UNIT V
LEASING AND HIRE PURCHASE

1. What is Leasing? Explain the different types of leasing.

Ans. Leasing is used as a method of financing of capital equipment. A lease is a contractual arrangement under which the owner of an asset (lessor or leasing company) agrees to allow the use of his asset by another party (Lessee) in exchange of periodic payments (Lease rents) for a specified period. The ownership of the asset remains with the lessor.

Types of Leasing:

The lease agreements may be of the following types:

(i)Finance Lease: A finance lease is an agreement in which the lessee acquires the use of an asset for a long period of time and which is irrevocable during its lease period. In case of finance lease all the risks incidental to the ownership of the asset and the benefits arising thereon are transferred to the lessee except the legal title. The lessee has to bear the cost of insurance, repairs and maintenance of the asset and other related expenses. This lease is fully amortised during the lease period because during this period the lessor recovers through the lease rentals, his total investment in the asset along with an acceptable rate of return.

(ii)Operating Lease: An operating lease is an agreement in which the lessee acquires the use of an asset on a period to period basis. Such lease contracts are for periods shorter than useful life of the asset and are cancellable at the option of the lessee. It does not give lessee all the benefits and the maintenance and service expenses of the leased equipment are borne by the lessor.

(iii)Sale and Lease Back: In case of this form of lease arrangement the firm sells an asset already owned by it to another firm/party and hires it back from the buyer. This lease is generally preferred by a firm that is suffering from the shortage of funds for its operations or is faced with liquidity crisis. The lease provisions are generally similar to that of the financial leases.

(iv)Leveraged Lease: A leveraged lease or third party lease in one that involves a third party who is a lender apart from the lessor and the lessee. This type of lease arrangement is generally used for assets requiring huge investment of capital. Under this arrangement, the lessors borrow funds from the lender and repay the debt out of lease rents.

2. Distinguish between operating and financial lease

Ans. Difference between operating and financial lease are:

Basis	Operating Lease	Financial Lease
1.Meaning	A lease in while all risks and rewards related to asset ownership remain with the lessor for the leased asset is called operating lease. In this lease, the asset is	In financial lease (Also known as a capital lease), the risks and rewards related to ownership of asset leased are transferred to the lessee.

	returned by the lessee after using it for lease term agreed upon.	
2.Ownership	Ownership of the asset remains with the lessor for the entire lease period.	Ownership transfer option at the end of the lease period is there with the lessee. The title might or might not be transferred eventually.
3.Accounting Effect	Operating lease is treated generally like renting. That means the lease payments are treated as operating expenses and the asset does not show on the balance sheet.	Financial lease is treated like loan generally. Here, the asset ownership is considered by the lessee and so asset appears on the balance sheet.
4.Purchase Option	In operating lease, the lessee does not have an option to buy the asset during the lease period.	Financial lease allows the lessee to have a purchase option at less than the fair market value of the asset.
5.Lease Term	Lease term extends to less than 75% of the projected useful life of the leased asset.	Lease term is generally more than or equal to the estimated economic life of the asset leased.
6.Running Cost	In operating lease, no running or administration costs are to be borne for example registration, repairs etc. since it gives only right to use the asset.	In a financial lease, running cost and administration expenses are higher.

3. Explain the advantages and disadvantages of leasing.

Ans. Advantages of Lease

The following are the advantages of leasing:

(i)Permit alternative use of funds: A leasing arrangement provides a firm with the use and control over asset without incurring huge capital expenditure. The firm is required only to make periodical rental payments. It saves considerable funds for alternative uses which would otherwise be tied up in fixed capital.

(ii)Faster and cheaper credit: Depending on tax structure of the lessee, it costs less than other methods of acquiring assets. It permits firms to acquire new equipment without going through formal scrutiny procedure. Hence, acquisition of assets under leasing agreement is cheaper and faster than any other source of finance.

(iii)Flexibility: Leasing arrangements may be tailored to the lessee's needs more easily than ordinary financing. Lease rentals can be structured to match the lessee s cash flows. It can be skipped during the months when the cash flows are expected to be low.

(iv) Facilitates additional borrowings: Leasing may increase long-term ability to acquire funds. The lessee can utilise more funds for working capital needs. Moreover, acquisition of assets under the lease agreement does not alter debt equity ratio. Hence, the lessee can go for an additional borrowing in case need arises.

(v)Protection against obsolescence: A firm can avoid risk of obsolescence by entering into operating lease agreement. This is highly useful in respect of assets which become obsolete at a faster rate.

(vi)No restrictive covenants: The restrictive covenants such as debt-equity ratio, declaration of dividend, etc., which are usually imposed under debenture or loan agreement are absolutely absent in a lease agreement.

(vii)Hundred Percent financing: Lease financing enables a firm to acquire the use of an asset without having to make a down payment. So, hundred per cent financing is assured to the lessee.

(viii)Boon to small firm: The firms which are either small or have uncertain records of earning are able to obtain the use of asset through lease financing. It is a boon to small firms and technocrats who are able to make promoter's contribution as required by financial institutions.

Disadvantages of Leasing:
The following are the disadvantages of leasing:

(i) Higher Cost: The lease rentals include a margin for the lessor as also the cost of risk of obsolescence; it is, thus, regarded as a form of financing at higher cost.

(ii) Loss of Moratorium Period: The lease rentals do not take care of the gestation period. It usually takes a long time before the asset generates funds to pay it back. The term loan provides certain moratorium period in repayments for that reason. But no such moratorium is permitted under lease arrangements.

(iii) Risk of being deprived of the Use of Asset: The lessee may be deprived of the use of the asset due to the deterioration in the financial position of the lessor or winding up of the leasing company.

(iv) No Alteration or Change in Asset: As the lessee is not the owner of the asset, he cannot make any substantial changes in the asset. Contrary to it, in case of outright purchase the buyer can modify or alter the asset to increase its utility.

(v) Loss of Ownership Incentives: There are certain advantages of owning the assets, such as depreciation and investment allowance, In case of lease; the lessee is not entitled to such benefits.

(vi) Penalties on Termination of Lease: The lessee is usually required to pay certain penalties if he terminates the lease before the expiry of the lease period.

(vii) Loss of Salvage Value of the Asset: An asset generally has certain salvage value at the expiry of the useful life. As the lessee does not become the owner of the asset, he cannot realise the salvage value at the expiry of the lease rather he has to return the asset to the lessor.

4. What is Hire Purchase System? Explain the features of hire purchase system.

Ans. Hire purchase is a method of financing of the fixed asset to be purchased on future date. Under this method of financing, the purchase price is paid in installments. Ownership of the asset is transferred after the payment of the last installment.

Features of Hire Purchase System:

(i) Arrangement for Contract: Hire Purchase System originates from agreement. There are two parties – hire vendor (seller) and hire purchaser (buyer).

(ii)Sales on Credit: Hire Purchase System was originated to provide credit facilities to the purchaser. The full value of goods is not paid immediately, but is to be paid in periodic installments as per agreement.

(iii)Payment by Installment: Under Hire Purchase System, the whole payment is made in installments. The amount and period of installment is fixed under the agreement.

(iv)Hire Purchase Possesses the Right to Use: When the buyer pays first installment the goods are delivered to him by the seller whereby he gets the rights to use those goods.

(v) Ownership with the Seller: The right of using goods is received by the purchaser, but the ownership on it remains with the seller till the last payment of installment is done.

(vi) Ownership of the Buyer: The buyer gets the ownership rights on goods only after paying the last installment.

(vii) Right to take the Commodity Back : If the customer fails to pay in installments on due date, the seller gets the right to take the goods back because the ownership remains with the seller up to the payment of last installments.

5. Distinguish between Hire Purchase and Leasing

Ans. Differences between Hire Purchase and Leasing

Basis	Hire Purchase	Leasing
1.Ownership	In Hire purchase, the agreement is entered for the transfer of ownership after a fixed period.	In Leasing it is only in financial lease, the ownership will get transferred. While in operating lease, the ownership is not transferred.
2. Agreement type	Hire purchase is a tripartite agreement involving the seller, finance company and the purchaser / hirer.	Leasing is only a bipartite agreement, involving lessor and lessee.
3. Depreciation Claim	Depreciation is claimed by the purchaser / hirer in a hire purchase.	In leasing, Depreciation is claimed by the lessor in the lease agreement.
4. Buyers count	In hire purchase, the goods or property is sold once and there cannot be more than one buyer.	But in operating lease, though the lessor can be one person, there can be a number of lessees.
5. Period of Agreement	Period of HP agreement is longer as valuable goods or properties are purchased.	In Leasing, the period of lease will be of shorter duration as technological changes will affect the lessee.
6. Relationship in agreement	The relationship between the seller and the buyer will be that of owner and hirer in a hire purchase.	But the relationship in a lease agreement is that of lessor and lessee.

7. Interest rates	The interest rate charged on HP is on a flat rate which is distributed for the entire period of HP agreement and collected along with the principal amount on the equated monthly installment basis.	In leasing, Interest does not form a major part of lease agreement, but the lease charges will include interest also as a part of it.
8.Payment defaults	Any default in payment of installment enables the seller / finance company to seize the goods from the purchaser / hirer.	On the termination of lease agreement if it is a operating lease, the equipment is taken back by the lessor. In the case of financial lease, the equipment can be sold for a particular value to the lessee.

6. What is financial counselling?

Financial counselling is a service that provides advice and support to people who are in financial difficulty. The service is largely government funded and is generally provided by financial counsellors via local organisations and agencies. According to Financial Counselling Australia (FCA), these services are "non-judgmental, free, independent and confidential".

7. What Is a Bank Guarantee? State the feature of valid Bank Guarantee.

Ans. Bank Guarantee a promise made by the bank to any third person to undertake the payment risk on behalf of its customers. Bank guarantee is given on a contractual obligation between the bank and its customers. Such guarantees are widely used in business and personal transactions to protect the third party from financial losses. This guarantee helps a company to purchase things that it ordinarily could not, thus helping business grow and promoting entrepreneurial activity.

Features of a Valid Guarantee

(i)The period until which the guarantee holds is clearly specified
(ii)The guarantee issuance is always for a specific amount
(iii)The purpose of the guarantee is clearly stated
(iv)The guarantee is valid for a specifically defined period
(v)The grace period allowed to enforce guarantee rights is also stated in the guarantee
(vi)Guarantee clearly states the events under which it can be enforced

8. What are the different types of bank guarantee? Explain.

Ans. The different types of bank guarantee:

(i)Deferred payment guarantee: This refers to a bank guarantee or a payment guarantee that is offered to the exporter for a deferred period or for a certain time period. When a buyer purchases capital goods or machinery, the seller will give credit to the buyer when the buyer's bank gives a guarantee that it will pay the unsettled dues of the buyer to the seller. Under this type of guarantee, payment will be made in installments by the bank for failure in supplying raw materials, machinery or equipment.

(ii)Financial guarantee: A financial bank guarantee assures that money will be repaid if the party does not complete a particular project or operation entirely. According to the financial guarantee agreement, when there is a delay in the completion of the project, the bank will make the payment.

(iii)Advance payment guarantee: Under this kind of guarantee, an advance payment will be made to the seller. There will also be a guarantee that if the seller fails to deliver the service or product accurately or promptly, the buyer will receive a refund of the payment.

(iv)Foreign bank guarantee: A foreign bank guarantee is provided by a bank on behalf of a borrower. This will be offered on behalf of the foreign beneficiary or creditor.

(v)Performance guarantee: Under a performance guarantee, compensation of money will be made by the bank when there is any delay in delivering the performance or operation. Payment will have to be made even if the service is delivered inadequately.

(vi)Bid bond guarantee: Under this type of guarantee, there will be a supply bidding procedure. This will be conducted by the contractor for the owner of an infrastructure or industrial project or any kind of operation. The contractor of the project will guarantee that the best bidder or the highest bidder will have the capability and authority to implement a project as per his or her preferences. The bid bond will be given to the owner of the project as a proof of guarantee and the bond will imply that the project will have to be devised according to the bid contract.

9. Explain the advantages and disadvantages bank guarantee.

Ans. Advantages of Bank Guarantee

(i)Bank guarantee reduces the financial risk involved in the business transaction.

(ii)Due to low risk, it encourages the seller/beneficiaries to expand their business on a credit basis.

(iii)Banks generally charge low fees for guarantees, which is beneficial to even small-scale business.

(iv)When banks analyse and certify the financial stability of the business, its credibility increases and this, in turn, increase business opportunities.

(v)Mostly, the guarantee requires fewer documents and is processed quickly by the banks (if all the documents are submitted).

Disadvantages of Bank Guarantee

(i)Sometimes, the banks are so rigid in assessing the financial position of the business. This makes the process complicated and time-consuming.

(ii)With the strict assessment of banks, it is very difficult to obtain a bank guarantee by loss-making entities.

(iii) For certain guarantees involving high-value or high-risk transactions, banks will require collateral security to process the guarantee.

10. What is Letter of Credit? State its features.

Ans. A letter of credit is a document that guarantees the buyer's payment to the sellers. It is issued by a bank and ensures the timely and full payment to the seller. If the buyer is unable to make such a payment, the bank covers the full or the remaining amount on behalf of the buyer. A letter of credit is issued against a pledge of securities or cash. Banks typically collect a fee, i.e., a percentage of the size/amount of the letter of credit.

Features of Letter of Credit

(i)Letter of credit is issued against collateral that may include buyer's fixed deposit and bank deposit, etc. as security

(ii)Certain fees is charged by the bank depending on the type of letter of credit

(iii)Guidelines are issued by International Chambers of Commerce (ICC) for any form of Letter of Credit

(iv)Correctness of Letter of Credit: As only documents are exchanged and no good and services are involved in this process. Therefore, mentioned details in letter should be correct that include name of seller, date, amount, product name and quantity, etc.

(v)Banks will deny the payment, if they find any slightest mistake in the buyer's name, product name, shipping date, etc.

(vi)As all parties deals in documents only and not goods and services, so the payment will not depend on the defects in goods and services, if any.

11. Explain the different types of Letters of Credit.

Ans. Letters of credit vary based on the need for them. The following are some of the most commonly used letters of credit:

(i) Irrevocable LC: This LC cannot be cancelled or modified without consent of the beneficiary (Seller). This LC reflects absolute liability of the Bank (issuer) to the other party.

(ii)Revocable LC: This LC type can be cancelled or modified by the Bank (issuer) at the customer's instructions without prior agreement of the beneficiary (Seller). The Bank will not have any liabilities to the beneficiary after revocation of the LC.

(iii)Stand-by LC: This LC is closer to the bank guarantee and gives more flexible collaboration opportunity to Seller and Buyer. The Bank will honour the LC when the Buyer fails to fulfill payment liabilities to Seller.

(iv) Confirmed LC: In addition to the Bank guarantee of the LC issuer, this LC type is confirmed by the Seller's bank or any other bank. Irrespective to the payment by the Bank issuing the LC (issuer), the Bank confirming the LC is liable for performance of obligations.

(v)Unconfirmed LC: Only the Bank issuing the LC will be liable for payment of this LC.

(vi) Transferable LC: This LC enables the Seller to assign part of the letter of credit to other party(ies). This LC is especially beneficial in those cases when the Seller is not a sole manufacturer of the goods and purchases some parts from other parties, as it eliminates the necessity of opening several LC's for other parties.

(vii) Back-to-Back LC: This LC type considers issuing the second LC on the basis of the first letter of credit. LC is opened in favour of intermediary as per the Buyer's instructions and on the basis of this LC and instructions of the intermediary a new LC is opened in favour of Seller of the goods.

(viii) Payment at Sight LC: According to this LC, payment is made to the seller immediately (maximum within 7 days) after the required documents have been submitted.

(ix) Deferred Payment LC: According to this LC the payment to the seller is not made when the documents are submitted, but instead at a later period defined in the letter of credit. In most cases the payment in favour of Seller under this LC is made upon receipt of goods by the Buyer.

(x) Red Clause LC: The seller can request an advance for an agreed amount of the LC before shipment of goods and submittal of required documents. This red clause is so termed because it is usually printed in red on the document to draw attention to "advance payment" term of the credit.

12. Distinguish between Letters of Credit and Bank Guarantee
Ans.

Basis	Letters of Credit	Bank Guarantee
1.Nature	LC is an obligation accepted by a bank to make payment to a beneficiary if certain services are performed. v	BG is an assurance given by the bank to the beneficiary to make the specified payment in case of default by the applicant.
2.Primary liability	Bank retains the primary liability to make the payment and later collects the same from the customer.	The bank assumes to make the payment only when the customer defaults to make payment.

3.Payment	Bank makes the payment to the beneficiary as and when it is due. It need not wait for a default to be made by the customer.	Only when the customer defaults the payment to the beneficiary, the bank makes the payment.
4.Way of working	LC ensures that the amount will be paid as long as the services are performed as per the agreed terms.	BG assures to compensate for the loss if the applicant does not satisfy the specified conditions.
5.Number of parties involved	There are multiple parties involved here – LC Issuing bank, its customer, the beneficiary (third party), and advising bank.	There are only three parties involved – banker, its customer, and the beneficiary (third party).
6.Suitability	Generally, this is more appropriate during the import and export of goods and services.	Suits any business or personal transactions.
7.Risk	Bank assumes more risk than the customer.	Customer assumes the primary risk.

13. What is Venture Capital? State its features.

Ans. Entrepreneurs need investments for their start-up companies. The investments or the capital that these entrepreneurs receive from wealthy investors is called Venture Capital and the investors are called Venture Capitalists.

Venture capital is long-term risk capital to finance high technology projects which involve risk but at the same time has strong potential for growth. Venture capitalists pool their resources including managerial abilities to assist new entrepreneurs in the early years of the project. Once the project reaches the stage of profitability, they sell their equity holdings at a high premium.

VC firms reduce the risk of investments by co-investing with other VC firms. Usually, there will be the main investor called the 'lead investor' and other investors will be called 'followers'.

Features of Venture Capital

Some of the features of venture capital financing are as under:

1. Venture capital is usually in the form of equity participation. It may also take the form of convertible debt or long-term loan.

2. Investment is made only in high risk but high growth potential projects.

3. Venture capital is available only for commercialisation of new ideas or new technologies and not for enterprises which are engaged in trading, booking, financial services, agency, liaison work or research and development.

4. Venture capitalist joins the entrepreneur as a copromoter in projects and shares the risks and rewards of the enterprise.

5. There is continuous involvement in business after making an investment by the investor.

6. Once the venture has reached the full potential, the venture capitalist disinvests his holdings either to the promoters or in the market. The basic objective of investment is not profit but capital appreciation at the time of disinvestment.

7. Venture capital is not just injection of money but also an input needed to set up the firm, design its marketing strategy and organise and manage it.

8. Investment is usually made in small and medium-scale enterprises.

14. Explain the scope/stages/types of venture capital.

Ans. Venture capital may take various forms at different stages of the project. There are four successive stages of development of a project, viz., development of a project idea, implementation of the idea, commercial production and marketing and finally large-scale investment to exploit the economies of scale and achieve stability. Financial institutions and banks usually start financing the project only at the second or third stage but rarely from the first stage. But venture capitalists provide finance even from the first stage of idea formulation. The various stages in the financing of venture capital are described below:

(1) Development of an idea — seed finance: In the initial stage, venture capitalists provide seed capital for translating an idea into business proposition. At this stage, investigation is made in depth which normally takes a year or more.

(2) Implementation stage — start-up finance: When the firm is set up to manufacture a product or provide a service, start-up finance is provided by the venture capitalists. The first and second stage capital is used for full scale manufacturing and further business growth.

(3) Fledging stage — additional finance: In the third stage, the firm has made some headway and entered the stage of manufacturing a product but faces teething problems. It may not be able to generate adequate funds and so additional round of financing is provided to develop the marketing infrastructure.

(4) Establishment stage — establishment finance: At this stage, the firm is established in the market and expected to expand at a rapid pace. It needs further financing for expansion and diversification so that it can reap economies of scale and attain stability. At the end of the establishment stage, the firm is listed on the stock exchange and at this point the venture capitalist disinvests their shareholdings through available exit routes.

Before investing in small, new or young hi-tech enterprises, the venture capitalists look for percentage of key success factors of a venture capital project. They prefer projects that address these problems.

15. Explain the importance/advantages of Venture Capital?

Ans. The importance/advantages of Venture Capital are:

(i)Expansion of Company: Venture capital provides large funding that a company needs to expand its business. It has the ability for company expansion that would not be possible through bank loans or other methods.

(ii)Expertise joining the company: Venture capitalists provide valuable expertise, advice and industry connections. These experts have deep knowledge of specific market standards and they can help you avoid your business from many downsides that are usually associated with startups.

(iii)Better Management: It’s not always that being an entrepreneur one is also a good business manager. However, since Venture Capitalists hold a percentage of equity in the business. They will have the power to say in the management of the business. So if one is not good at managing the business, this is a significant benefit.

(iv)No Obligation to repay: In addition, there is an obligation to repay to investors as it would be in case of banks loans. Rather, investors take the investment risk on their own shoulders because they believe in the company’s future success.

(v)Value Added Services: Venture Capitalists provide HR Consultants, who are specialist in hiring the best staff for your business. This helps in avoiding to hire the wrong person. It also offers a number of other such services such as mentoring, alliances and also facilitates the exit.

16. What do you mean by Venture Capital Company?

Ans. A venture capital company is defined as 'a financing institution which joins an entrepreneur as a copromoter in a project and shares the risks and rewards of the enterprise'.

17. What is Factoring? Explain the different types of factoring.

Ans. Management of cash and receivables is of utmost importance to any business concern irrespective of its size. The key to success of business lies in converting credit sales into cash within a short period of time.
Factoring is a financial service that assist in financing credit sales and help the business unit to maintain liquidity Factoring is a continuing arrangement under which a financial intermediary known as the factor purchases the account receivables or book debts of a business unit (the client). This arrangement enables the factor to control the credit extended to the customers by the business unit and administer the sales ledger. In short, factoring is an activity of managing the trade debts of a business concern and converting credit sales invoices into ready cash.

Types of Factoring: Following are the different types of factoring -

1. Recourse factoring: In recourse factoring, the factor purchase trade debts and renders collection service. However, the factor does not bear the risk of bad debts. In case of default or non-payment by a trade debtor, the client refunds the amount to the factor.

2. Non-recourse factoring: In case of non-recourse factoring, the factor assumes the risk of bad debts. It is the most comprehensive factoring facility offering all types of services such as finance, collection, sales ledger management, debt protection and customer information. (In non-recourse factoring, factor charges are high as they offer the client protection against bad debts.)

3. Advance factoring: Advance factoring is an arrangement whereby the factor pay a pre-specified portion of the receivables in advances to the client. The balance portion is paid upon collection or on the due date of payment of receivables.

4. Maturity factoring: Maturity factoring is also known as collection factoring. Under this factoring, no advance payment is made by the factor but payment is made only on the maturity date or on the date collection.

5. Disclosed factoring: In case of disclosed factoring the customer is notified about the factoring arrangement and is also directed to make payments to the factor instead of the business unit.

6. Undisclosed factoring: Under undisclosed factoring, the factoring arrangement is not declared to the customer. Debt collection is done by the client.

7. Invoice discounting: In case of invoice discounting the factor only provides finance against the receivables. The client deals with the customers directly and collects the receivable itself.

8. International factoring: In international factoring, factoring services are provided by factors of both countries i.e. the exporter country's factor and the importer country's factor. In such a case, beside the ordinary services of a factor, the factor assuming the responsibility of complying with all legal and procedural formalities concerned with international trade.

18. Explain the functions of factoring.

Ans. The factor performs the following functions:

(i)Maintenance of Sales Ledger: A factor is responsible for maintaining the sales ledger of the client. So the factor takes care of all the sales transactions of the client.

(ii)Financing: The factor finances the client by purchasing all the account receivables.

(iii)Credit Protection: In the case of non-recourse factoring, the risk of non-payment or bad debts is on the factor.

(iv)Collection of Money: The factor performs the duty of collecting funds from the client’s debtors. This enables the client to focus on core areas of business instead of putting energies in the collection of money.

19. State the steps involved in factoring process.

Ans. The following steps are involved in the process of factoring:

(i)The seller sells the goods to the buyer and raises the invoice on the customer.

(ii)The seller then submits the invoice to the factor for funding. The factor verifies the invoice.

(iii)After verification, the factor pays 75 to 80 percent to the client/seller.

(iv)The factor then waits for the customer to make the payment to him.
(v)On receiving the payment from the customer, the factor pays the remaining amount to the client.

(vi)Fees charged by factor or interest charged by a factor may be upfront i.e. in advance or it may be in arrears. It depends upon the type of factoring agreement.

(vii)In case of non – recourse factoring services factor bears the risk of bad debt so in that case factoring commission rate would be comparatively higher.

(viii)The rate of factoring commission, factor reserve, the rate of interest, all of them is negotiable. These are decided depending upon the financial situation of the client.

20. What are the advantages and disadvantages of factoring?

Ans. Advantages of Factoring

The following are the advantages:

(i)It reduces the credit risk of the seller.

(ii)The working capital cycle runs smoothly as the factor immediately provides funds on the invoice.

(iii)Sales ledger maintenance by the factor leads to a reduction of cost.

(iv) Improves liquidity and cash flow in the organization.

(v)It leads to improvement of cash in hand. This helps the business to pay its creditors in a timely manner which helps in negotiating better discount terms.

(v)It reduces the need for the introduction of new capital in the business.

(vi)There is a saving of administration or collection cost.

Disadvantages of Factoring

The following are the disadvantages:

(i)Factor collecting the money on behalf of the company can lead to stress in the company and the client relationships.

(ii)The cost of factoring is very high.

(iii)Bad behaviour of factor with the debtors can hamper the goodwill of the company.

(iv)Factors often avoid taking responsibility for risky debtors. So the burden of managing such debtor is always in the company.

(v)The company needs to show all the details about company customers and sales to factor.

21. What is Credit Rating? Explain the functions of Credit Rating Agencies

Ans. Credit rating is an assessment of the capacity of an issuer of debt security, by an independent agency, to pay interest and repay the principal as per the terms of issue of debt. A rating agency collects the qualitative as well as quantitative data from a company which has to be rated and assesses the relative strength and capacity of company to honour its obligations contained in the debt instrument throughout the duration of the instrument. The rating given is based on an objective judgement of a team of experts from the rating agency.

According to ICRA, Ratings are opinions on the relative capability of timely servicing of corporate debt and obligations. These are not recommendations to buy or sell....neither the accuracy nor the completeness of the information is guaranteed'.

Functions of Credit Rating Agencies

1. Provide Independent Opinion: Rating agencies provide an unbiased opinion on the relative capability of the issues to meet obligations of the security which are offered to be issued. The agency is independent from the issuer and has no vested interest in the issue.

2. Provide Professional Assessment: The assessment of the securities made by rating agencies is authentic, reliable and based on the information processed by the highly trained staff.

3. Provide Easily Understood Information: The assessment provided by rating agencies is expressed in terms of rating symbols which are easily understandable by the intended investors, some of which have no expertise to understand the witty-knotty of the securities.

4. Provide Basis for Investment: The rating/assessment provided by rating agencies provides a basis for investment by the investors. Investors are provided with the expertise knowledge on the risk and returns associated with the securities. Investors may pick-up the securities for investment as per their risk preferences.

5. Keep a Discipline on Borrowers: The rating agencies continuously monitor the securites rated by them. It keeps the borrowers under discipline to fulfil their obligations under the securities. The fear of lowering down the ratings keeps the borrowers on their toes.

22. Explain the advantages and limitations of credit ratings.

Ans. Benefits of Rating Agencies to the Investors:

1. Facilitate Investment Decisions: With the ratings on the securities, investors can take quick decisions about the investment to be made. Investors may quickly assess the risk level and rate of returns of the rated security. Rating also facilitates choice among the many alternative investments available.

2. Facilitate Review of Investments: As the rating agency reviews continuously the ratings given to the instruments/securities, the investors in those securities can decide whether to keep the investment or to sell it off. For example, in case a rating being downgraded, investors may think of selling the instrument/security.

3. Safeguard against Bankruptcy: Rating agencies give an idea to the prospective investors about the degree of financial strength and creditworthiness of the issuer. High rating given to a security gives an assurance of safety and minimum risk of bankruptcy.

4. Saving in Cost and Efforts: Investors in securities need not take advice of stockbrokers, merchant bankers or the security analysts while making investment decisions. This reduces the efforts of the investors in taking investment decisions. Investors may save their time in collecting and analysing the information on the creditworthiness of the issuer.

Benefits to the Issuers/Companies

1. Improves Corporate Image: High credit rating creates confidence and trust of the investors about the company. This in turn enhances corporate image.

2. Lower Cost of Borrowing: Companies/Issuers that have high credit ratings for their instruments get funds at lower cost from the market. Investors tend to accept the securities having less risk at low interest rates.

3. Market for Debts: Credit rating creates market for debts securities. Issuers can price their issues as per the ratings and reach out to the new investors. 4. Easy to Raise Funds for Closely-held Companies. Closely held companies and lesser known companies may find investors for its securities in case of high ratings for their instruments/securities.

5. Aid Growth and Expansion: Credit rating agencies create market for debts and facilitate the companies to get finance easily for growth and expansion.

Practical problems/ Limitations of Credit ratings:

1. The absence of widespread branch network of the rating agency may limit its skills in rating.

2. Inexperienced, unskilled or overloaded staff may not do justice to their job and the resulting ratings may not be perfect.

3. Since rating exercise involves a number of factors, a rigid mathematical formula cannot be applied to finalise rating and some element of subjectivity creeps in, thereby giving scope for bias.

4. The time factor greatly affects rating and gives misleading conclusions. A company which experiences adverse conditions temporarily will be given a low rating judged on the basis of temporary phenomenon.

5. since the rating agencies receive a sizable fee from the companies for awarding ratings, a tendency to inflate the ratings may develop.

6. The rating is not permanent but subject to changes and moreover the agencies cannot give any guarantee for the investors.

23. Name the Credit rating agencies in India

Ans. Seven SEBI registered and authorised credit rating agencies in India are:

(i)Credit Rating Information Services of India Limited (CRISIL)

(ii) Investment Information and Credit Rating Agency of India (ICRA) Limited

(iii) Credit Analysis and Research (CARE).

(iv)Acuite Ratings & Research (earlier SMERA Ratings Limited).

(v)Brickwork Ratings India Private Limited.

(vi) India Ratings and Research Pvt. Ltd

(vii) Infometrics Valuation and Rating Pvt. Ltd

24. What is credit rating agency?
Ans. A credit rating agency does assessment of the financial strength of companies and other government entities. They help investors identify the company's ability to pay debts and their level of risk.

25. What is the difference between credit ratings and credit score?
Ans. A credit rating is given to a company, organisation or a government body by calculating its ability to repay the debt and to predict the likelihood of default. On the other hand, a credit score is given to an individual after taking a look at his credit history and repayment behaviour.

26. Who regulates credit rating agencies?
Ans. All the credit rating agencies in India are regulated by Securities and Exchanges Board of India (SEBI). The credit rating agencies are monitored and reviewed by SEBI.

27.How is credit rating denoted?
Ans. Rating is denoted by a simple alphanumeric symbol, for e.g. AA+, A-, etc.

28.How much time does it take for the rating process to be over?
Ans. Credit Rating is a long process and takes around 3-4 weeks to complete from the date of receipt.