purchased items

3.7 Electronic payments Issues:

- Secure transfer across internet
- High reliability: no single failure point
- Atomic transactions
- Anonymity of buyer
- Economic and computational efficiency: allow micropayments
- Flexibility: across different methods
- Scalability in number of servers and users

Security Requirements In Electronic Payment Systems:

- **Integrity and authorization**

  A payment system with integrity allows no money to be taken from a user without explicit authorization by that user. It may also disallow the receipt of payment without explicit consent, to prevent occurrences of things like unsolicited bribery. Authorization constitutes the most important relationship in a payment system. Payment can be authorized in three ways: via out-band authorization, passwords, and signature.

- **Out-band authorization**

  In this approach, the verifying party (typically a bank) notifies the authorizing party (the payer) of a transaction. The authorizing party is required to approve or deny the payment using a secure, out-band channel (such as via surface mail or the phone). This is the current approach for credit cards involving mail orders and telephone orders: Anyone who knows a user‘s credit card data can initiate transactions, and the legitimate user must check the statement and actively complain about unauthorized transactions. If the user does not complain within a certain time (usually 90 days), the transaction is considered ―approved‖ by default.

- **Password authorization**

  A transaction protected by a password requires that every message from the authorizing party include a cryptographic check value. The check value is computed using a secret

known only to the authorizing and verifying parties. This secret can be a personal identification number, a password, or any form of shared secret. In addition, shared secrets that are short - like a six-digit PIN - are inherently susceptible to various kinds of attacks. They cannot by themselves provide a high degree of security. They should only be used to control access to a physical token like a smart card (or a wallet) that performs the actual authorization using secure cryptographic mechanisms, such as digital signatures.

- **Signature authorization**

  In this type of transaction, the verifying party requires a digital signature of the authorizing party. Digital signatures provide non repudiation of origin.

- **Confidentiality**

  Some parties involved may wish confidentiality of transactions. Confidentiality in this context means the restriction of the knowledge about various pieces of information related to a transaction: the identity of payer/payee, purchase content, amount, and so on. Typically, the confidentiality requirement dictates that this information be restricted only to the participants involved. Where anonymity or un-traceability are desired, the requirement may be to limit this knowledge to certain subsets of the participants only, as described later.

- **Availability and reliability**

  All parties require the ability to make or receive payments whenever necessary. Payment transactions must be atomic: They occur entirely or not at all, but they never hang in an unknown or inconsistent state. No payer would accept a loss of money (not a significant amount, in any case) due to a network or system crash. Availability and reliability presume that the underlying networking services and all software and hardware components are sufficiently dependable. Recovery from crash failures requires some sort of stable storage at all parties and specific resynchronization protocols. These fault tolerance issues are not discussed here, because most payment systems do not address them explicitly.

3.8 Electronic Data Interchange(EDI):

- Electronic Data Interchange (EDI) - interposes communication of business information in standardized electronic form.
- Prior to EDI, business depended on postal and phone systems that restricted communication to those few hours of the workday that overlap between time zones.

Why EDI?

- Reduction in transaction costs
- Foster closer relationships between trading partners

EDI & Electronic Commerce

- Electronic commerce includes EDI & much more
- EDI forges boundary less relationships by improving interchange of information between trading partners, suppliers, & customers.

3.9 EDI layered architecture:

- Semantic (or application) layer
- Standards translation layer
- Packing (or transport) layer
- Physical network infrastructure layer

EDI semantic layer	Application level services	
EDI standard layer	EDIFACT business form standards	
	ANSI X12 business form standards	
EDI transport layer	Electronic mail	X.435, MIME
	Point to point	FTP, TELNET
	World Wide Web	HTTP
Physical layer	Dial-up lines, Internet, I-way	

EDI semantic layer:

- Describes the business application
- Procurement example
  - – Requests for quotes
  - – Price quotes
  - – Purchase orders
  - – Acknowledgments
  - – Invoices
- Specific to company & software used

Standards translation:

• Specifies business form structure so that information can be exchanged

• Two competing standards

– American National Standards Institute(ANSI)X12

– EDIFACT developed by UN/ECE, Working Party for the Facilitation of International Trade Procedures

EDI transport layer

• How the business form is sent, e.g. post, UPS, fax

• Increasingly, e-mail is the carrier

• Differentiating EDI from e-mail

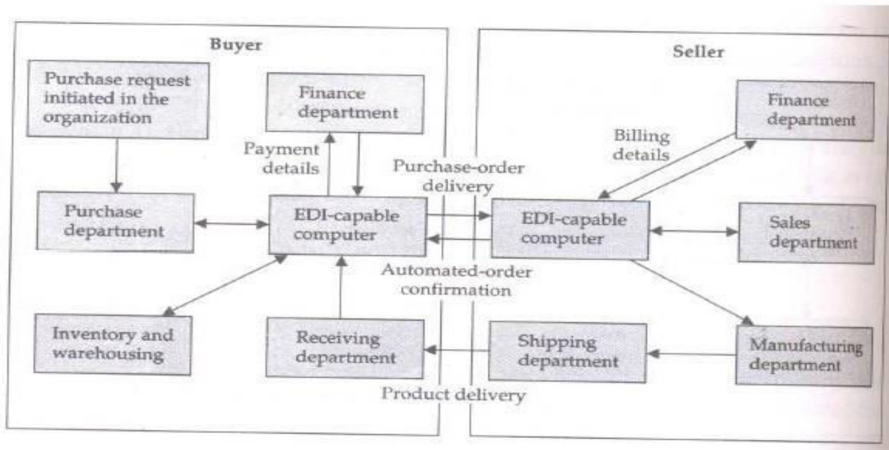
– Emphasis on automation

– EDI has certain legal status

Physical network infrastructure layer

• Dial-up lines, Internet, value-added network, etc.

Information flow with EDI:



1. Buyer sends purchase order to seller computer
2. Seller sends purchase order confirmation to buyer
3. Seller sends booking request to transport company
4. Transport company sends booking confirmation to seller
5. Seller sends advance ship notice to buyer
6. Transport company sends status to seller
7. Buyer sends Receipt advice to seller

8. Seller sends invoice to buyer
9. Buyer sends payment to seller

3.10 Applications of EDI:

1. Role of EDI in international trade:

- Reduced transaction expenditures
- Quicker movement of imported & exported goods
- Improved customer service through ―track & trace‖ programs
- Faster customs clearance & reduced opportunities for corruption, a huge problem in trade

2. Interbank Electronic Funds Transfer (EFT)

• EFTS is credit transfers between banks where funds flow directly from the payer‗s bank to the payee‗s bank.

• The two biggest funds transfer services in the United States are the Federal Reserve‗s system, Fed wire, & the Clearing House Interbank Payments System (CHIPS) of the New York clearing house

3. Health care EDI for insurance EDI

• Providing good & affordable health care is a universal problem

• EDI is becoming a permanent fixture in both insurance & health care industries as medical provider, patients, & payers

• Electronic claim processing is quick & reduces the administrative costs of health care.

• Using EDI software, service providers prepare the forms & submit claims via communication lines to the value-added network service provider

• The company then edits sorts & distributes forms to the payer. If necessary, the insurance company can electronically route transactions to a third-party for price evaluation

• Claims submission also receives reports regarding claim status & request for additional Information

4. Manufacturing & retail procurement using EDI

• These are heavy users of EDI

• In manufacturing, EDI is used to support just-in-time.

• In retailing, EDI is used to support quick response

3.11 EDI Protocols:

- ANSI X12
- EDIFACT

Comparison of EDIFACT & X.12 Standards:

- These are comprised of strings of data elements called segments.
- A transaction set is a set of segments ordered as specified by the standard.
- ANSI standards require each element to have a very specific name, such as order date or invoice date.
- EDIFACT segments, allow for multiuse elements, such as date.
- EDIFACT has fewer data elements & segments & only one beginning segment (header),but it has more composites.
- It is an ever-evolving platform.

3.12 E-Marketing:

- E-marketing is directly marketing a commercial message to a group of people using email. In its broadest sense, every email sent to a potential or current customer could be considered email marketing.
- It usually involves using email to send ads, request business, or solicit sales or donations, and is meant to build loyalty, trust, or brand awareness.
- Email marketing can be done to either sold lists or a current customer database. Broadly, the term is usually used to refer to sending email messages with the purpose of enhancing the relationship of a merchant with its current or previous customers, to encourage customer loyalty and repeat business, acquiring new customers or convincing current customers to purchase something immediately, and adding advertisements to email messages sent by other companies to their customers.

Advantages:

- An exact return on investment can be tracked and has proven to be high when done properly. Email marketing is often reported as second only to search marketing as the most effective online marketing tactic.
- Email marketing is significantly cheaper and faster than traditional mail, mainly because of high cost and time required in a traditional mail campaign for producing the artwork, printing, addressing and mailing.
- Advertisers can reach substantial numbers of email subscribers who have opted in (i.e., consented) to receive email communications on subjects of interest to them.
- Almost half of American Internet users check or send email on a typical day with email blasts that are delivered between 1 am and 5 am local time outperforming those sent at other times in open and click rates.
- Email is popular with digital marketers, rising an estimated 15% in 2009 to £292 m in the UK.
- If compared to standard email, direct email marketing produces higher response rate and higher average order value for e-commerce businesses.

Disadvantages:

- A report issued by the email services company Return Path, as of mid-2008 email deliverability is still an issue for legitimate marketers. According to the report, legitimate email servers averaged a delivery rate of 56%; twenty percent of the messages were rejected, and eight percent were filtered.
- Companies considering the use of an email marketing program must make sure that their program does not violate spam laws such as the United States' Controlling the Assault of Non-Solicited Pornography and Marketing Act (CAN-SPAM),the European Privacy and Electronic Communications Regulations 2003, or their Internet service provider's acceptable use policy.

3.13 Tele Marketing:

- Telemarketing is a method of direct marketing in which a salesperson solicits prospective customers to buy products or services, either over the phone or through a subsequent face to face or Web conferencing appointment scheduled during the call.
- Telemarketing can also include recorded sales pitches programmed to be played over the phone via automatic dialing.
- Telemarketing may be done from a company office, from a call center, or from home. It may involve a live operator voice broadcasting which is most frequently associated with political messages.
- An effective telemarketing process often involves two or more calls. The first call (or series of calls) determines the customer‘s needs. The final call (or series of calls) motivates the customer to make a purchase. Prospective customers are identified by various means, including past purchase history, previous requests for information, credit limit, competition entry forms, and application forms. Names may also be purchased from another company's consumer database or obtained from a telephone directory or another public list. The qualification process is intended to determine which customers are most likely to purchase the product or service.
- Charitable organizations, alumni associations, and political parties often use telemarketing to solicit donations. Marketing research companies use telemarketing techniques to survey the prospective or past customers of a client‘s business in order to assess market acceptance of or satisfaction with a particular product, service, brand, or company. Public opinion polls are conducted in a similar manner.
- Telemarketing techniques are also applied to other forms of electronic marketing using e-mail or fax messages, in which case they are frequently considered spam by receivers.

Disadvantages:

- Telemarketing has been negatively associated with various scams and frauds, such as pyramid schemes, and with deceptively overpriced products and services
- Telemarketing is often criticized as an unethical business practice due to the perception of high-pressure sales techniques during unsolicited calls.

- Telemarketers marketing telephone companies may participate in telephone slamming, the practice of switching a customer's telephone service without their knowledge or authorization.
- Telemarketing calls are often considered an annoyance, especially when they occur during the dinner hour, early in the morning, or late in the evening.

3.14 Security Threats to E-commerce:

E-Commerce security requirements can be studied by examining the overall process, beginning with the consumer and ending with the commerce server. Considering each logical link in the commerce chain, the assets that must be protected to ensure secure e-commerce include client computers, the messages travelling on the communication channel, and the web and commerce servers – including any hardware attached to the servers. While telecommunications are certainly one of the major assets to be protected, the telecommunications links are not the only concern in computer and e-commerce security. For instance, if the telecommunications links were made secure but no security measures were implemented for either client computers or commerce and web-servers, then no communications security would exist at all.

Client threats

Until the introduction of executable web content, Web pages were mainly static. Coded in HTML, static pages could do little more than display content and provide links to related pages with additional information. However, the widespread use of active content has changed this perception.

Active content: Active content refers to programs that are embedded transparently in web pages and that cause action to occur. Active content can display moving graphics, download and play audio, or implement web-based spreadsheet programs. Active content is used in e-commerce to place items one wishes to purchase into a shopping cart and to compute the total invoice amount, including sales tax, handling, and shipping costs. The best known active content forms are Java applets, ActiveX controls, JavaScript, and VBScript.

Malicious codes: Computer viruses, worms and trojan horses are examples of malicious code. A trojan horse is a program which performs a useful function, but performs an unexpected action as well. Virus is a code segment which replicates by attaching copies to existing executables. A

worm is a program which replicates itself and causes execution of the new copy. These can create havoc on the client side.

Server-side masquerading*:* Masquerading lures a victim into believing that the entity with which it is communicating is a different entity. For example, if a user tries to log into a computer across the internet but instead reaches another computer that claims to be the desired one, the user has been spoofed. This may be a passive attack (in which the user does not attempt to authenticate the recipient, but merely accesses it), but it is usually an active attack.

Communication channel threats

The internet serves as the electronic chain linking a consumer (client) to an e-commerce resource. Messages on the internet travel a random path from a source node to a destination node. The message passes through a number of intermediate computers on the network before reaching the final destination. It is impossible to guarantee that every computer on the internet through which messages pass is safe, secure, and non-hostile.

Confidentiality threats: Confidentiality is the prevention of unauthorized information disclosure. Breaching confidentiality on the internet is not difficult. Suppose one logs onto a website – say www.anybiz.com – that contains a form with text boxes for name, address, and e-mail address. When one fills out those text boxes and clicks the submit button, the information is sent to the web-server for processing. One popular method of transmitting data to a web-server is to collect the text box responses and place them at the end of the target server‘s URL. The captured data and the HTTP request to send the data to the server is then sent. Now, suppose the user changes his mind, decides not to wait for a response from the anybiz.com server, and jumps to another website instead – say www.somecompany.com. The server somecompany.com may choose to collect web demographics and log the URL from which the user just came (www.anybiz.com). By doing this, somecompany.com has breached confidentiality by recording the secret information the user has just entered.

Integrity threats: An integrity threat exists when an unauthorized party can alter a message stream of information. Unprotected banking transactions are subject to integrity violations. Cyber vandalism is an example of an integrity violation. Cyber vandalism is the electronic defacing of an existing website page. Masquerading or spoofing – pretending to be someone you are not or representing a website as an original when it really is a fake – is one means of creating havoc on websites. Using a security hole in a domain name server (DNS), perpetrators can

substitute the address of their website in place of the real one to spoof website visitors. Integrity threats can alter vital financial, medical, or military information. It can have very serious consequences for businesses and people.

Availability threats: The purpose of availability threats, also known as delay or denial threats, is to disrupt normal computer processing or to deny processing entirely. For example, if the processing speed of a single ATM machine transaction slows from one or two seconds to 30 seconds, users will abandon ATM machines entirely. Similarly, slowing any internet service will drive customers to competitors‘ web or commerce sites.

Server threats

The server is the third link in the client-internet-server trio embodying the e-commerce path between the user and a commerce server. Servers have vulnerabilities that can be exploited by anyone determined to cause destruction or to illegally acquire information.

Web-server threats: Web-server software is designed to deliver web pages by responding to HTTP requests. While web-server software is not inherently high-risk, it has been designed with web service and convenience as the main design goal. The more complex the software is, the higher the probability that it contains coding errors (bugs) and security holes – security weaknesses that provide openings through which evildoers can enter.

Commerce server threats: The commerce server, along with the web-server, responds to requests from web browsers through the HTTP protocol and CGI scripts. Several pieces of software comprise the commerce server software suite, including an FTP server, a mail server, a remote login server, and operating systems on host machines. Each of this software can have security holes and bugs.

Database threats: E-commerce systems store user data and retrieve product information from databases connected to the web-server. Besides product information, databases connected to the web contain valuable and private information that could irreparably damage a company if it were disclosed or altered. Some databases store username/password pairs in a non-secure way. If someone obtains user authentication information, then he or she can masquerade as a legitimate database user and reveal private and costly information.

Common gateway interface threats: A common gateway interface (CGI) implements the transfer of information from a web-server to another program, such as a database program. CGI and the programs to which they transfer data provide active content to web pages. Because CGIs

are programs, they present a security threat if misused. Just like web-servers, CGI scripts can be set up to run with their privileges set to high – unconstrained. Defective or malicious CGIs with free access to system resources are capable of disabling the system, calling privileged (and dangerous) base system programs that delete files, or viewing confidential customer information, including usernames and passwords.

Password hacking: The simplest attack against a password-based system is to guess passwords. Guessing of passwords requires that access to the complement, the complementation functions, and the authentication functions be obtained. If none of these have changed by the time the password is guessed, then the attacker can use the password to access the system.

3.15 Security Requirements For E-Commerce:

Authentication:

This is the ability to say that an electronic communication (whether via email or web) does genuinely come from who it purports to.Without face-to-face contact, passing oneself off as someone else is not difficult on the internet.

In online commerce the best defence against being misled by an imposter is provided by unforgeable digital certificates from a trusted authority (such as VeriSign). Although anyone can generate digital certificates for themselves, a trusted authority demands real-world proof of identity and checks its validity before issuing a digital certificate. Only certificates from trusted authorities will be automatically recognized and trusted by the major web browser and email client software.

Authentication can be provided in some situations by physical tokens (such as a drivers license), by a piece of information known only to the person involved (eg. a PIN), or by a physical property of a person (fingerprints or retina scans). Strong authentication requires at least two or more of these. A digital certificate provides strong authentication as it is a unique token and requires a password for its usage.

Privacy:

In online commerce, privacy is the ability to ensure that information is accessed and changed only by authorized parties. Typically this is achieved via encryption. Sensitive data (such as credit card details, health records, sales figures etc.) are encrypted before being transmitted across the open internet – via email or the web. Data which has been protected with strong 128-bit encryption may be intercepted by hackers, but cannot be decrypted by them within a short

time. Again, digital certificates are used here to encrypt email or establish a secure HTTPS connection with a web-server. For extra security, data can also be stored long-term in an encrypted format.

Authorization:

Authorization allows a person or computer system to determine if someone has the authority to request or approve an action or information. In the physical world, authentication is usually achieved by forms requiring signatures, or locks where only authorized individuals hold the keys.

Authorization is tied with *authentication*. If a system can securely verify that a request for information (such as a web page) or a service (such as a purchase requisition) has come from a known individual, the system can then check against its internal rules to see if that person has sufficient authority for the request to proceed.

In the online world, authorization can be achieved by a manager sending a digitally signed email. Such an email, once checked and verified by the recipient, is a legally binding request for a service. Similarly, if a web-server has a restricted access area, the server can request a digital certificate from the user‘s browser to identify the user and then determine if they should be given access to the information according to the server‘s permission rules.

Integrity:

Integrity of information means ensuring that a communication received has not been altered or tampered with. Traditionally, this problem has been dealt with by having tight control over access to paper documents and requiring authorized officers to initial all changes made – a system with obvious drawbacks and limitations. If someone is receiving sensitive information online, he not only wants to ensure that it is coming from who he expects it to (authentication), but also that it hasn‘t been intercepted by a hacker while in transit and its contents altered. The speed and distances involved in online communications requires a very different approach to this problem from traditional methods.

One solution is afforded by using digital certificates to digitally ―sign‖ messages. A travelling employee can send production orders with integrity to the central office by using their digital certificate to sign their email. The signature includes a hash of the original message – a brief

numerical representation of the message content. When the recipient opens the message, his email software will automatically create a new hash of the message and compare it against the one included in the digital signature. If even a single character has been altered in the message, the two hashes will differ and the software will alert the recipient that the email has been tampered with during transit.

Non-repudiation:

Non-repudiation is the ability to guarantee that once someone has requested a service or approved an action. Non-repudiation allows one to legally prove that a person has sent a specific email or made a purchase approval from a website. Traditionally non-repudiation has been achieved by having parties sign contracts and then have the contracts notarized by trusted third parties. Sending documents involved the use of registered mail, and postmarks and signatures to date-stamp and record the process of transmission and acceptance. In the realm of e-commerce, non repudiation is achieved by using digital signatures. Digital signatures which have been issued by a trusted authority (such as VeriSign) cannot be forged and their validity can be checked with any major email or web browser software. A digital signature is only installed in the personal computer of its owner, who is usually required to provide a password to make use of the digital signature to encrypt or digitally sign their communications. If a company receives a purchase order via email which has been digitally signed, it has the same legal assurances as on receipt of a physical signed contract.

3.16 Security policy for E-commerce:

The security policy may cover issues like:

- What service types (e.g., web, FTP, SMTP) users may have access to?
- What classes of information exist within the organization and which should be encrypted before being transmitted?
- What client data does the organization hold. How sensitive is it? How is it to be protected?
- What class of employees may have remote access to the corporate network?
- Roles and responsibilities of managers and employees in implementing the security policy.
- How security breaches are to be responded to?

The security policy should also consider physical aspects of network security. For example,

- Who has access to the corporate server?
- Is it in a locked environment or kept in an open office?
- What is the procedure for determining who should be given access? The security policy regulates the activities of employees just as much as it defines how IT infrastructure will be configured. The policy should include details on how it is to be enforced
- How individual responsibilities are determined?

For it to be effective, the policy needs regular testing and review to judge the security measures. The review process needs to take into account any changes in technology or business practices which may have an influence upon security. Lastly, the policy itself needs to be regarded as a living document which will be updated at set intervals to reflect the evolving ways in which the business, customers and technology interact.

Security Standards:

There are various standards pertaining to the security aspects of enterprises. Some of them are

- ISO 17799 (Information technology – Code of practice for information security management).
- (ISO/IEC 2000).
- SSE-CMM (Systems security engineering – Capability maturity model).
- (SSE-CMM 2003).
- COBIT (Control objectives for information and related technology).
- (COBIT 2000).

ISO 17799 provides detailed guidelines on how a management framework for enterprise security should be implemented. It conceives ten security domains. Under each domain there are certain security objectives to be fulfilled. Each objective can be attained by a number of controls. The controls may prescribe management measures like guidelines and procedures, or some security infrastructure in the form of tools and techniques. It details various methods that can be followed by enterprises to meet security needs for e-commerce. It talks about the need for security policies, security infrastructure, and continuous testing in
the same manner as has been detailed above.

The main objective of the COBIT is the development of clear policies and good practices for security and control in IT for worldwide endorsement by commercial, governmental and professional organizations. The SSE-CMM is a process reference model. It is focused upon the requirements for implementing security in a system or series of related systems that are in the Information Technology Security domain.

3.17 Firewall:

A firewall is a network security system that controls the incoming and outgoing network traffic based on an applied rule set. A firewall establishes a barrier between a trusted, secure internal network and another network (e.g., the Internet) that is assumed not to be secure and trusted. Firewalls exist both as software to run on general purpose hardware and as a hardware appliance. Many hardware-based firewalls also offer other functionality to the internal network they protect, such as acting as a DHCP server for that network.

Many personal computer operating systems include software-based firewalls to protect against threats from the public Internet. Many routers that pass data between networks contain firewall components and, conversely, many firewalls can perform basic routing functions.

Types of Firewall:

There are different types of firewalls depending on where the communication is taking place, where the communication is intercepted and the state that is being traced.

- Network layer Firewall
- Application layer firewall
- Proxy server
- Network address translation

- **Network layer Firewall:**

  Network layer firewalls, also called packet filters, operate at a relatively low level of the TCP/IP protocol stack, not allowing packets to pass through the firewall unless they match the established rule set. The firewall administrator may define the rules; or default rules may apply.

Network layer firewalls generally fall into two sub-categories,

- Stateful Firewalls
- Stateless Firewalls

Stateful firewalls maintain context about active sessions, and use that "state information" to speed packet processing. Any existing network connection can be described by several properties, including source and destination IP address, UDP or TCP ports, and the current stage of the connection's lifetime (including session initiation, handshaking, data transfer, or completion connection). If a packet does not match an existing connection, it will be evaluated according to the rule set for new connections. If a packet matches an existing connection based on comparison with the firewall's state table, it will be allowed to pass without further processing.

Stateless firewalls require less memory, and can be faster for simple filters that require less time to filter than to look up a session. They may also be necessary for filtering stateless network protocols that have no concept of a session. However, they cannot make more complex decisions based on what stage communications between hosts have reached.

- **Application Layer Firewall:**

Application-layer firewalls work on the application level of the TCP/IP stack (i.e., all browser traffic, or all telnet or ftp traffic), and may intercept all packets traveling to or from an application. They block other packets (usually dropping them without acknowledgment to the sender).

On inspecting all packets for improper content, firewalls can restrict or prevent outright the spread of networked computer worms and trojans. The additional inspection criteria can add extra latency to the forwarding of packets to their destination.

Application firewalls function by determining whether a process should accept any given connection. Application firewalls accomplish their function by hooking into socket calls to filter the connections between the application layer and the lower layers of the OSI model. Application firewalls that hook into socket calls are also referred to as socket

filters. Application firewalls work much like a packet filter but application filters apply filtering rules (allow/block) on a per process basis instead of filtering connections on a per port basis. Generally, prompts are used to define rules for processes that have not yet received a connection. It is rare to find application firewalls not combined or used in conjunction with a packet filter.

Also, application firewalls further filter connections by examining the process ID of data packets against a ruleset for the local process involved in the data transmission. The extent of the filtering that occurs is defined by the provided ruleset. Given the variety of software that exists, application firewalls only have more complex rulesets for the standard services, such as sharing services. These per process rulesets have limited efficacy in filtering every possible association that may occur with other processes.

- **Proxy server:**

A proxy server running either on dedicated hardware or as software on a general-purpose machine may act as a firewall by responding to input packets (connection requests, for example) in the manner of an application, while blocking other packets. A proxy server is a gateway from one network to another for a specific network application, in the sense that it functions as a proxy on behalf of the network user.

Proxies make tampering with an internal system from the external network more difficult and misuse of one internal system would not necessarily cause a security breach exploitable from outside the firewall. Conversely, intruders may hijack a publicly reachable system and use it as a proxy for their own purposes; the proxy then masquerades as that system to other internal machines. While use of internal address spaces enhances security, crackers may still employ methods such as IP spoofing to attempt to pass packets to a target network.

- **Network Address Translation:**

  Firewalls often have network address translation (NAT) functionality, and the hosts protected behind a firewall commonly have addresses in the "private address range", as defined in RFC 1918.

  Firewalls often have such functionality to hide the true address of protected hosts. Originally, the NAT function was developed to address the limited number of IPv4 routable addresses that could be used or assigned to companies or individuals as well as reduce both the amount and therefore cost of obtaining enough public addresses for every computer in an organization. Hiding the addresses of protected devices has become an increasingly important defense against network reconnaissance.

3.18 Digital Signatures:

A digital signature is a mathematical scheme for demonstrating the authenticity of a digital message or document. A valid digital signature gives a recipient reason to believe that the message was created by a known sender, such that the sender cannot deny having sent the message (authentication and non-repudiation) and that the message was not altered in transit (integrity). Digital signatures are commonly used for software distribution, financial transactions, and in other cases where it is important to detect forgery or tampering.

Digital signatures are often used to implement electronic signatures, a broader term that refers to any electronic data that carries the intent of a signature, but not all electronic signatures use digital signatures. In some countries, including the United States, India, Brazil, and members of the European Union, electronic signatures have legal significance.

A digital signature scheme typically consists of three algorithms;

- A key generation algorithm that selects a private key uniformly at random from a set of possible private keys. The algorithm outputs the private key and a corresponding public key.
- A signing algorithm that, given a message and a private key, produces a signature.

- A signature verifying algorithm that, given a message, public key and a signature, either accepts or rejects the message's claim to authenticity.

Applications of digital signatures:

Authentication:

Although messages may often include information about the entity sending a message, that information may not be accurate. Digital signatures can be used to authenticate the source of messages. When ownership of a digital signature secret key is bound to a specific user, a valid signature shows that the message was sent by that user. The importance of high confidence in sender authenticity is especially obvious in a financial context. For example, suppose a bank's branch office sends instructions to the central office requesting a change in the balance of an account. If the central office is not convinced that such a message is truly sent from an authorized source, acting on such a request could be a grave mistake.

Integrity:

In many scenarios, the sender and receiver of a message may have a need for confidence that the message has not been altered during transmission. Although encryption hides the contents of a message, it may be possible to change an encrypted message without understanding it. (Some encryption algorithms, known as nonmalleable ones, prevent this, but others do not.) However, if a message is digitally signed, any change in the message after signature invalidates the signature. Furthermore, there is no efficient way to modify a message and its signature to produce a new message with a valid signature, because this is still considered to be computationally infeasible by most cryptographic hash functions (see collision resistance).

Non-repudiation:

Non-repudiation, or more specifically non-repudiation of origin, is an important aspect of digital signatures. By this property, an entity that has signed some information cannot at a later time deny having signed it. Similarly, access to the public key only does not enable a fraudulent party to fake a valid signature.

Some digital signature algorithms:

- RSA-based signature schemes, such as RSA-PSS
- DSA and its elliptic curve variant ECDSA
- ElGamal signature scheme as the predecessor to DSA, and variants Schnorr signature and Pointcheval–Stern signature algorithm
- Rabin signature algorithm
- Pairing-based schemes such as BLS
- Undeniable signatures
- Aggregate signature - a signature scheme that supports aggregation: Given n signatures on n messages from n users, it is possible to aggregate all these signatures into a single signature whose size is constant in the number of users. This single signature will convince the verifier that the n users did indeed sign the n original messages.
- Signatures with efficient protocols - are signature schemes that facilitate efficient cryptographic protocols such as zero-knowledge proofs or secure computation.

3.19 Digital Certificate:

- It is an electronic document used to prove ownership of a public key. The certificate includes information about the key, information about its owner's identity, and the digital signature of an entity that has verified the certificate's contents are correct. If the signature is valid, and the person examining the certificate trusts the signer, then they know they can use that key to communicate with its owner.

- The most common use of a digital certificate is to verify that a user sending a message is who he or she claims to be, and to provide the receiver with the means to encode a reply. An individual wishing to send an encrypted message applies for a digital certificate from a Certificate Authority (CA). The CA issues an encrypted digital certificate containing the applicant's public key and a variety of other identification information. The CA makes its own public key readily available through print publicity or perhaps on the Internet.
- The recipient of an encrypted message uses the CA's public key to decode the digital certificate attached to the message, verifies it as issued by the CA and then obtains the

sender's public key and identification information held within the certificate. With this information, the recipient can send an encrypted reply.

- The most widely used standard for digital certificates is X.509.

Contents Of a Typical Digital Certificate:

- Serial Number: Used to uniquely identify the certificate.
- Subject: The person, or entity identified.
- Signature Algorithm: The algorithm used to create the signature.
- Signature: The actual signature to verify that it came from the issuer.
- Issuer: The entity that verified the information and issued the certificate.
- Valid-From: The date the certificate is first valid from.
- Valid-To: The expiration date.
- Key-Usage: Purpose of the public key (e.g. encipherment, signature, certificate signing...).
- Public Key: The public key.
- Thumbprint Algorithm: The algorithm used to hash the public key certificate.
- Thumbprint (also known as fingerprint): The hash itself, used as an abbreviated form of the public key certificate.

Chapter-4

4.1 Enterprise Resource Planning:

Enterprise resource planning (ERP) is business management software—usually a suite of integrated applications—that a company can use to collect, store, manage and interpret data from many business activities, including:

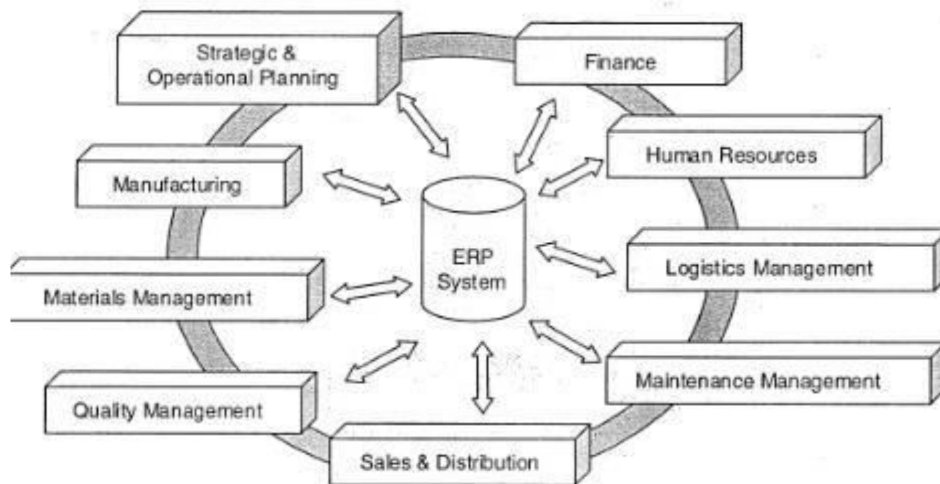
- Product planning, cost
- Manufacturing or service delivery
- Marketing and sales
- Inventory management
- Shipping and payment

- ❖ ERP provides an integrated view of core business processes, often in real-time, using common databases maintained by a database management system. ERP systems track business resources—cash, raw materials, production capacity—and the status of business commitments: orders, purchase orders, and payroll. The applications that make up the system share data across the various departments that provide the data. ERP facilitates information flow between all business functions, and manages connections to outside stakeholders.
- ❖ Enterprise system software is a multi-billion dollar industry that produces components that support a variety of business functions. IT investments have become the largest category of capital expenditure in United States-based businesses over the past decade. Though early ERP systems focused on large enterprises, smaller enterprises increasingly use ERP systems.
- ❖ The ERP system is considered a vital organizational tool because it integrates varied organizational systems and facilitates error-free transactions and production. However, ERP system development is different from traditional systems development.
- ❖ ERP systems run on a variety of computer hardware and network configurations, typically using a database as an information repository.

4.2 Functional areas of ERP:

An ERP system covers the following common functional areas. In many ERP systems these are called and grouped together as *ERP modules*:

- Financial accounting: General ledger, fixed asset, payables including vouchering, matching and payment, receivables cash application and collections, cash management, financial consolidation
- Management accounting: Budgeting, costing, cost management, activity based costing
- Human resources: Recruiting, training, rostering, payroll, benefits, 401K, diversity management, retirement, separation
- Manufacturing: Engineering, bill of materials, work orders, scheduling, capacity, workflow management, quality control, manufacturing process, manufacturing projects, manufacturing flow, product life cycle management
- Order Processing: Order to cash, order entry, credit checking, pricing, available to promise, inventory, shipping, sales analysis and reporting, sales commissioning.
- Supply chain management: Supply chain planning, supplier scheduling, product configurator, order to cash, purchasing, inventory, claim processing, warehousing (receiving, putaway, picking and packing).
- Project management: Project planning, resource planning, project costing, work breakdown structure, billing, time and expense, performance units, activity management
- Customer relationship management: Sales and marketing, commissions, service, customer contact, call center support - CRM systems are not always considered part of ERP systems but rather Business Support systems (BSS).
- Data services : Various "self–service" interfaces for customers, suppliers and/or employees.



4.3 Benefits of ERP:

- ERP can improve quality and efficiency of the business. By keeping a company's internal business processes running smoothly, ERP can lead to better outputs that may benefit the company, such as in customer service and manufacturing.
- ERP supports upper level management by providing information for decision making.
- ERP creates a more agile company that adapts better to change. ERP makes a company more flexible and less rigidly structured so organization components operate more cohesively, enhancing the business—internally and externally.
- ERP can improve data security. A common control system, such as the kind offered by ERP systems, allows organizations the ability to more easily ensure key company data is not compromised.
- ERP provides increased opportunities for collaboration. Data takes many forms in the modern enterprise. Documents, files, forms, audio and video, emails. Often, each data medium has its own mechanism for allowing collaboration. ERP provides a collaborative platform that lets employees spend more time collaborating on content rather than mastering the learning curve of communicating in various formats across distributed systems.

4.4 Disadvantages of ERP:

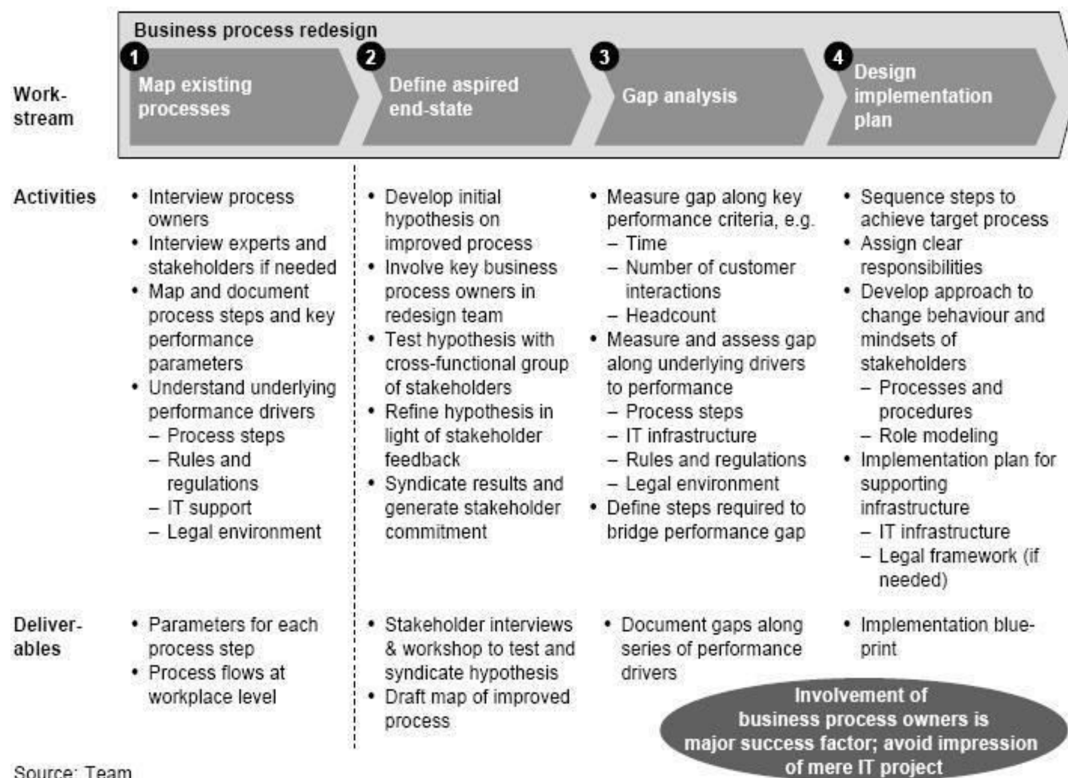
- Customization can be problematic. Compared to the best-of-breed approach, ERP can be seen as meeting an organization‘s lowest common denominator needs, forcing the organization to find workarounds to meet unique demands.

- Re-engineering business processes to fit the ERP system may damage competitiveness or divert focus from other critical activities.
- ERP can cost more than less integrated or less comprehensive solutions.
- High ERP switching costs can increase the ERP vendor's negotiating power, which can increase support, maintenance, and upgrade expenses.
- Overcoming resistance to sharing sensitive information between departments can divert management attention.
- Integration of truly independent businesses can create unnecessary dependencies.
- Extensive training requirements take resources from daily operations.
- Due to ERP's architecture (OLTP, On-Line Transaction Processing) ERP systems are not well suited for production planning and supply chain management (SCM).
- Harmonization of ERP systems can be a mammoth task (especially for big companies) and requires a lot of time, planning, and money.

4.5 Business Process Redesign:

- ❖ It is a business management strategy focusing on the analysis and design of workflows and business processes within an organization.
- ❖ BPR aimed to help organizations fundamentally rethink how they do their work in order to dramatically improve customer service, cut operational costs, and become world-class competitors.
- ❖ Business Process Reengineering (BPR) is the practice of rethinking and redesigning the way work is done to better support an organization's mission and reduce costs. Reengineering starts with a high-level assessment of the organization's mission, strategic goals, and customer needs.
- ❖ Within the framework of this basic assessment of mission and goals, re-engineering focuses on the organization's business processes—the steps and procedures that govern how resources are used to create products and services that meet the needs of particular customers or markets. As a structured ordering of work steps across time and place, a business process can be decomposed into specific activities, measured, modeled, and improved. It can also be completely redesigned or eliminated altogether. Re-engineering identifies, analyzes, and re-designs an organization's core business processes with the aim of achieving dramatic improvements in critical performance measures, such as cost, quality, service, and speed.
- ❖ Re-engineering recognizes that an organization's business processes are usually fragmented into subprocesses and tasks that are carried out by several specialized

functional areas within the organization. Often, no one is responsible for the overall performance of the entire process. Re-engineering maintains that optimizing the performance of sub processes can result in some benefits, but cannot yield dramatic improvements if the process itself is fundamentally inefficient and outmoded. For that reason, re-engineering focuses on re-designing the process as a whole in order to achieve the greatest possible benefits to the organization and their customers. This drive for realizing dramatic improvements by fundamentally re-thinking how the organization's work should be done distinguishes re-engineering from process improvement efforts that focus on functional or incremental improvement.



4.6 Knowledge Engineering:

Knowledge Engineering (KE) refers to all technical, scientific and social aspects involved in building, maintaining and using knowledge-based systems.

There were essentially two approaches that were attempted:

1. Use conventional software development methodologies
2. Develop special methodologies tuned to the requirements of building expert systems

Many of the early expert systems were developed by large consulting and system integration firms such as Andersen Consulting. These firms already had well tested conventional waterfall methodologies (e.g. Method/1 for Andersen) that they trained all their staff in and that were virtually always used to develop software for their clients. One trend in early expert systems development was to simply apply these waterfall methods to expert systems development.

Another issue with using conventional methods to develop expert systems was that due to the unprecedented nature of expert systems they were one of the first applications to adopt rapid application development methods that feature iteration and prototyping as well as or instead of detailed analysis and design. In the 1980s few conventional software methods supported this type of approach.

The final issue with using conventional methods to develop expert systems was the need for knowledge acquisition. Knowledge acquisition refers to the process of gathering expert knowledge and capturing it in the form of rules and ontologies. Knowledge acquisition has special requirements beyond the conventional specification process used to capture most business requirements.

These issues led to the second approach to knowledge engineering: development of custom methodologies specifically designed to build expert systems.[1] One of the first and most popular of such methodologies custom designed for expert systems was the Knowledge Acquisition and Documentation Structuring (KADS) methodology developed in Europe.

4.7 Business Modules In ERP:

The important modules in ERP are

- **Finance:**
  - The entire concept of information technology is based on the premise that providing the right information, to the right people, at the right timecan make a critical difference to the organization.
  - Much of this key information could be taken from the financial data. But merely having the financial data is not enough.
  - You need a set of processes and views of your data that provided up-to-the minute financial information in exactly the form you need it to make that critical difference and help with that critical decision.
  - Accounting software needs access to information in each area of organisation, from R&D and market research through manufacturing, distribution and sales.
  - Financial solution must provide the management with information that can be leveraged for strategic decisions, in order to achieve comprehensive advantage.
  - In today‘s business enterprise, you need to know that your financial decisions are based on today‘s data, not numbers from records closed a month ago, or even a week ago.And you need to know that this same ‗today‘s‘ data represents every segment of your organization's activities, whether your enterprise stretches across a room or around the globe.
  - This is essential, because the most efficient way to get our enterprise to where you want it tomorrow is to know exactly where it is today.
  - What ever be the financial goals of the organization, the financial application components of the ERP solutions work hand-in-hand to improve the bottom line.
  - The Finance modules of the most ERP systems provide financial functionality and analysis
  - support to thousands of businesses in many countries across the globe.

- ❖ These ERP systems include not only financial application components, but also Human resources, Logistics, Business workflow and links to the internet.

- ❖ Financial Accounting has several sub systems. They are:
  - General Ledger
  - Accounts receivable and payable
  - Asset accounting
  - Legal Consolidation
  - Controlling

➢ Investment Management:

- ❖ Investment Management provides extensive support for investment processes right from planning through settlement.
- ❖ Investment management facilitates investment planning and budgeting at a level higher than that needed for specific orders or projects.
- ❖ You can define an investment program hierarchy using any criteria-for example department-wise.
- ❖ Investment program allows you to distribute budgets, which are used during the capital spending process.
- ❖ Investment Management provides tools, enabling you to plan and manage your capital spending projects right from the earliest stage
- ❖ Investment Management module recognizes the importance of the asset accounting aspects of investment measures.
- ❖ The system automatically separates costs requiring capitalization from costs that are not capitalized, debiting the correct costs to the asset under construction.
- ❖ Asset accounting provides precise proof of origin for all transactions affecting acquisition and production costs.

➢ Plant Maintenance:

- ❖ The achievement of world class performance demands delivery of quality products expeditiously and economically.Organizations simply cannot achieve excellence with unreliable equipment.

- The attitude towards maintenance management has changed as a result of quick response manufacturing, Just-intime reduction of work in process inventory and the elimination of wasteful manufacturing practices.
- Machine breakdown and idle time for repair was once an accepted practice.
- Today when a machine breaks down, it can shut down the production line and the customer‘s entire plant.
- The preventive Maintenance module provides an integrated solution for supporting the operational needs of an enterprise-wide system.
- The plant Maintenance module include an entire family of products covering all aspects of plant/equipment maintenance and becomes integral to the achievement of process improvement.
- The major subsystems of a plant Maintenance module are:
  - Preventive Maintenance Control
  - Equipment Tracking
  - Component Tracking
  - Plant Maintenance Calibration Tracking
  - Plant Maintenance Warranty Claims
  - Tracking

Quality Management:

- The ISO9000 series of standards defines the functions of quality management and the elements of a quality management system.
- The functions in the Quality Management module support the essential elements of such a system. The other integrated modules in the system complement this functionality.
- The ISO standards require that quality management systems penetrate all processes within an organization.
- The task priorities, according to the quality loop, shift form production (implementation phase) to production planning and product development (planning phase) to procurement and sales and distribution, as well as into the entire usage phase.
- Computer-integrated Quality Management (CIQ) is more appropriate term in comparison to Computer-Aided Quality Management (CAQ), because an isolated CAQ system cannot carry out the comprehensive tasks of a quality management system.

- ❖ The ERP system takes this into consideration by integrating the quality management functions into the affected applications themselves (for example, procurement, warehouse, warehouse management, production and sales/distribution), instead of delegating them to isolated CAQ systems.
- ❖ As a result of this approach, the processes described in the quality manual can be implemented and automated in the electronic data processing (EDP) system.
- ❖ As a part of the Logistics applications, the Quality Management module handles the traditional tasks of:
    - Quality planning
    - Quality inspection
    - Quality Control.
- ❖ For example, it support quality management in procurement, product verification, quality documentation and in the processing of problems.
- ❖ The quality Management module's internal functions do not directly interact with the data or processes of other modules.

The quality Management module fulfills the following functions:

- ➢ Quality planning (Management of basic data for quality planning and inspection planning, material specifications, Inspection planning).

- ➢ Quality Inspection (Trigger inspections, Inspection processing with inspection plan selection and sample calculation, print shop papers for sampling and inspection, Record results and defects, Make the usage decision and trigger follow-up actions).

- ➢ Quality Control: (Dynamic sample determination on the basis of the quality level history, Application of statistical process control techniques using quality control charts.

- ❖ The Quality Management module uses the system's integration to link the tasks of quality management with those of the other applications, such as materials management, production, sales/distribution and cost accounting.

- **Materials Management:**
  - The Material Management module optimizes all purchasing processes with workflow-driven processing functions, enables automated supplier evaluations, lower procurement and warehousing costs with accurate inventory and warehouse management and integrates invoice verification.
  - The main modules of the Material Management module are:
    - Pre-purchasing Activities
    - Purchasing
    - Vendor Evaluation
    - Inventory Management
    - Invoice Verification and Material Inspection.
  - The pre-purchasing activities include maintaining a service master database, in which the descriptions of all services that are to be procured can be stored.
  - Purchasing is a very important component of the Material Management module. It supports all phases of material management: materials planning and control, purchasing, goods receiving, inventory management and invoice verification.
  - The vendor evaluation component has been completely integrated into the Material management module. Information such as delivery dates, prices and quantities can be taken from purchase orders. the continual monitoring of exiting supply relationships.
  - Inventory Management system allows you to manage your stocks on a quantity and value basis, plan, enter and check any goods movements and carry out physical inventory.
  - Invoice Verification component is part of the material management system. It provides the link between the material management components and the financial accounting, controlling and asset accounting components.

4.8 ERP Market:

Some of the top-tier ERP vendors are

- SAP-AG
- BAAN
- PeopleSoft
- Oracle Corporation
- J.D. Edwards

These companies are covering the major ERP market revenue.

➢ SAP-AG:

- SAP is the world's leading provider of business software, SAP delivers products and services that help accelerate business innovation for their customers. Today, more than 82,000 customers in more than 120 countries run SAP applications – from distinct solutions addressing the needs of small businesses and midsize companies to suite offerings for global organizations.
- SAP defines business software as comprising enterprise resource planning and related applications such as supply chain management, customer relationship management, and supplier relationship management
- SAP AG was founded in 1972 by five German engineers with IBM in Mannheim, Germany and is one of the top most ERP vendors providing the client server business application solutions.
- SAP serves as a standard in the industries like chemicals, customer products, oil & high technology. The SAP group has offices in more than 50 countries worldwide & employs a workforce of over 19300.
- SAP‘s ERP package comes in 2 versions i.e. mainframe version (SAP R/2) & client server version (SAP R/3).(R-Real)
- With SAP, customers can install the core system & one or more of the fundamental components, or purchase the software as a complete package.
- SAP has developed extensive library of more than 800 predefined business processes.
- These processes may be selected from SAP library & can be included within installed SAP application solution to suit the user exact requirements.
- SAP software has special features like, linking a company‘s business processes & applications, & supporting immediate responses to change throughout different organizational levels & real time integration.
- Also, the new technologies are available regularly to cop-up with the changes of the new business trends.

- The international standards have been considered while designing the software like support of multiple currencies simultaneously, automatically handles the country specific import/export requirements
- The modules of R/3 can be used individually as well as user can expand it in stages to meet specific requirements.

BAAN:

- Baan company was founded in Netherlands in 1978 by brothers Jan and Paul Baan..
- The BAAN Company is the leading global provider of enterprise business software.
- The BAAN company products reduce complexity and cost, improve core business processes, are faster to implement and use, are more flexible in adapting to business changes.
- The products offered by the company supports several business tools. The tools are based on multi-tier architecture.
    - The BAAN products are having open component architecture.
    - The special feature of BAAN product is the use of BAAN DEM (Dynamic Enterprise Modeling).
    - Baan DEM provides a business view via a graphical process/model based views.
    - BAAN products has multi-tiered architecture for maximum and flexible configuration.
    - The application supports the new hardware, OS, networks and user interfaces w/o any modification to the application code.
    - The Baan series based products include :
        - BAAN Enterprise Resource Planning.
        - BAAN Front Office.
        - BAAN Corporate Office Solutions.
        - BAAN Supply Chain Solutions.
    - The main advantages of Baan series-based family of products are the best in class components version independent integration and evergreen delivery.
    - BAAN ERP includes the following components –

Manufacturing Module:

This includes bills of material, cost price calculation, shop floor control, material requirement planning, etc.

Finance Module:

This includes accounts payable, accounts receivable, cash management, fixed assets, etc

Project Module:

This includes project budget, project definition, project estimation,project planning, etc

Distribution Module: This includes sales management, purchase management and warehouse management.

➢ Oracle Corporation:

- Oracle Corporation was founded in the year 1977 and is the world‘s largest s/w company and the leading supplier for enterprise information management.
- This is the first s/w company to implement internet computing model for using the enterprise s/w across the entire product line.
- It provides databases and relational servers, application development, decision support tools and enterprise business applications.
- Oracle application consists of 45 plus software modules which are divided into following categories
  - ➢ Oracle Financials
  - ➢ Oracle Human Resource
  - ➢ Oracle Projects
  - ➢ Oracle Manufacturing
  - ➢ Oracle Supply Chain
  - ➢ Oracle Front Office

❖ Oracle Financial:

– This application transforms a finance organization into a strategic force and also helps to access the financial management functions.

- By working with these applications the companies can work globally, lower the administrative cost & improve the cash management.
- It also provides strategic information to make timely & accurate decisions.

❖ **Oracle Projects:**

- These applications improve operational efficiency by providing an integrated project management environment that supports the full lifecycle of a project and increases the revenue growth and profitability.

❖ **Oracle Supply Chain:**

- This application manages the supply chain process by providing a single integrated environment.
- It helps in effective partner collaboration & supply chain optimization capabilities.
- It helps in increasing market share while improving customer service & minimizing the cost.

❖ **Oracle Front Office:**

- These applications provide a better understanding for customer relationships, their values & profitability
- These applications increase top line revenues & maintain customer satisfaction & retention
- It also helps to attract and retain profitable customers through deployment channels including mobile & call centre.

❖ **Oracle Human Resources:**

- This application helps in managing the human resources which directly improve profitability and contribute to competitive advantage

– It also helps in the ability to hire motivate & retain the most capable working force and also helps in providing comprehensive and up-to-date information.

❖ **Oracle Manufacturing:**

– Oracle manufacturing application enables the companies to achieve market leadership by becoming more customer responsive & efficient.

– This module also supports the companies to increase revenue, profitability & customer loyalty by capturing the demand & planning the manufacturing process in an efficient way.

➢ People Soft:

- PeopleSoft Inc. was established in 1987 to provide innovative software solutions that meet the changing business demands of enterprises worldwide.
- It employs more than 7000 people worldwide.& the annual revenue for the year 1998 was $ 1.3 million.
- PeopleSoft‘s mission is to provide innovative software solutions that meet the changing business demands of organizations worldwide.
- PeopleSoft develops markets and supports enterprise-wide software solutions to handle core business functions including human resources management, accounting and control, project management, treasury management performance measurement and supply chain management.
- PeopleSoft provides industry-specific enterprise solutions to customers in select markets, including communications, finance services, healthcare, manufacturing.
- PeopleSoft products support clients running, Microsoft Windows and popular Web browsers, as well as a range of mainframe, midrange and LAN relational database server platforms.
- PeopleSoft solutions run on a variety of leading hardware and database platforms, including Compaq, Hewlet-Packard, IBM, Sun Microsystems, Informix, Microsoft SQL Server, Sybase, DB2 and others.
- PeopleSoft delivers Web-enabled applications, workflow, online analytical processing (OLAP) etc.

- The PeopleSoft application serves the whole business management solutions, commercial solutions & industry solutions.

- The PeopleSoft's business management solutions are in the areas given below:-

  - Human Resources Management
  - Accounting and Control
  - Treasury Management
  - Performance Measurement
  - Project Management
  - Sales and Logistics
  - Materials Management
  - Supply Chain Planning
  - Service Revenue Management
  - Procurement

➢ JD Edwards:

- On March 17, 1977 J.D. Edwards was formed, by Jack Thompson, Dan Gregery & Ed-Mc Vaney.
- In early years J.D. Edwards designed software for small & medium sized computers.
- In 1980's it focused on IBM system/38.
- As the company began to out grow, its headquarter in Denver, opened branch offices in Dallas & Newport Beach, California, Houston, San Francisco & Bakenfield. And then internationally expanded its Europe headquarters in Brussels & Belgium.
- As it grew it became obvious that servicing a large number of customers was creating a challenge
- By the mid of 1980's, J.D Edwards was being recognizes as an Industry-leading supplier of application software for the highly successful IBM AS/400 computer.
- Today J.D Edwards is a publicly traded company that has more than 4700 customers with sites in over 100 countries & more than 4200 employees.

  J.D Edwards emphasizes on the following three matters:

- ❖ **Solution**: JD Edwards offers a balance of technology & service options tailored by the unique industry & its processes. This allows JD Edward to ensure timely implementation & outgoing quality of the solution.
- ❖ **Relationships**: With JD Edwards, you have a partner committed to ushering you through changes in the business & technology.
- ❖ **Value**: JD Edwards provides with an appreciating software asset – one with the potential to increase in value over the lift of your business.

- JD Edwards is a leading provider of integrated software for distribution, human resource, finance, manufacturing & SCM.

- These software's are operated in multiple computing environments & also JAVA & HTML enabled.

4.9 Enterprise application integration(EAI):

- ❖ Enterprise application integration (EAI) is the use of software and computer systems' architectural principles to integrate a set of enterprise computer applications.
- ❖ Enterprise application integration is the process of linking such applications within a single organization together in order to simplify and automate business processes to the greatest extent possible, while at the same time avoiding having to make sweeping changes to the existing applications or data structures. Applications can be linked either at the back-end (database) or the front-end (GUI).
- ❖ The various systems that need to be linked together may reside on different operating systems, use different database solutions or computer languages, or different date and time formats, or may be legacy systems that are no longer supported by the vendor who originally created them. In some cases, such systems are dubbed "stovepipe systems" because they consist of components that have been jammed together in a way that makes it very hard to modify them in any way.

EAI can be used for different purposes:

- Data integration: Ensures that information in multiple systems is kept consistent. This is also known as enterprise information integration (EII).

- Vendor independence: Extracts business policies or rules from applications and implements them in the EAI system, so that even if one of the business applications is replaced with a different vendor's application, the business rules do not have to be re-implemented.
- Common facade: An EAI system can front-end a cluster of applications, providing a single consistent access interface to these applications and shielding users from having to learn to use different software packages.

Multiple technologies are used in implementing each of the components of the EAI system:

Bus/hub:

This is usually implemented by enhancing standard middleware products (application server, message bus) or implemented as a stand-alone program (i. e., does not use any middleware), acting as its own middleware.

Application connectivity:

The bus/hub connects to applications through a set of **adapters** (also referred to as **connectors**). These are programs that know how to interact with an underlying business application. The adapter performs two-way communication, performing requests from the hub against the application, and notifying the hub when an event of interest occurs in the application (a new record inserted, a transaction completed, etc.). Adapters can be specific to an application (e. g., built against the application vendor's client libraries) or specific to a class of applications (e. g., can interact with any application through a standard communication protocol, such as SOAP, SMTP or Action Message Format (AMF)). The adapter could reside in the same process space as the bus/hub or execute in a remote location and interact with the hub/bus through industry standard protocols such as message queues, web services, or even use a proprietary protocol. In the Java world, standards such as JCA allow adapters to be created in a vendor-neutral manner.

Data format and transformation:

To avoid every adapter having to convert data to/from every other applications' formats, EAI systems usually stipulate an application-independent (or common) data format. The EAI system usually provides a data transformation service as well to help convert between application-

specific and common formats. This is done in two steps: the adapter converts information from the application's format to the bus's common format. Then, semantic transformations are applied on this (converting zip codes to city names, splitting/merging objects from one application into objects in the other applications, and so on).

Integration modules:

An EAI system could be participating in multiple concurrent integration operations at any given time, each type of integration being processed by a different integration module. Integration modules subscribe to events of specific types and process notifications that they receive when these events occur. These modules could be implemented in different ways: on Java-based EAI systems, these could be web applications or EJBs or even POJOs that conform to the EAI system's specifications.

Support for transactions:

When used for process integration, the EAI system also provides transactional consistency across applications by executing all integration operations across all applications in a single overarching distributed transaction (using two-phase commit protocols or compensating transactions).

Disadvantages of EAI:

1. Constant change: The very nature of EAI is dynamic and requires dynamic project managers to manage their implementation.
2. Shortage of EAI experts: EAI requires knowledge of many issues and technical aspects.
3. Competing standards: Within the EAI field, the paradox is that EAI standards themselves are not universal.
4. EAI is a tool paradigm: EAI is not a tool, but rather a system and should be implemented as such.
5. Building interfaces is an art: Engineering the solution is not sufficient. Solutions need to be negotiated with user departments to reach a common consensus on the final outcome. A lack of consensus on interface designs leads to excessive effort to map between various systems data requirements.

6. Loss of detail: Information that seemed unimportant at an earlier stage may become crucial later.
7. Accountability: Since so many departments have many conflicting requirements, there should be clear accountability for the system's final structure.