VARIOUS TYPES OF FINANCES FOR CO-OPERATIVES AND NON PROFIT ORGANIZATIONS

The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)
New Delhi

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Foreword

The growing Indian economy is burgeoning to become a strong economic force in the world. In the era of globalization, successful implementation of development programmes requires appropriate policy framework, formulation of suitable plan schemes, and effective delivery machinery. Liberalization, open policies, social reforms, welfare and development, per se have taken place in this country and continue to do so. Inclusive growth, social justice and sustainable development are some of the priority areas for the Indian Government. It is important that education, medical facilities and basic amenities are available to everybody in the country. In this regard nonprofit organizations extend their support to effectively complement the efforts of the government.

More efficient utilization of financial resources through effective implementation of programs, sensitivity to the needs of poor, providing timely information to citizens are some of the requirements of Cooperative & NPO Sectors. In view of the social and crucial responsibility taken up by such organizations, Chartered Accountants with their strong financial and strategic acumen can significantly contribute towards the cause of the sector.

I am extremely happy that the Committee for Cooperative & NPO sectors of the Institute of Chartered Accountants of India has come up with this book on various types of finances for cooperatives and non-profit-organizations for guidance of members in this socially relevant crucial area.

I congratulate CA. Vijay Kumar Garg, Chairman, Committee for Cooperative & NPO Sectors; CA. V. Murali, Vice-Chairman and other members of the Committee for publishing this book. I am sure that this book would be found extremely useful to the readers.

Date: Jan 22, 2013 | CA. Jaydeep Narendra Shah
Place: Delhi | President, ICAI

Preface

A strong and vibrant and innovative Cooperative and NPO sector is essential to achieve a productive and inclusive nation. The Cooperative and NPO sectors plays a central role in enriching people through its charitable, social, cultural, educational and environmental contribution and in providing support to weaker section of the society.

With a view to providing appropriate guidance to the members of the institute on the finance for Cooperative and NPO Sectors, Committee for Cooperatives and NPO sectors has issued the book 'Various Types of Finances for Cooperatives and Non-Profit Organizations'. The book describes the history of Cooperative and NPOs, discusses about the need of finance, Types of finances for Co-operative Sector, Conventional ways of financing for Co-operative sector, Modern ways of financing for Co-operative sector, International Finance, Various types of Finances for Non Profit sector.

At this juncture, I also wish my sincere thanks to CA. Mangesh Rajendra Mundankar, for squeezing time out of their other pressing preoccupations to prepare the basic draft of this Book.

I compliment the members of Committee for Co-operative & NPO sectors for their valuable comments.

I also thank CA. Jaydeep Narendra Shah President, ICAI and CA. Subodh Kumar Agrawal, Vice-President, ICAI for their able guidance.

I wish to extend my sincere thanks to Dr. Amit Kumar Agrawal, Secretary to the committee, Committee Secretariat and others who were directly or indirectly instrumental in bringing to this document.

I firmly believe this publication would be of great help for those engaged with Cooperatives & NPO Sectors and benefit the readers at large.

Date: Jan 14, 2013
Place: Delhi

CA. Vijay Kumar Garg,
Chairman
Committee for Co-operative & NPO sectors (CCONPO)

Index

Chapter 1
History

Co-operatives Sector

In India, 65 per cent of the population lives in rural areas. Majority of the population depend on agricultural. Hence development of agriculture, agro-based industries, employment generating activities, infrastructure facilities like roads, drinking water, water for irrigating the crops, electricity, telephones, markets, etc. form part of the rural development. After the post independence, national policy of India reaffirmed the faith in the co-operative movement as a vital instrument for the economic development and as a vehicle of social change and social justice.

Agriculture is the main activity of the rural population in India. But farmers have been facing a number of socio-economic problems, Such as- lack of credit availability for small farmers, persecution by moneylenders, inability to repay debts following crop Failure, high interest rate charged by the moneylenders, rising cost of the cultivation etc. the agricultural sector has been witnessing low growth and productivity, non-remunerative prices for the produce, input and output marketing constraints, institutional credit, insurance, infrastructure and investment. These have resulted in poor performance of the sector in spite of healthy overall economic growth.

The Central Government has realised the importance of the co-operative movement as the best medium through which could be successfully undertaken for rural development, people's empowerment and poverty alleviation programme.

NPO Sector

India's complexity as a country lies in its religious, political, ethnic, social, and cultural diversity, as well its long history of civilization. Therefore, defining the nonprofit sector in India is a difficult task because no single underlying theme or pattern can characterize the development of the nonprofit sector. Hence, this chapter uses a historical perspective as an analytical tool to describe definitions -- both conceptual and legal -- that are then related to the structural/operational definition of the nonprofit sector suggested by Salamon and Anheier (1992). The sector and the various terms used to describe it are analyzed in the context of the broader political economy at various periods of history to uncover underlying themes that are useful to understand its present and past role.

Chapter 2
Introduction

Co-operative sector

The basic objective of the co-operative societies is to encourage the ‘values of self-help, democracy, equality, and solidarity. Co-operative members believe in the ethical values of honesty, openness, and social responsibility and caring for others. The prime objective in addition to the above are to make available the goods and services in required quantity, of better quality and at a reasonable price to its members. It does not mean that Co-operative Society is a charitable organization. It should, therefore, conduct itself in a businesslike manner in attaining its objectives efficiently.

NPO sector

Voluntary efforts have always been an integral part of Indian culture and social tradition. In a societal context, voluntary organizations constitute the” third sector”, the first being the “government”, second being the “market” or private business and third being the “independent sector”, emphasizing the important role voluntary organizations play as an independent force outside the realm of government and private business though, in financial terms, this sector depends heavily on government and private business. Some voluntary organizations are also called Non- Governmental Organizations.

Chapter 3
Principles of Co-operative and NPO Sectors

We need to understand the principles on which Co-operative and NPO sectors run their operations. We all know that, the basic idea behind establishing any co-operative organization is growth through mutual help and efforts. Though the motive of any co-operative organization is to run a commercial business, the organization must give top priority to the benefits of members of that organization.

The object of emphasising this point in this research study is that, the consultant Chartered Accountant should know the basic principles which govern the co-operative sector. He should consult the organization by keeping in mind the principles set out hereunder.

Some of the sources of finance are risky for the Co-operative organization, like Asset Debt Securitization, Venture Capital Arrangements, complex derivative transactions, International Depository Models etc. the Consultant should consider all these factors.

In case of Non Profit Sector, the main object is not to run a commercial entity or earn maximum profits. These organizations heavily rely on the funding of the government and private sector. They should not enter into high risky financial models or transactions.

Following are the Principles of Co-operative sector

1. **Legal Status:** A co-operative society is a body corporate registered under the applicable State Act with perpetual succession and having a common seal. It can acquire, hold and dispose of the properties, enter into contracts and it can sue and it can be sued.

2. **Voluntary Association:** Co-operative Society is essentially an association of persons who have come together for the per suit of a common objective of economic development or for mutual help.

3. **Self Help and Mutual Help:** The office bearers or executive committee members are elected as per democratic election procedure. A co-operative Society functions on the principle of self help and mutual help.

4. **Equality:** In the co-operative sector, the principle of "One Man one Vote" is provided in the statute so as to ensure that the capital does not dominate the administration of co-operative society.

5. **Social Approach/ No Profit Motive**: A the society is working on democratic principle and the office bearers of the society will be functioning like trustees for the better management for the society and there no separate benefit is provided to the executive committee members. Service is the main motto and profit is not the main concern in co-operative societies.

6. **Open Membership**: Any person can apply for the membership of the society without any discrimination. The membership is open for all.

7. **Profits and Returns to the Members**: A Co-operative Society being an association of members and certain percentage profits earned by the society, as decided in the meeting of the general body will be distributed in the form of dividend to the members.

8. **Limited Interest on Shares**: Irrespective of the shareholding, each member has only one vote in the decision making in the general body or at the time of election of the management committee. The shares are not traded in the stock exchange.

9. **Democratic Control:** The Control of a co-operative enterprise in not in the hands of a capitalists who can corner the share capital and obtain control and management of the society.

10. **Personal Participation:** The members have to personally attend the meeting or for voting. They are not allowed to appoint proxies for attending the general body meeting or for passing resolution.

11. **Educations and Co-operations:** Every society has to contribute towards the education fund maintained and looked after by the district co-operative board as per the notification issued from time to time for educating the members or the office bearers of the society.

12. **Co-operation among Co-operative Institutions:** The funds generated or mobilized through the co-operative societies have to be deposited/invested in the Co-operative Sector only.

Following are the features of NPO Sector:

1. **Self Governing**: NPOs have their own mechanism for internal governance; have the power to cease operations on their own authority, and in control of their own affairs.

2. **Not for Profit**: NPOs are not primarily commercial in purpose and do not distribute profits to a set of directors, stakeholders or managers.

3. **Voluntary**: NPOs involve a meaningful degree of voluntary participation, either in the actual conduct of their or management of their affairs.

4. **Non Religious**: These are not primarily involved in the promotion of religious worship or religious education. This automatically excludes temples, churches, synagogues, mosques, religious congregations where religious worship takes place, but includes all not for profit organizations affiliated to religious institutions, e.g. schools run by the Arya Samaj or Christian missionaries etc.

5. **Non Political**: NPOs are not primarily involved in promoting candidates for elected office etc.

6. **Volunteerism**: The typical and most outstanding feature of the NPO sector is the extent of voluntary services rendered by people to such organizations.

7. **Funding**: A unique feature of the NPO sector is that significant funds are received from those who do not expect either repayment or economic benefit proportionate to the resource provided.

Chapter 4
Objectives

Following objectives are taken into consideration for the Research Study.

- To understand the traditional mode of getting funds.
- To focus on new and emerging modes of Finance.
- To develop new financial models suitable to the conditions.
- To focus on ways of getting funds from foreign entities.
- To understand the legal provisions for getting different types of Finances.
- To understand the procedures for getting various types of Finances.
- To explore Cost Effective Source of Finance.

Chapter 5
Scope of the Study

1. Conventional ways of getting Finance: Mainly for Co-operatives other than credit co –operative societies.

- Retained Earnings
- Capital Subsidy/ Incentives
- Rupee Term Loan
- Foreign Currency Loan
- Loan from Banks
- Public Deposits
- Hire Purchase and Lease Financing

2. Modern ways of Finance: Mainly for co – operatives other than credit co – operative societies

- Venture Capital Financing
- Asset / Debt Securitisation
- Various types of Foreign Currency Funds etc.

3. Finances for NPO Sector:

- Reserve Fund
- Education Fund (Requirement in Some States in India)
- Grants received from Government
- Foreign Contribution received under FCRA, 2010
- Donations
- Funding from corporates under Corporate Social Responsibility programs
- Others etc.

Chapter 6
Need for Finance

- All organizations need funding for their activities. For Example – a loan to purchase a new computer system or a bank overdraft to pay suppliers before the receipt of customer cash.
- Just like people, organizations require a variety of funding for a range of purposes.
- A business should match the source of finance to its specific use – in practice this means that a business should secure *long-term sources of finance* for long term uses or needs and for more *short term finance* immediate needs.
- The cost of the source of finance.
- The organization's objectives for procuring finance.
- The flexibility and availability of the finance, for example, how easy it is to switch from one form of funding to another, or whether a particular form of finance is available for a new business with no trading record.
- Impact of the new funding would have on the organizations current financial structure, for example, its balance sheet.
- The state of the external environment, for example the economy and consumer trends and needs of members of the co-operative organization.

Chapter 7

Types of Finances for Co-operative Sector

We have divided various types of Finance for Co-operative and Non Profit Sectors are divided into two parts:

1) Conventional Methods

2) Modern Methods.

Conventional Methods of Financing for Co-operatives and Non Profit Sector

Conventional Methods of financing are also called as Traditional methods of financing. When any sector is evolved, when there is a birth of any sector, there are certain pre defined objectives for that sector. The need of a society is said to be the main motive for evolving or developing any sector.

When the development of such sector begins, the scope gets widened. Any sector or any particular, organization in that sector needs funds to run the day to day activities. One of the aspects of development of the sector is financing of the sector. When the sector develops, some financing methods or models get developed for that sector. Certain types of finances are specially developed considering the needs of the sector. Sometimes the law governing the sector specifies the modes of raising funds. E.g. Equity Share Capital for Companies and Co-operative organizations. Such types of finances are called as “Conventional Ways of Financing”.

It is a traditional method, of less risky, highly costly and a simple model. Any organization at its initial stages of business should concentrate on such types of finances, because, entities are not that strong enough financially to take high risks and enter into complex and risky commercial financial transactions.

Co-operative organizations cannot take high risks because the objective of the Co-operative society is “Growth through Mutual Help”. When an organization expands its business operation and it is capable enough to take financial leverage and has sufficient capital back-up it can go for modern methods of financing and adopt complex financial models.

Chapter 8
Conventional Methods of Financing for Co-operatives Sector

Equity Share Capital

Equity share capital is owner's capital.

Any person who wants to become a member of a co-operative organization, needs to purchase shares of that organization. According to the Multi State Co-operative Societies Act, 2002, any member of a co-operative society is entitled to purchase shares in a co-operative society up to 20% of the total share capital of the said co-operative organization. Bye Laws of Multi State Co-operative Society may define limit for maximum number of shares to be purchased, but it should not exceed 20% as prescribed by the Multi State Co-operative Societies Act, 2002.

One has to consider the legal position on share capital, member's rights and responsibilities. We here considered the Multi State Co-operative Societies Act, 2002, because each state in India has its own enactment on co-operative sector. Multi State Co-operative Societies Act is the only enactment, applicable to the whole of India.

Members in different states can refer the Co-operative Societies act for their own state on the issues like share capital, members rights and responsibilities.

Following are the key features of Share Capital in a Co-operative Organization:

- Co-operative Societies can raises funds from their members.
- Equity Share Capital is a permanent source of funds.
- Equity Share Holders being the owners of the society assumes the risks of business.
- Equity Share Holders have the right to elect the Managing Board or Managing Committee and have control over the management of the society.
- The original investment by the members is often used to fund the purchase of the organizations initial assets and sometimes to fund

the working capital needs of the business while other funding being organized.

- However, what a long term source of finance and therefore should be used for long-term needs, such as purchasing machines or computer systems or acquiring businesses.
- When a business expands it can ask existing shareholders to being in additional money into the business and therefore new shares are issued in proportion to the size of the increase in the share capital.

Following are the issues relating to Multi State Co-operative Societies Act, 2002 regarding Share Capital and Members:

- Shares of a Co-operative organization are redeemable in accordance with the bye-laws in case the bye laws do not contain any provision in this regard, in such manner as may be agreed upon between the co-operative society and such authority.
- According to Multi State Co-operative Societies Act, 2002, if any member of a multi state co-operative society wants to redeem his/her shares, it shall be redeemed on the face value of the shares.
- On the death of a member, a multi-state cooperative society may transfer the share or interest of the deceased member to the person nominated in accordance with the bye-law made in this behalf or, if there is no person nominated, to such person as may appear to the board to be the heir or legal representative of the deceased member, or pay to such nominee, heir or legal representative, as the case may be, a sum representing the value of such member's share or interest as ascertained in accordance with the rules:

  No such transfer or payment shall be made except with the consent of the nominee, heir or legal representative, as the case may be.
- A multi-state cooperative society shall, unless within six months of the death of the member prevented by an order of a competent court, pay to such nominee, heir or legal representative, as the case may be, all other moneys due to the deceased member from the society.
- All transfers and payments made by a multi-state cooperative society in accordance with the provisions of this section shall be valid and effectual against any demand made upon the society by any other person.

Subject to the provisions of sub-section (2), the liability of a past member or of the estate of a deceased member of a multi-state cooperative society for the debts of the society as they existed- Shall continue for a period of two years from such date.

1. In case of a past member, on the date on which he ceased to be a member.
2. In case of a deceased member, on the date of his death.

- Notwithstanding anything contained here above, where a multi-state cooperative society is ordered to be wound up under section 86, the liability of a past member who ceased to be a member or of the estate of a deceased member who died within two years immediately preceding the date of the order of winding up, shall continue until the entire liquidation proceedings are completed, but such liability shall extend only to the debts of the society as they existed on the date of cessation of membership or death, as the case may be.
- Shares of any co-operative society can be asked for security to lenders of fund.

Advantages and Disadvantages of Members Share Capital:

Advantages of Members Share Capital:

1. It is an easily accessible source of finance.
2. It is permanent source of finance.
3. It is risk free source of Capital.
4. There are no interest payments and hence no drain on company profits.
5. If existing members increase their investment by buying more shares in proportion to the current levels, there is no change in control. However, if new shares are bought by new members that may dilute the control of the original shareholders.

Disadvantages of Members Share Capital:

1. It is by far the costliest capital accessed by the co-operative organizations.
2. It is a permanent liability in the business of a co-operative organization.

3. It is one of the most strictly regulated finance.
4. Members may still expect rewards in the form of dividends, and this is paid out of profits. Unlike the arrangement with loan capital, if the business does not make a profit and does not have a reserve of past profits, it cannot be compelled to pay a dividend.

Retained Earnings/Reserve Fund:

- This is one of the most important sources of business finance.
- It represents the profits generated from sales ***after*** interest payments to lenders, taxes to the government and payments to shareholders in the form of dividends.
- A Co-operative organization may plough back profits earned. Accumulated retained profits are reserves and hence part of equity or net worth.
- They belong to members. Increase in net worth strengthens the member's equity base and service as promoter's contribution, if represented by liquid funds. It increases the borrowing capacity.
- Such funds entail no risks.
- Further there is no dilution of control of the present management group.

Following are the provisions regarding Reserve Fund of Multi State Co-operative Societies Act, 2002.

A multi-state cooperative society shall, out of its net profits in any year-

1. Transfer an amount not less than twenty-five per cent, to the reserve fund;
2. Credit one per cent, to cooperative education fund maintained, by the National Cooperative Union of India Limited, New Delhi, in the manner as may be prescribed;
3. Transfer an amount not less than ten per cent to a reserve fund for meeting unforeseen losses.

Advantages of Retained Earnings:

- That there are no associated borrowing costs and that businesses do not see a rise in debt levels (gearing).

- The owners control is not diluted and decisions are not vetted by lenders (banks)

Disadvantages of Retained Earnings:

- The owners may take out all the organization's surplus cash and there will be no buffer if the business suddenly needs cash or another market opportunity arises.
- Equally some businesses are more focused on investment decisions when borrowing money, but are more lax when using the retained profits.
- There may be no outsiders to be made accountable – especially small and family run businesses with no outside shareholders.

Capital Subsidy/Incentives:

In order to encourage the dispersal of industries in less developed areas, Government has been giving a package to New/Expansion units set up in the developing region.

The package schemes of incentives introduced in 1964 were amended from time to time e.g. Government of Maharashtra introduced a new scheme viz. Package Scheme of Incentives 2001 for accelerating the process of dispersal of industries to the less developed regions and promoting high-tech industries in the developed areas of the state coupled with the object of generating mass employment opportunities.

The following categories of industrial and other units will be considered for the incentives:

1. Industries listed in the First Schedule to the Industries (Developed and Regulation) Act, 1951.
2. Small Scale Industries, Coir, Silk, Handicraft and Khadi Industries.
3. Information Technology.
4. Hotels.
5. Poultry and Agro Industries.
6. Bio Technology.
7. Non Conventional Energy.

The quantum of incentives varies with reference to developed areas. No incentives are allowed to units located in developed area but maximum benefits are extended to units located in backward areas.

The incentives may be in the form of:

1. Special Capital incentives as a grant computed on the basis of certain percent of fixed capital investment, with a ceiling.
2. Interest Subsidy.
3. Refund of Octroi/Entry Tax.
4. Exemption from Electricity Duty.
5. Exemption of Sales Tax or Deferment of Sales Tax.

The Capital Incentives form part of long term finance. However one must not be dependent on the availability of incentives for the economic viability of the project.

The incentives are sanctioned and released to the units only after they have taken effective steps. The release of incentives by the concerned State Government generally takes one to three years. The promoters therefore find it convenient to avail bridge finance against the sanctioned capital incentives. However bridge finance is normally made available to the extent of 85% of the sanctioned incentives.

Sale of Assets

- Many of the Co-operative organizations during their growth period purchase lots of properties by way of investment.
- Many large retail co-operative businesses that own considerable property have decided to sell off their property portfolio and raise fresh expansion capital or cash.
- Co-operative Marketing Societies and Co-operative Banks are examples. They see themselves as retailers not property developers.
- Some of the co-operative organizations sell their property for property development and then lease back it for fixed period of time.
- Cash flows generated from selling of property can be used for expansion, diversification or modernization of a business.

Advantages of Sale of Asset:

- The main advantage is that there is no associated borrowing costs or debts.

Disadvantages of Sale of Assets:

- The business can only sell the `family silver` once, hence it needs to take care as to what need to be sold and how wisely it uses the cash.

Depreciation: Conventional and Internal Source of Finance

How is depreciation a source of finance?

- By recognizing that assets lose value and by attempting to identify how much each assets falls in value, it is possible to set apart cash every year to replace the assets when they are no longer of any use.
- Depreciation is a major tax deduction. Depreciation is recognized as an expense which can be claimed to reduce the taxable income. One gets benefitted from both the sides, as we can set apart cash for future purchase of asset and can also have tax shield i.e., claim deduction from taxable income and save tax on depreciation amount.

What is depreciation?

Depreciation is a measure of the wearing out, consumption or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortization of assets whose useful life is predetermined.

Depreciation is a reduction in value of assets, which occurs naturally through wear and tear in the production process of a business.

Measuring this fall in value over time is not always easy.

Accounting Standard 6 deals with Depreciation and its Accounting. But AS 6 does not recommend any method of calculating depreciation. AS 6 says that depreciation should be provided according to the relevant statute governing the co-operative or nonprofit organization.

If the statute is silent, then there are two normal methods of calculating the level of asset depreciation, namely,

- Straight Line Method.
- Reducing Balance Method.

Other Issues relating to Depreciation:

Inflation:

- A major disadvantage is that depreciation does not take into account the fall in purchasing power over time due to inflation.

Working Capital:

Working Capital is the capital required for the smooth and uninterrupted functioning of the business.

- Working Capital = Current Assets *less* Current Liabilities.
- Current Assets are those, which can be converted into cash within a short period of duration, i.e. a period less than one year. Hence Current Assets = Sum of Inventories, Debtors, Cash and Bank Balances, Prepaid Expenses, Loans and Advances, Marketable Investments.
- Current Liabilities are those which fall due for payment or settlement within a short duration, i.e. generally a period less than one year. Hence Current Liabilities = Sum of Creditors, Outstanding Expenses, Tax Provisions, Proposed and Unclaimed Dividend, Short Term Loans, Bank Overdraft, Cash Credit.
- Working capital is the money tied up in the business and used to finance its day to day needs, such as buying raw materials.
- All businesses have a working capital cycle that identifies how this money moves around the business

Classification of Working Capital:

Working Capital can be classified based on (a) Concept or (b) Time Factor.

Working Capital based on Concept:

- Gross Working Capital = Current Assets only.
- Net Working Capital = Current Assets *less* Current Liabilities.

Working Capital based on Time Factor:

Permanent Working Capital: It is the minimum level of investment required in the business at every point of time and hence it is called Fixed or Hard Core Working Capital.

Temporary Working Capital: It represents working capital requirements over and above the permanent working capital and is dependent on factors like peak season, trade cycle, boom etc. It is also called Fluctuating or variable Working Capital.

Importance of Adequate Working Capital:

The need for adequate investment in Working Capital can be understood from the following points.

- Working Capital is required to use fixed assets profitably. For example, a machine cannot be used productively without raw material and raw material cannot be produced without capital funds.
- Funds are required for the day to day operations and transactions. These are provided by Cash and Cash Equivalents, forming part of Current Assets.
- Adequate working capital determines the short term solvency of the organization. Inadequate working capital means that the firm will be unable to meet its immediate payment commitments. This represents under capitalization.
- Increase in activity levels and sales should be backed by suitable investment in working capital.
- Liquidity and profitability should be analyzed suitably by the Finance Manager. Too much emphasis on profitability may affect liquidity.
- Working capital levels are said to be adequate when:
  - ➢ Current Assets are greater than Current Liabilities.
  - ➢ Current Ratio = Current Assets/Current Liabilities is about 2:1. This may differ from industry to industry.

Cycle of Working Capital in a Manufacturing Co-operative Organization:

- The first part of the cycle starts with cash being spent on raw materials.

- These materials become stock, and hence the cash is now tied up as unsold stock items.
- When the finished items of stock are finally sold to customers, (on credit) these customers owe money to the entity end. They in effect become the debtors of the business.
- When paid, the debtor's cash is returned to the business and the cycle carries on in funding new stock or paying the expenses of the business (e.g.: paying suppliers or reducing bank deficit.
- If the business is making a profit some of the cash may remain in the business as retained profit and not spent in the short term.

A possible source of finance is squeezing or reducing working capital needs.

Therefore the cash is more efficiently used. For example if the stock levels are minimized the amount of money tied up in stock will get reduced.

Factors to be taken into account while determining working capital requirements.

A number of factors determine whether the amount of Working Capital held by the firm is high or low. Some illustrative factors are listed below.

Factor	High Working Capital	Low or Moderate Working Capital
1. Production Policies	High Production during peak seasons e.g. dairies, calendars etc.	Uniform Production over the year.
2. Production Process	Labour Intensive Process	Capital Intensive Process
3. Length of manufacturing process	Long manufacturing process or production cycle.	Short and quick manufacturing process, more batch runs etc.
4. Nature of business	Manufacturing concerns	Trading concerns
5. Credit Policy	Liberal credit policy and low efforts for debtors follow up.	Strict Credit and efficient credit collection Mechanism.
6. Market Standing	Newly established concern – Credit Sales	Reputed and established

		are made but purchases are settled in cash.	organizations – better and advantageous credit terms with debtors and suppliers.
7.	Inventory policy	High storage period or Stockholding Period.	Just in Time Inventory Policy and moderate stockholding period.
8.	Market Conditions	Fierce Competition or Buyers market.	Seller market – quick disposal of stocks and immediate collection of receivables
9.	Inflationary conditions	In case of highly inflationary conditions.	For moderate and mild inflationary conditions.
10.	Business cycle	During peak or boom conditions.	During moderate active conditions.

Major Considerations in Working Capital Management and Policies:

The three major considerations in working capital management are:

Profitability: If the amount of working capital is high, liquidity is high. But due to low Capital Turnover Ratio, the return on investment or profitability will also be low.

Liquidity: If the amount of Working Capital is less, a high turnover indicates higher profitability. But liquidity may be seriously affected, causing loss of reputation in the short run.

Structural Health: The structural health of the organization on long term and short term basis depends upon the optimum amount of working capital.

Hence, the Finance manager has to strike a balance between liquidity and profitability without affecting the structural health of the firm.

Reducing Working Capital needs for Manufacturing Co-operative Organizations:

1. **Just in Time Production (JIT):** In today's context the concept of producing just in time (JIT) and only to a specific order widely followed. When a customer orders a bed or dining table he may in some cases have to be wait 2 to 4 weeks for delivery. This is because some items are not held in stock by the retailer or manufacturer – they are both minimizing their working

capital needs and the amount of money tied up in the unsold stock. The consumer therefore pays upfront to the retailer and effectively funding the retailing and manufacturing of the product.

2. Early Payment Incentives: A business can ask its customers who purchase goods on credit to pay more promptly, by offering a financial incentive, for instance, a 5% discount for payment within 14 days and this helps to reduce the funding needs from the bank or shareholders.

3. Delaying Payments to Creditors:

- A business can slow down payment to it suppliers or creditors and use resources for longer without paying for them.
- Suppliers or creditors are being asked to fund more of entity's operations.

4. MRP and MRP 2 for Manufacturing Co-operative Organizations:

- Better management of stock can be done internally and without always affecting delivery scheduled.
- Better MRP (Material Resource Planning) and MRP2 (Manufacturing Resource Planning) systems are making ordering of stock materials more efficient.
- These systems reduce the time that stock is left unused and therefore reduce the amount of money tied up in stock.

Advantages of Reducing Working Capital Needs:

- The advantage of squeezing working capital as a source of finance is that you do not have to ask a bank or shareholders to give you more money and on terms that may be expensive.

Disadvantages of Reducing Working Capital Needs:

- The disadvantage is that suppliers and customers may not be happy waiting for money or paying upfront for goods, especially when competitors may be able to offer a better delivery schedule for customers or better payment terms to their suppliers.
- Caution has to be exercised and effective communication with these two stakeholders is of paramount importance.

Financial Assistance from Credit Co-operative Societies:

Credit Co-operative Societies: Credit Co-operative Societies are financial institutions that are owned and controlled by their members. Credit Co-operative Societies provide the same financial services as banks but adhere to co-operative principles.

Many of the Credit Co-operative Societies provide finance for their members only. They provide financial help to their members on the principle of "Growth through mutual help". In India, by and large Credit Co-operative Societies work in the agriculture sector. Most of the farmers need working capital to cater to the daily farming needs. It is very difficult to access such finance from nationalized banks or large co-operative banks.

In India, Credit Co-operative societies work at base level in villages. To uplift the poor farmers and unorganized labour, Government of India understood the importance of such small credit co-operative societies and giving more and more attention towards them. In small villages, all these small credit co-operative societies collect money from small vegetable vendors, small farmers, and unorganized laborers through various schemes called "Daily Collection" and bring that money in to the main stream of economy.

Small Credit co-operative societies should target such customers to earn finance and advance them to members.

Conventional Working Capital Finance:

Credit from Trade and Expense Creditors: This represents the credit granted by the suppliers of goods or expenses as terms of contract. Usually trade creditors grant a credit varying between 15 to 90 days. It generates automatically in the course of business and is common to all business operations. It may be in the form of "Open Account" or "Bills Payable". It is without any explicit cost, keeps on rotating, is a source of finance for the gross working capital.

Expense creditor period may vary according to the terms and conditions of contract e.g. salaries and wages are payable monthly but a bonus is payable annually or royalty may be payable on quarterly basis. This type of credit has also no explicit cost and keeps on rotating on a going concern.

A Co-operative Manufacturing Organization engaged in producing or manufacturing costly goods involving long period of time usually demands advance from customers at the time of accepting order for execution. Similarly monopolistic organizations may demand advance from customers before the order is accepted. This source of finance has no explicit cost of capital.

Bank Advances: There are various forms of Bank advances, they are:

- Overdraft:

Under this facility, the customer is allowed to withdraw in excess of its balance in current account up to a fixed limit. Though overdraft is repayable on demand, it generally continues for long period by annual renewals. Interest on this facility is charged on the basis of daily products and usually the rate of interest is higher than other short term finance. The security for overdraft account may be by way of Shares, Debentures, Government Securities, and Fixed Deposits etc.

The bank also allows clean overdraft to customers, who are financially sound and reputed for their integrity. In case of clean overdraft, banks usually rely upon personal security of the borrower. A clean overdraft is generally granted for a short period only.

- Cash credit:

Under cash credit, a limit is sanctioned by the bank and the borrower can withdraw required fund at any time, within that limit. The withdrawable amount may be fixed on the drawing power, which is calculated at a certain prefixed percentage of inventory/receivables. Interest is charged on a daily product basis. Cash credit is usually secured against hypothecation of inventory and security of book debts. Though this is a short term finance used for working capital purpose, the facility continues for a longer period on its annual renewals.

The borrower some time provides the security of goods by way of pledge. In this case, the borrower delivers the goods from pledge godown only on depositing the borrowed amount with the bank. Similarly on pledge of additional goods, the borrower is allowed to withdraw additional funds.

- Bill Discounting:

Bank also provides short term finance by discounting the bills of exchange drawn on customers. Out of working capital total limit, bill discounting also may be fixed by the bank. The discount depends upon the amount of the bill, the maturity period and prevailing rate of interest.

One of the shortcomings of the bill discounting system is that the bank which discounts the bill must establish and verify creditworthiness of the buyer, which at times may be difficult, complicated and time consuming process.

- Letter of Credit:

A Letter of Credit (LC) is a guarantee provided by the buyer's bankers to the seller in case of failure or default of the buyer. Letter of Credit issued by the bank thus serves the purpose as security to the seller. The LC provides a non- fund based financing as the funds are not involved in the issue of LC. It is a contingent liability of the bank and shall arise only if buyer fails to pay. Whenever LC is issued, the amount is adjusted against the fund based cash credit limit of the buyer. It is an indirect form of financing.

- Pre – shipment Packing Credit Finance:

Packing credit is advance provided by the banks to an exporter for the purpose of buying, manufacturing or processing, packing and shipping the goods to overseas buyers. An exporter who has in hand a firm order from a foreign buyer or irrecoverable letter of credit opened in his favour can approach bank for availing packing credit. An advance so taken is required to be liquidated within 180 days from the date of its commencement by negotiation of export bills or receipt of export proceeds in an approved manner. Packing credit in the case of customers of long standing may also be allowed against firm contracts entered into by them with the overseas buyers.

Types of Packing Credit:

- Clean Packing Credit:

This is an advance made available to an exporter only on a production of a firm production order or a letter of credit without exercising any charge or control over raw material or finished goods. It is a clean export advance. Each and every proposal is considered according to the requirements of trade and creditworthiness of the borrower. Bank has to maintain a considerable margin and Cover from Export Credit Guarantee Corporation can also be obtained.

- Packing Credit against hypothecation of goods:

Export finance is made available to the exporter on certain terms and conditions, exporter has pledge able interest. Goods are hypothecated by the bank as a security with a considerable amount of margin. At the time of utilizing the advance given by the bank, the exporter is required to submit, along with a firm export order or a letter of credit as the case may be, stock statement and is required to submit them over a period of time whenever there is a movement in stocks.

- Packing Credit against Pledge of Goods:

Export finance is made available on certain terms and conditions, where exportable finished goods are pledged to the bank with approved clearing agents who will ship the same from time to time as required by the exporter. The possession of goods so pledged lies with the bank and is kept under lock and key.

- ECGC Guarantee:

Any loan given to an exporter be it for manufacture, processing, purchasing, or packing of goods meant for export of goods against a firm order qualifies for packing credit. In that case, credit guarantee may be issued by Export Credit Guarantee Corporation (ECGC) after considering the facts of the case.

- Forward Exchange Contract:

One of the requirements of Packing Credit facility is that if the export bill is to be drawn in a foreign currency, the exporter can enter a forward exchange contract with the bank, thereby avoiding risk involved in daily fluctuations in an exchange rate.

Procedural Aspects from the applicants:

Following procedural aspects/documents taken are required by the bank for awarding any of the above finance.

1. Joint and Several demand by the managing members or the Board of Managing members with the signature.
2. Letter of Continuity of Business.
3. Letter of Authority to operate the account.
4. Letter of Pledge to secure demand cash credit against goods in case of pledge or hypothecation to secure demand cash credit (in case of hypothecation)
5. Undertaking of Co-operative Organization.
6. Letter of Hypothecation.
7. Agreement to utilize monies drawn in terms of contract.
8. General guarantee of the members of the general body in their joint and several personal capabilities.
9. Certified copy of resolution passed at general body.

All the above documents are required to be submitted to the concerned bank. Co-operative organization is also required to submit a filled form given by the bank. If at all bank officials have any query, they can ask for the same with the Chief Manager or Operating Officer who may resolve the queries by attending the same personally.

Post Shipment Packing Credit finance:

Finance may be provided by the bank or financial institution to exporters by purchasing export bills drawn payable at sight or by discounting the said export bill, which has confirmed the sale. The application should be backed by documents including the document of title of goods, custom receipts like bill of lading, air consignment note or post parcel receipts.

Procedural Aspects for Post Shipment Packing Credit finance:

- Post Shipment Packing Credit Finance is given to exporters by banks through negotiations, purchase of a bill, discounts on a bill. Banks also take into account the question whether the proposal qualifies for Post Shipment packing Credit Finance.
- It is necessary for the exporter that he should obtain a shipment or contract risk policy from Export Credit Guarantee Corporation (ECGC).
- Sometimes banks insist on the exporters or make it compulsory for the exporter to take contract risk policy covering both political and commercial risk.
- The Corporation on acceptance of the policy will fix credit limits for individual exporters and the corporation's liability will be limited to the extent of the liability of individual exporter concerned irrespective of the amount of policy.

Documents to be submitted:

1. Letter of hypothecation covering the goods
2. General Guarantee of the members of the general body on a letter head of the co-operative organization.

Other types of Finances:

There are some other finances which are not very much popular, but can be used by co-operative organizations to meet the short term requirements of funds. These are:-

- Advance against Goods:

Advance against Goods, is a very safe and liquid finance to any organization. In total bank credit, Advance against Goods has been given an important place by banking system. Goods as security provide many advantages to bank, one being that, it is a very reliable source of repayment.

Generally, Advance against Goods is provided either by way of Hypothecation or by way of Pledge. The term 'goods' includes all types of movable goods. They may be agricultural commodities, industrial raw material or finished goods or goods whose work is in process.

The Reserve Bank of India issues directives from time to time imposing restrictions on advances against certain commodities. It is obligatory on banks to follow these directives in letter and spirit. The directives also sometimes stipulate changes in the margin.

- Advance against document of title to goods:

Any document becomes document of title when its possession is recognized as possession of goods in a law or business usage. The document of title includes railway receipt, bill of lading, dock warehouse keeper's certificate etc. persons in possession of such document can by delivery or by endorsement and enable the other person to take delivery of goods in his rights.

An advance against such documents can be considered to be an advance against the pledge of such goods.

- Advance against supply of Bills:

Advance against bills for supply of goods to government or semi-government departments against firm orders after acceptance of tender fall under this category. The other types of bills which also come under this category are bills from contractors for work executed either wholly or partially under firm contracts entered into with the abovementioned Government Agencies.

These bills are clean bills without being accompanied by any document of title of goods. But they evidence supply of goods directly to Government Agencies. Sometimes these bills are also accompanied by inspection notes form representatives of government agencies for having inspected the goods before they are dispatched. If the bills are without the inspection report, banks would like to examine them with the accepted tender or contract for verifying that the goods supplied under the bills strictly conform to the terms and conditions in the acceptance tender.

These supply bills represent debt in favour of suppliers/contractors, for the goods supplied to the government bodies or work executed under contract from the Government bodies. It is this debt that is assigned to the bank by endorsement of supply bills and executing irrecoverable power of attorney in favour of banks for receiving the amount of supply bills from the Government departments. The power of attorney has got to be registered with the Government department concerned. The banks also take separate letter from the suppliers/contractors instructing the government body to the amount of bills direct to the bank.

Supply bills do not enjoy the legal status of negotiable instrument because they are not bills of exchange. The security available to the banker is by way of assignment of debts represented by the supply bills.

- Advance against export bills sent for collection:

Finance may be provided by the banks to exporters by way of advance against export bills forwarded through them for collection, taking into account the creditworthiness of the party, nature of goods exported, usage, standing of drawee etc. Appropriate margin is also kept by the bank.

Documents required for obtaining finance against export bills sent for collection:

1. Demand Promissory Note
2. Letter of Continuity
3. Letter of Hypothecation
4. General Guarantee of members of general body of the co-operative organization

- Advance against duty drawbacks, cash subsidy etc.:

To finance export losses sustained by the exporters, bank advance against duty draw backs, cash subsidy etc. receivable by them against export performance. Such advances are of clean nature and hence necessary precaution should be exercised.

Banks providing finance in such types of cases should see that the relative export bills are either negotiated or forwarded for collection through it, so that it is in a position to verify the exporter's claim for duty drawback, cash subsidy etc. 'An advance so availed by an exporter is required to be liquidated within 180 days from the date of shipment of the relative goods

Documents to be submitted for obtaining finance:

1. Demand Promissory Note
2. Letter of Continuity
3. General Guarantee of Members of General Body of a co-operative organization.
4. Undertaking from the co-operative organization that it will deposit the cheques/payments received from appropriate authorities immediately with the bank and will not utilize it any other way.

- Advance from Customers:

Manufacturing Co-operative organization engaged in producing or manufacturing costly goods involving considerable length of manufacturing process usually demand advance money from their customers at the time of accepting their orders for executing their contracts or supplying goods. This is a cost free finance and is really very useful.

Term Loan from Financial Institutions:

There are certain specialized institutions which provide long term finance to all types of organizations, be it Co-operatives, Corporate, NPOs or proprietary concerns.

Some of the Financial Institutions providing finance are:

- The Industrial Finance Corporation of India.
- The Life Insurance Corporation of India.
- The State Financial Corporation.
- The National Small Industries Corporation Limited.
- The Industrial Credit and Investment Corporation of India.
- The Industrial Development Bank of India.
- The Industrial Reconstruction Corporation of India.
- The State Industrial Development Corporations.

- The Small Industries Development Bank of India.
- Unit Trust of India
- General Insurance Corporation of India (GIC) and its subsidiaries.
- Shipping Credit and Investment Company of India Ltd.

Loans from Financial Institutions are available under different schemes of financial institutions and are available at different rate of interest. Repayment of loan should be as per the repayment schedule given by the financial institution. For giving such types of loans, Financial Institutions ask for various terms and conditions regarding management, financial and operational policy decisions of that Co-operative organization.

One such scheme is Technology Upgradation Scheme for Co-operative Sugar Industries. Another Example is 'Technology Provision and Upgradation scheme of Ethanol Producing Co-operative Sugar factories'. The scheme was specifically introduced by the Ministry of Agriculture for the growth and upliftment of Co-operative Sugar Industries. The main goal behind the introduction of the scheme was to increase the production of sugar factories and help export the sugar.

After Independence, the institutional set up in India for the provision of medium and long term credit for the industry has been broadened. The assistance sanctioned and disbursed by these specialised institutions has increased impressively.

Before the loan is sanctioned, any co-operative organization has to satisfy the financial institution regarding technical, commercial, economical, financial and managerial liability of the project. Such loans are available at different rates under different schemes.

A lending institution stipulates a number of conditions regarding the managerial and other financial policies of the company. The important conditions or covenants of loan agreement includes –

- Amount of Loan
- Rate of Interest
- Additional interest
- Commitment charges
- Reimbursement of Costs etc.
- Last date of withdrawal

- Repayment schedule
- Conversion right
- Security for the loan
- Restriction on payments of dividend
- Permission to carry out Expansion or diversification.
- Appointment of manager
- Raising unsecured loans
- Raising financial resources
- Review of project cost
- Maintenance of Property.
- Material Happenings to be informed
- Changes in Bye laws of the co-operative organization with prior approval affecting institutional interest.
- Submission of Physical and Financial Progress Reports.
- Withhold disbursement in certain cases.
- Inspection of Books and Property.
- Commitment to investment of funds.
- Consent for change in scheme.

Loan from Commercial Banks:

The primary objective of commercial banks is to cater to the short term financial requirements of businesses. But over a period of time, commercial banks including commercial co-operative banks have started providing long term loans by several ways.

Funding provided by outside banks and lenders is generally referred to as debt or loan capital.

It is usually provided for a fixed period of time, with repayments evenly spread out over the length of the loan.

Interest is paid on the loan at regular intervals, although interest rate holidays_(where the lender agrees not to take interest for a short period of time) can be negotiated if the business is struggling to fund the debt.

Loan capital is provided for more than one year and so is a long term form of finance.

Any loan for a period shorter than one year is classified as current liabilities or debt.

- Commercial Banks provide long term loans to co-operative organizations for the purpose of setting up or expansion of the organization. The liquidity of the loan depends on the projected income generation of the borrower.

The limitation for such types of loans to co-operative organization is that, all the commercial banks are not capable of making the appraisal to such types of loan. Banks are very much cautious because over a period of time, there are chances of changing the conditions of the co-operative organization. Therefore sometimes, banks have to assess the situation to make proper proposal. The decision in such cases would depend on various factors affecting the conditions of the industry concerned and the earning potential of the co-operative organization.

- As a part of long term funding policies of commercial banks, they also provide finance for long term working capital requirements of co-operative organizations. It is also called as Working Capital Term Loan. Commercial banks always finance that portion of a working capital which has to be kept at all times by any co-operative organization. This working capital is not changed by changing business situations. Working capital term loan is more permanent than other term loan from bank. The main reason for that is, a term loan is repayable on a fixed date and as per the Schedule given by the bank. In case of a working capital loan, though it is payable on demand, the account is never actually adjusted as such and if at all the payment is asked back, it is with a clear purpose and intention of refinance being provided at the beginning of the next year or half year.

This technique of providing long term finance can be technically called as “rolled over for a period exceeding more than one year”. Therefore, commercial banks many a times, instead of accepting a path way of roll over method, extend a credit term after a proper appraisal of application for term loans. In short, the degree of liquidity in a regular amortization of a term loan is more than demand loans which are renewed year after year.

Actually, term financing by commercial banks disciplines both borrowing co-operative organization and the banker. Long term planning is required to ensure that cash inflows are adequate to meet the regular repayment installments and also allow the active turnover of bank loans. The adoption of formal term loan lending by commercial banks will not in any way hamper the criteria of liquidity and as a matter of fact, it will introduce flexibility in the operations of the banking system.

Bridge Finance:

Bridge Finance refers to loans taken by the co-operative organization, normally from commercial banks, for a short period because of pending disbursements of loans sanctioned by financial institutions. Though it is of short term in nature, since it is an important step in the facilitation of long term loan, it is discussed after the term loan from financial institutions and commercial banks. In a normal course of business, it takes time for commercial lending institutions to disburse a loan to co-operative organization, especially one where lots of money is involved. However, once loans are approved by the term lending institutions, co-operative organization, arrange short term loans from commercial banks with a view to avoid delays in the commencement of the project.

Bridge loans are repaid or adjusted out of term loans as and when disbursed by the concerned institution. Bridge loans are normally secured by hypothecating movable assets, personal guarantees and demand promissory notes. Generally, the rate of interest on bridge finance is high as compared with term loan.

Advantages of Loan Capital:

- The advantage of this form of finance is that it is often easier to access and use for specific purposes like purchase of fixed assets, such as machines or property.
- Payment is spread out over the useful revenue-earning life of the asset.
- If the loan has a fixed interest rate, and interest rates rise in the future, the loan could turn out to be a very smart investment.
- Interest on term loan is tax deductible in nature.
- Administrative cost of serving a loan is minimal as compare to the cost related to other types of finances.
- Rate of interest depends on the credit rating of the borrower, perceived risk of lending and cost of funds to the lender.

Disadvantages of Loan Capital:

- The disadvantage is that lenders have to be paid even if the business does not make a profit.
- Any default (not paying the loan on time) can lead to the lender controlling future decision making, in effect they call the shots.
- Equally if the loan is secured against an asset then the asset can be repressed/ seized if payments are defaulted.
- If the loan has fixed interest rate, and interest rate falls, there would be additional burden on the business.
- Large and profitable organizations may be able to renegotiate terms with lenders.
- Foreign currency loans carry a risk of exchange rate fluctuations.
- Financial Institutions or Commercial Banks keep a clause reserving the right to convert the loan into share capital of the co-operative society subject to certain conditions and after complying the laws prevailing the co-operative organizations.
- Financial Institutions or Commercial Banks have a right to appoint a nominee member on the general body of the borrower co-operative organization. But co-operative organization and lender financial institution or bank has to follow the rules and regulations of the laws applicable to that co-operative organizations.

Lease Financing:

Leasing is a general contract between the owner and the user of the asset over a specified period of time. The asset is initially purchased by the lessor (Leasing co-operative organization) and thereafter leased to the user (lessee co-operative organization) which pays the specific rent at specific periodical intervals. Thus, Leasing is an alternative to the purchase of an asset out of owned or borrowed capital. Moreover, lease finance can be arranged much faster as compared to term loan from financial institution.

In short, a lease is a contractual arrangement, whereby one party (i.e.) owner of the asset – lessor) grants a right to the other party (i.e. user of the asset – lessee) the right to use the asset in return for a periodic payment.

When purchasing assets such as machinery or vehicles it can sometimes be useful to consider leasing as a source of finance.

Many airlines resort to lease purchase of the aircrafts. GE, a large US finance company, is one of the largest leasing companies in the world.

Equally leasing can be arranged with co-operative organization's own bank.

The advantages are that the business does not require large initial sums to buy the equipment and can thus pay for the asset from its own revenue.

The disadvantages are that the ownership of the asset does not pass to the lessee until the last installment of lease rent is paid and the business will probably be paying a high interest.

There are two types of leases:

1. Operating Lease. and
2. Financial Lease

From the point of view of Co-operative Organizations, Financial Lease has more importance.

Operating Lease:

A Lease is classified as operating lease, if it does not secure for the lessor the recovery of capital outlay plus a return on the funds invested during the lease period. Normally, these are cancellable with proper notice.

The term of this type of lease is generally shorter than the assets economic life. The lessee is obliged to make payments until the lease expiration.

Features of Operating Lease:

1. The lease can be cancelled by the lessee prior to its expiration on a shorter notice.
2. The lessor is responsible for the upkeep and maintenance of the asset.
3. The lessee is not given any option to purchase the asset at the end of the lease period.
4. The lease is for a shorter period.
5. The sum of all the lease payments by the lessee does not necessarily provide for the recovery of the cost of the asset.
6. The lessor has the option to lease out the asset again to another party.
7. This type of lease is preferred by the lessee when long term suitability of the asset is uncertain, when the asset is subject to rapid

obsolescence or when the asset is required for immediate use to get over a temporary problem. Computers and Office appliances are the most common assets which form the subject matter of many operating lease agreements.

Financial Lease:

In contrast to an operating lease, a financial lease is for a longer term and Non-concealable. In general, term finance lease can be regarded as any leasing arrangement that is to finance the use of equipment for the major parts of its useful life. The lessee has a right to use the equipment while the lessor retains the legal title. It is also called capital lease, and it is nothing but a loan in disguise.

Features of Financial Lease:

1. The lease is for a longer period.
2. It is non-cancellable, in the sense that the lessee is contractually obliged to make lease payments during the entire period specified in the contract.
3. This form of lease entails lower risk to the lessor as compared to operating lease.
4. Insurance, maintenance and service costs are generally borne by the lessee.
5. The lessee acquires most of the economic values associated with the outright ownership of the asset.
6. At the end of the lease period, generally, the lessor agrees to transfer the title of the lessee at a nominal cost.
7. The lessee is given an option to purchase the asset at the expiry of the lease.
8. Usually, 90% of the fair value of the asset is recovered by the lessor as lease rentals period.

Other types of leases:

- Sale and Lease back:

Under this type of lease, the owner of the asset sells the asset to the party (the buyer), who in turn leases back the same to the owner in consideration of lease rentals. Under this arrangement, the asset is not physically transferred, but only book entries are made. The main advantage of this method is that the lessee can satisfy himself, completely regarding the quality of the asset and after possession of the asset convert the sale into lease agreement.

Under this transaction, the seller assumes the role of lessee and the buyer assumes the role of the lessor. The seller gets the agreed selling price and the buyer gets the lease rentals.

- Leveraged Lease:

A leveraged lease is one that involves a third party who is a lender, in addition to the lessor and lessee. Under this arrangement, the lessor borrows fund from the lender and himself acts as equity participant. Normally, the amount borrowed is substantial vis-à-vis the funds provided by the lessor himself. The third party usually involved in financing the transaction is a financial institution like, UTI, Insurance Company, Commercial Banks etc.

Such types of leases are popular in structuring the leases of very expensive assets such as the Lease of an aircraft or a ship.

- Sales-Aid-Lease:

When the leasing organization enters into, an arrangement with the seller, usually manufacturer of the equipment, to market the seller's product through its own leasing operations, it is called a sales-aid-lease. The leasing organization usually gets a commission on such sales from the manufacturer and doubles its profits.

Advantages to the lessee:

- Leasing is an alternative to the buying of an asset out of own or borrowed funds.
- Lease rentals are tax deductible item.
- Lease financing can be arranged much faster than term loan financing.
- Lease is generally for medium term finance.
- Ownership risk gets shifted from lessee to the lessor.
- Lease rentals can be fixed on the basis of projected cash flows, which are supposed to vary over a period of time.

Advantages to Lessor:

- The lessor can claim depreciation in his books of accounts. For instance, some of the highly depreciable assets result in an effective tax saving measures. Computer systems are eligible for 60% depreciation rate and hence substantial amounts of taxes amount of taxes can be saved.

- It's an income generating source of finance. Rate of income is higher than term lending.
- Ownership of assets remains with the lessor.

Hire Purchase and Instalment Financing System:

In case of Hire purchase, the seller hands over the asset to the buyer, but the title of the goods is transferred only after the payment of the last instalment. In case of default in payment, the seller has a right to repossess the goods. The instalments paid by the buyer to the seller on repossession are treated as 'hire' towards the use of an asset. The hire purchaser discloses the asset in his balance sheet and can claim depreciation, which is tax deductible, although he may not be owner at that time. The interest part of the instalment being an expenditure is also tax deductible.

In case of instalment sale, the title of the goods is immediately transferred to the buyer, though the payment of price along with interests is settled over the agreement period. This is like a credit sale over a longer period. In case of default, the seller has no right to repossession, but has the remedy to sue and recover the dues through the court of law.

Both Hire Purchase and Instalment Financing System can be availed much faster as compared to term loans from financial institution or commercial banks.

Difference between Hire Purchase and Lease Financing:

Sr. No.	Basis	Hire Purchase	Lease Financing
1.	Ownership	Hirer becomes the owner on the payment of last instalment.	The lessor is the owner and ownership never passes to the lessee.
2.	Down Payment	20-25% of the cost is paid as down payment	No Down Payment.
3.	Depreciation	Charged in the books of hirer.	Charged in the books of lessor.

4.	Maintenance	Borne by hirer.	Operating Lease – lessor, Finance leas – lessee
5.	Capitalization	In the books of hirer.	In the books of leasing organization.
6.	Tax Benefits	On depreciation and Finance charge.	On lease rentals.
7.	Risk of Obsolescence	Borne by the hirer.	Operating Lease – lessor, Finance leas – lessee
8.	Reporting	The asset is shown in the Balance Sheet of hirer and the instalment payable as a liability.	

Chapter 9

Modern Modes of Financing the Co-operative Sector

Modern modes of financing means, those modes of finance which are not generally used by the co-operative organizations for financing their projects or needs. We can also conclude that the mode of finance which be recently developed and which are specifically developed for co-operative organization can be said to be a modern modes of financing a co-operative organization.

Here we are not differentiating finances on the basis of short term or long term mode of finance. We generally know that the finance arrangement which has repayment period of more than 5 years is said to be long term source of finance. The period of repayment less than 5 years but more than 1 year is considered as medium term of finance. The period of finance for less than 1 year is short term source of finance.

Following are the different modes of modern financing:

Venture Capital Financing:

Venture Capital financing refers to new high risk ventures promoted by qualified entrepreneurs who lack experience and funds to give shape to their ideas. Co-operative form of organization is a very strong tool in the hands of newly qualified entrepreneurs who lack experience and funding. In a broad sense, under the venture capital financing the venture capitalist make investments to purchase shares of co-operative organization formed by such qualified entrepreneurs. The venture capitalist invests in a high risk projects with having a potential of success.

Methods of Venture Capital Financing:

We have to understand different methods of Venture Capital Financing in India for a proper understanding of the subject. But for that we have to understand the history of Venture Capital Financing in India.

History of Venture Capital Financing in India:

In India, Venture Capital financing was first the responsibility of development financial institutions such as the Industrial Development Bank of India (IDBI), Industrial Credit Investment Corporation of India (ICICI) and the State

Financial Corporations (SFCs). In 1988, the Government of India took a policy initiative and announced guidelines for Venture Capital Funds (VCFs). In the same year, a Technology Development Funds (TDF) financed by the levy on all payments for technology imports was established. This fund was meant to facilitate the financing of innovative and high risk technology programmes through the IDBI.

The guidelines mentioned above restricted the setting up of Venture Capital Funds by banks and financial institutions only. Subsequently, guidelines were issued in September 1995, for overseas investment in Venture Capital in India.

A major development in venture capital financing in India was in the year 1996 when the Securities and Exchange Board of India (SEBI) issued guidelines for venture capital funds to follow. All those guidelines described a venture capital fund as a fund established in the form of company or trust, which raises money through loans, donations, issues of securities or units and makes or proposes to make investments in accordance with the regulations. This move was instrumental in the entry of various foreign venture capital funds to enter India. The guidelines were further amended in April 2000 with the objective of fuelling the growth of Venture Capital activities in India.

Venture Capital industry is of recent origin. It is a national priority especially in the areas of telecommunication, Non-conventional energy, Quality upgrading, Biotechnology, Information Technology, Induction of new technology etc. In 1999 the existing guidelines were relaxed to increase the attractiveness of the venture schemes and induce the high net worth investors to commit their funds to sunrise sector, particularly the information technology sector. Initially the contribution to the funds available for the venture was only from all India financial institutions, State Development Corporations, commercial banks and private corporates. In the last couple of years, many offshore funds have been established in the country and maximum contribution is form foreign institutional investors.

Some methods of Venture Capital Financing are as follows:

Members Share Financing: A venture capital undertaking by a here co-operative organization generally requires funds for a longer period but may not be able to provide returns to the investors during the initial stages. Therefore, it is advisable to co-operative organizations to issue shares to the investors. But legal restriction on issue of shares to investors should be taken into consideration by the co-operative organization and its qualified member entrepreneurs. Generally, only 20% shares are allowed to be issued to a single investor. The main objective of keeping a cap of 20% only is that one should not be able to influence the decision of any co-operative organization.

Conditional Loan: A conditional loan is repayable in the form of a royalty after the venture is able to generate sales. No interest is paid on such loans. In India venture capital financiers charge royalty ranging between 2% – 15%; the actual rate depends on other factors of the venture such as gestation period, cash flow patterns, risks and other factors of the enterprise. Some Venture Capital Financiers give a choice to the enterprise to pay a high rate of interest (which could be well above 20%) instead of royalty on sales once it becomes commercially sound.

Newly high qualified persons having potential of business and growth through self help, may be able to reap the benefits of venture capital financing.

In India if co-operative sector in to grow bring potential talent to in the main stream of our country, we have to use and robust modes of financing. Mobilization of funds becomes easier in such types of financing.

Income Note: Income Note is a hybrid financial model which includes features of both conventional financing and conditional loan financing. A co-operative venture Capital undertaking has to pay both Interest as well as Royalty on sales, but both at substantially lower rates.

Factors to be considered by Venture Capital organization before financing to Co-operative Organization.

- Level of expertise of organizations management:

Most of the venture capitalist before financing any project of a co-operative organization believe that the management of the co-operative society should be highly qualified, competent and committed to its project. They believe that success of any project is highly dependent on the quality of its management. They expect that co-operative society should have skilled people working in the organization.

- Level of technical expertise:

The venture capitalist checks that the society has necessary technical ability to carry out the project. They are competent enough to work on their idea of new product or service and develop and produce new product or service.

- Features of new product or service:

The whole concept of venture capitalism is based on innovation and funding that innovation by investors to a high risky project having potential to success. The venture capitalist considers the technical feasibility of new product or service. Sometimes, venture capitalists opt for due diligence audit for such newly formed co-operative organization before financing the same. Venture capitalists also examine the idea proposed by new entrepreneurs.

- Future Prospects:

A newly formed co-operative society lacks professional expertise and experience. The risk involved in financing such co-operative society is quiet high as against the established co-operative society. In such a high risky environment, the expectation of returns by the investors is also high. Therefore, any co-operative organization seeking venture capital financing should draw a detailed business plan and strategy for future, so that they can become more comfortable while financing the project.

- Competition:

Venture Capitalist assures himself that society of qualified entrepreneurs has actually a new product different from existing products and it has market for the growth of that product. Due diligence sometimes also includes research carried out by the entrepreneurs.

- Risk borne by the entrepreneur:

Many of the venture capitalists ensure themselves that the entrepreneur or society of entrepreneurs involved in a project bears a high degree of risk. This ensures the investor that society will show high level of commitment. And they will face a huge loss should the project fail.

- Exit Route:

The members of co-operative society should know that venture capitalist always try to establish a number of exit routes. It’s not quite easy for investor to have number of exit options from co-operative organization, because the co-operative sector is strictly regulated by law of land.

- General Body Membership:

In case of co-operative society, to ensure proper protection of their investment, venture capitalist should require a place on a general body. This will enable them to have their say on all significant matters affecting the business.

Asset Debt Securitisation:

Securitisation is a financial transaction in which assets are pooled and securities representing interests in the pool are issued.

The term securitisation refers to both switching away from bank intermediation to direct financing via capital market and/or money market, and the transformation of illiquid assets like automobile loans, mortgage loans, trade receivables into marketable securities.

“Securitisation is a process of transformation of illiquid assets into security, which may be traded later in the open market”.

We now explain the conceptual process of Asset Debt Securitisation with the help of an example.

A Co-operative Bank or Co-operative Financial Organization has issued a large number of car loans. It desires to raise further cash so as to be in a position to issue more loans. One way to achieve this goal is by selling all the existing loans. However, in the absence of a liquid secondary market for individual car loans, this may not be feasible. Instead, the company pools a large number of these loans and sells interest in the pool to investors. This process helps the organization, to disburse further loans. Similarly, the process is beneficial to the investors as it creates a liquid investment in a diversified pool of auto loans, which may be an attractive option to other fixed income instruments. The whole process is carried out in such a way, that the ultimate debtors the car owners – may not be aware of the transaction. They shall continue making payments the way they were doing before, however, these payments shall reach the new investors instead of the company they (the car owners) had financed their car from.

The example provided above illustrates the general concept of securitisation as understood in common spoken English.

It is a method of recycling the funds. It is especially beneficial to financial intermediaries to support lending volumes. Assets generating steady cash flow are packaged together and against this asset pool, market securities can be issued.

The securitisation process has three pillars. They are Originating Function, Pooling Function and Securitisation function.

Securitisation Process:

1. **The Origination Function:** The borrower seeks a loan from a co-operative bank or co-operative finance organization. The finance is provided by the co-operative organization to the borrower by evaluating his creditworthiness. Loan is provided to the borrower in the normal course with repayment schedule.

2. **The pooling Function:** The originated assets viz. auto loans, housing loans, trade receivable, lease rentals etc. according to the maturity pattern, rate of interest and risk factor are clubbed together to create a pool. This pool is transferred in favour of Special Purpose Vehicle (SPV), which acts as a trustee to the investor. Once the assets are transferred they are held in SPV's portfolio.

3. **The Securitisation function:** Special Purpose Vehicles structures the assets in a proper format. An asset pool is created for identical assets. Specific Interest Rate and Maturity period is awarded to the assets in assets pool. Investors are the people who purchase those assets from asset pool. Investors for such types of assets are mutual fund, financial institutions, hedge funds, insurance companies, commercial banks and High Net worth Individuals etc. The originator earns income from the interest received from borrowers and interest paid to the investor.

The whole securitisation process is generally without recourse. The investor bears the risk of default. The issuer of the asset is only responsible for payment of cash to the investor till he receives it from the borrower. The legal remedy is available to the issuer against the borrower in case of default. Investor can reduce his risk by taking insurance cover, letter of credit and guarantees.

The securitisation is divided in two instruments which are Pass through and Pay through.

Pass Through Securities:

Pass through Process is instruments in which issuer passes all the cash flows received from borrower to the investor. Issuer in this case only acts as an agent of the investor. But here that in a great risk to the investor of pre payment. It essentially means that if a pre payment takes place on a 10 year pass through instrument, its life may shrink to even one day.

Pay Through Securities:

Pay through securities are different from pass through securities as the investors are given the cash flows at the pre determined time irrespective of the cash from the original portfolio in the deal. In other words we can say that Pre payment risk in the instrument is absorbed by the Special Purpose Vehicle. What happens practically in the deal is that the SPV maintains the pre paid cash flows at its end and pay to the final investors at the pre determined time only.

Features of Special Purpose Vehicle:

From the above discussion, we can say that SPV plays an important role in the whole process of Asset Debt Securitisation. It is essentially a means of converting one form of asset into another form.

1. It is a vehicle to transfer assets into securities.
2. It is an agency which is created to hold the assets in trust of investors.
3. As per Securitization Bill recently cleared by the government, SPV may take the form of a trust or a company.
4. The structure of Special Purpose Vehicle is exactly the same as that of mutual fund.

We have seen two types of securitization and those are Securitization with recourse and Securitization without recourse. Any future cash flows can be securitized in the market. Following are the assets may be covered under securitization:

1. Physical Assets
2. Financial Assets
3. Operational Assets
4. Any other receivables.

To put in a perspective, there is a wide scope for imagination and creativity. There are lots of opportunities in the market for this evolving area in the sources of finance. If you look from the creativity point of view we can say that there is scope for huge innovation in the market.

But if we look from the risk point of view, we have to understand the basic principle behind any deal of lending and borrowing. In a traditional contract of lending and borrowing, the lender is very much cautious of the creditworthiness and paying capacity of the borrower. If there is a default on the part of borrower, it directly causes loss to the lender. Therefore, the lender becomes tied up in the contract.

In Asset Debt Securitization, the lender pools all the loans and transfers it in the favour of Special Purpose Vehicle. The special Purpose Vehicle then sales the assets to the investors. The lender gets freed from the loss arising from non payment by the borrower. It may happen that wrong borrowers may be chosen by the lender for lending money just to sell it to the investors. In many cases of securitization, creditworthiness and payment capacity of the borrower is not checked by the lender. This has happened in United States over period of time and the whole system got collapsed in the year 2008 called the Sub Prime Mortgage Crises.

In India, the Reserve Bank of India (RBI) has issued guidelines on securitisation of standard assets in April 2005. These guidelines were applicable to banks, financial institutions and non banking financial companies. The guidelines were suitably modified and brought into effect from February 2006.

Benefits to the originator:

1. The assets are shifted off the balance sheet, thus giving the originator recourse to off balance sheet funding.
2. It converts illiquid assets to liquid portfolio.
3. It facilitates better balance sheet management as assets are transferred off balance sheet facilitating satisfaction of capital adequacy norms.
4. The originator’s credit rating enhances.

Benefit to the Investor:

1. Investor gets security which is backed by adequate collateral and has credit enhancement.
2. Securities are rated by credit rating agencies. It becomes easier for an investor to compare the risk return profile of assets backed securities with other investible instruments and make an informed choice.
3. It opens up new investment avenues.

For a developed securitisation market, high quality assets with low default rate are essential with standardised loan documentation and stable interest rate structure. Developed secondary debt market is very essential for this route. In Indian context debt securitisation has just taken off.

Opportunities for Co-operative sector in Asset Debt Securitisation:

Originator:

There are many co-operative banks or Credit Co-operative societies which gives various types of loans to different types of customers. It may be home loans, auto loans, short term funding, term loans to business undertakings etc. Co-operative bank or Credit Co-operative Societies can function as originator for any asset debt securitisation. Due to its vast public relations, Co-operative banks and credit co-operative societies can effectively act as originator for any asset debt securitisation.

The Originating function is itself a source of finance. After providing finance to various borrowers, co-operative bank or credit co-operative society has to wait till the repayment schedule is complete. In Asset Debt Securitisation, co-operative bank or credit co-operative society can easily transfer its illiquid assets into liquid by selling it to investors through Special Purpose Vehicle (SPV).

The Co-operative Bank or Credit Co-operative Society must follow the guidelines issued by Reserve Bank of India on securitisation of standard assets.

A Co-operative organization cannot act as Special Purpose Vehicles because; Special Purpose Vehicle can only be a trust or a company.

In the case of investment in Asset Debt Securitisation, a co-operative organization must follow the provisions of co-operative laws applicable to that particular co-operative organization. In case of multi state co-operative organization, it can only invest in shares or securities of other financial institution or bank. Investment in shares of limited or unlimited company is strictly prohibited.

Other Modern Sources of Financing:

- Seed Capital Assistance:

The seed capital assistance scheme has designed by IDBI for professionally or technically qualified entrepreneurs or co-operative societies possessing relevant experience, skills and entrepreneurial traits. All the projects eligible for financial assistance from IDBI, directly or indirectly through refinance are eligible under the scheme, the cost of project should not exceed Rs. 2

crores. This is a cap on lending of funds should be on the institution. It shows that Seed Capital Assistance is for small scale co-operative organizations. The maximum assistance to any co-operative organization will be restricted to 50% of the required promoter's contribution or Rs. 15 lacs whichever is lower.

The Seed Capital Assistance is interest free but it carries a service charge of minimum 1 % for at least minimum five years and at increasing rate thereafter. However IDBI will have the option to charge interest at such rate as may be determined by the IDBI on the loan if the financial position and profitability of the co-operative society so permits during the currency of the loan. The repayment schedule is fixed depending upon the repaying capacity of the unit with an initial moratorium up to five years.

For projects with a cost exceeding Rs. 2 crore, seed capital may be obtained from the Risk Capital and Technology Corporation Ltd. (RCTC) For small projects costing up to assistance under National Equity Fund of the SIDBI may be availed.

- Risk Capital Foundation Scheme:

The Risk Capital Foundation Scheme is a foundation established and funded by Industrial Finance Corporation of India (IFCI). The cap is set up by IFCI. Capital of a co-operative organization should range from Rs. 2 crores to Rs. 15 crores. The ceiling on finances provided by the IFCI varies from Rs. 15 lakhs to Rs. 40 lakhs depending upon the financial health of the co-operative organization.

- Unsecured Loans:

Sometimes, there is a need of immediate cash to the co-operative society, in that case to meet the urgency, members of the society provide finance to the society as loan. These loans are also called as subordinate loans. Many times members do not charge interest for the loan given or charge very less amount of interest. In such types of cases, provisions of various laws applicable to the society should be taken into consideration. Unsecured loans are considered as a part of equity for the purpose of calculating of debt equity ratio.

- Deferred Payment Guarantee:

Many a time suppliers of machinery provide deferred credit facility under which payment for the purchase of machinery can be made over a period of time. The entire cost of the machinery is financed by the organization or supplier and co-operative society is not initially liable to towards the acquisition of the machinery. Normally, the supplier of the machinery insists on the society that bank guarantee should be furnished by the buyer. Such a facility does not have a moratorium period for repayment. Hence, it is advisable only for an existing profit making or financially strong co-operative organization.

- Internal Cash Accruals:

Existing profit making co-operative societies which undertake an expansion/diversification programmes may be permitted to invest a part of their accumulated reserves or cash profits for creation of capital assets. In such cases, past performance of the co-operative organization permits the capital expenditure from within the society by way of disinvestment of working/invested funds. In other words. The surplus generated from operations, after meeting all the contractual, statutory and working requirement of funds, will be available for further capital expenditure.

- Capital Incentives:

The backward area development incentives often determine the location of a new industrial unit. These incentives usually consist of a lump sum subsidy and exemption from or deferment of sales tax and Octroi duty. The quantum of incentives is determined by the degree of backwardness of the location.

The special capital incentive in the form of a lump sum subsidy is a quantum sanctioned by the implementing agency as a percentage of the fixed capital investment subject to an overall ceiling. This amount forms a part of the long term means of finance for the project. However it may be mentioned that the viability of the project must not be dependent on the quantum and availability of the incentives. Institutions, while appraising the project, assess the viability of the project per se, without considering the impact of incentives on the cash flows and profitability of the project.

Special incentives are sanctioned and released to the units only after they have complied with the requirements of the relevant scheme. The requirements may be classified into initial effective steps and final effective steps. The initial effective steps include formation of a co-operative society, acquisition of land in the backward area and registration for the manufacture of the products. The final effective steps include obtaining clearances under FEMA, capital goods clearance/import license, conversion of letter of intent to industrial Licenses, tie up of the means of finance, all clearances required for the setting up of the unit, aggregate expenditure incurred for the project should exceed 25% of the project cost and at least 10% of the fixed assets should have been created/ acquired site.

The release of special capital incentives by the concerned State Government generally takes one to two years. The promoters therefore find it convenient to avail bridge finance against the capital incentives. Provision for the same should be made in the pre-operative expenses considered in the project cost. Further, as the bridge finance may be available to the extent 85% , the balance may have to be brought in by the members of the co-operative organization from their own resources.

In modern methods of financing, there are certain instruments of financing which a co-operative organization may use for financing its projects. The various new financial instruments which are discussed hereunder have been introduced in early 90's. These instruments are staggering in their nature and diversity.

We now look at each of them in detail:

- Deep Discount Bond:

Deep Discount Bonds are basically a form of zero interest bonds. After calculations of Present value of money, these bonds are sold at discounted value and at certain maturity of a bond; these bonds are redeemed at a face value of a bond. There are many banks or financial institutions in the market offering deep discount bonds. But, IDBI is the first to come up with deep discount bonds. IDBI came up with Deep Discount Bonds in January 1992.

Features of Deep Discount Bonds:

If a bond of a face value of Rs. 1.00 Lacs was sold for Rs. Rs. 2700/- with a maturity period of 25 years.

The investor can hold bond for whole 25 years. The bonds may be redeemed at the end of every five years with a specific maturity value, as calculated by the bank or financial institution.

Source of Finance for Co-operative Organization:

Deep Discount Bond is a source of finance to the co-operative organization. The initial investment in the bond is very less. For example, if a co-operative organization invests Rs. 2700/- for 25 years, then we can have Rs. 1.00 Lac at the end of year 25. A co-operative organization, can withdraw certain amount of funds as and when required by it. If we calculate annualized rate of interest, then we come to know that it ranges from 15 to 16 percent per year. The redemption is shown in the following table.

Sr. No.	Particulars	Internals of Redemption				
1	Holding Period (Years)	5	10	15	20	25
2	Maturity Value (Rs.)	5700/-	12000/-	25000/-	50000/-	100000/-
3	Annual Rate of Interest	16.12	16.09	15.99	15.71	15.54

Deep Discount Bonds are very useful to the co-operative organization, because, it is source of finance at a specific period of interval to the organization. Returns are also very high as compared to other instrument of finances available in the market.

But, here's the catch; the source of finance we have talked is a kind of investment in bonds and the returns which will be obtained by the co-operative organization is a source of finance to the organization. Basically it is investment cum source of finance.

In case of co-operative organization, laws governing the organization restrict the organization in investing the funds of the organization in various bonds. Multi State Co-operative Societies Act, 2002 restricts the society in investing in various such types of bonds. Co-operative Organization should look into the provisions applicable to the organization regarding investment of funds.

- Zero Coupon Bonds:

Zero Coupon Bonds may be issued by the company or a financial institution or a commercial bank. Zero Coupon bonds are same as that of Deep Discount banks, but the main difference is that zero coupon bonds can be issued by a company form of organization. Zero coupon bonds do not carry any interest but it is sold by the issuing financial institution or bank at discount. The difference between the discounted value and maturing or face value represents the interests the interests to be earned by the investor on such bonds.

Zero Coupon bonds are not very much flexible compared to deep discount bonds. You cannot redeem the bonds in between the period. There is a lock in period to the investment.

In case of Zero Coupon Bonds also co-operative organization has to consider the laws applicable to the organization. Each state has its own enactment on co-operative sector. Co-operative society registered in the any state has to follow the provisions of co-operative enactment of that state.

- Double Option Bonds:

Double Option Bonds are issued by IDBI. As per Multi State Co-operative Societies Act, 2002 any Multi State Co-operative Organization can invest in the shares, securities or assets of any financial institution or commercial bank. The same provision is also being stated in Maharashtra Co-operative Societies Act, 1960. In this case of Double Option bonds, issued by IDBI multi state co-operative societies can invest in the bonds of IDBI.

The face value of a bond is Rs. 5000/- The bond generally carries interest rate at 15% compounded half yearly from the date of allotment (subject to variation as per market conditions). The bond has a maturity period of 10 years. Each bond is separated in two parts in the form of two different certificates. One is for principal of Rs. 5000/- and other for interest (including redemption premium) of Rs. 16500/- Both the certificates are listed on the stock exchange. The investor has the facility of selling either one or both parts anytime he likes.

But before purchasing Double Option Bonds by any Co-operative Organization, that organization should check out whether its byelaws allow to sell off certificate on stock exchange and generate funds. If byelaws does not allow to purchase and sale through stock exchange (recognized or unrecognized) the concerned co-operative organization should modify the byelaws at a general meeting and then only go for Double Option Bonds.

- Option Bonds:

These are cumulative and non cumulative bonds where interest is payable on maturity or periodically. Redemption premium is also offered to attract investors. These were issued by financial institutions like IDBI, ICICI, and IFCI etc.

- Floating Rate Bonds:

In this type of bonds, the interest rate is not fixed and is allowed to float depending upon the market conditions. This is an ideal instrument which can be resorted to by the issuer to hedge themselves against the volatility in the interest rates. This has become more popular as a money market instrument and has been successfully issued by financial institutions like IDBI, ICICI etc.

Factoring:

In India Factoring is a new concept in financing. It's an easy and simple means of finance. In developed countries, factoring concept has been evolved and at a developed stage at this point of time. Factoring is very useful to Agriculture Marketing Co-operative societies, Co-operative manufacturing industries, Co-operative agro industries, Co-operative trading organizations, Co-operative Marketing Societies etc. Factoring concept is very useful to large number of co-operative organizations included in above and related field.

Factoring refers to outright sale of accounts receivables to a factor or a financial agency. A factor is a firm which acquires receivables of other firms and pays out to that firm. A factoring lays down the condition for sale in a factoring agreement. The factoring agency bears the right of collection and services the accounts for a fee.

Before going to the features and advantages of factoring, we first have to understand how the factoring mechanism works.

The following is the procedure in the factoring service:

- The factoring organization and its client (Co-operative organization) have a formal contract of factoring indicating the terms and conditions of factoring.
- The factor carries out due diligence of the debtor or buyer of his client. It includes past financial history, creditworthiness, current financial position and paying capacity etc.
- Factor also suggests his clients how much credit limit should be approved to a particular client.
- Client of a factor sells goods to his customer in a normal course of business.
- One copy of invoice should be sent to a factor by the client.
- Factor, then sends notice of assignment to the buyer.
- Factor finances the client with the invoice amount after retaining certain percentage of margin. The retention margin is around 10 – 20%.
- On the expire of particular credit period, buyer makes payment to the factor. At this point the factor pays to seller margin money retained as

per above point. Factor cut his commission from the retained margin money.

Features of Factoring:

Following are the important features of factoring process:

- The factor engages itself with only those clients which are able to handle by a factor. The factor establishes the terms of contract with client regarding margin money, commission to be paid, credit limit, credit period etc.
- The factor assumes the responsibility of handling the client and collecting money from them. Factor pays to the client as soon as it takes responsibility of handling the accounts.
- The factor advances money to the client against not yet collected and not yet due for payment. This credit usually runs up to 70 – 80% of the face value of the debts and carries interest rates which may be equal to or marginally higher than the lending rate of commercial bank.
- There are many types of factoring. Important once being Recourse Factoring and Non Recourse Factoring
- The factor charges a commission which may be 1 to 2 per cent of the face value of the debt factored.
- Normally, the client notifies to the customer the existing factoring arrangement between the seller and factor advices customer to pay directly to the factor. This is known as disclosed factoring. Whereas in undisclosed factoring, such notification is not made and the client makes over payment to the factor on receipt from debtors, if advance has been availed of against such debts.

Advantages of Factoring:

- Conversion of accounts receivables into liquid cash without botheration of collection from customers.
- It ensures definite cash flows from credit sales.
- Continuous factoring eliminates the need for collection department and thus reducing the administrative costs.
- Opportunity cost of funds gets saved thus substantial cost saving is possible.

- Management can focus on core activities.
- Reduction in bad debts.
- Easy availability of finance.
- Professional management of Accounts Receivables.

Limitations of Factoring:

- Sometimes cost of factoring is higher than cost of traditional collection of debts.
- Factoring of debt may be perceived as a sign of financial weakness and lack of professional management of finances within the organization.
- Confidential data is handled by third party.

Types of Factoring:

There are various types of factoring but we will now consider only two types of factoring i.e. recourse factoring and non - recourse factoring.

Recourse Factoring: Under recourse factoring, the factor purchases the receivables of his clients on the condition that any loss arising out of irrecoverable receivables will be borne by the client. In this case if receivables turn out to be bad the loss is to be borne by the client himself.

Non – Recourse factoring: It is exactly opposite to Recourse Factoring. Under Non – recourse Factoring, the client gets total credit protection. If receivables turn out to be bad, the loss of bad debts is to be borne by the factoring agency. In this type of factoring, as the components of service, viz. Short Term Finance, administration of sales ledger and credit protection are available to the client.

Chapter 10
International Finance

International sources of finance constitutes of all foreign currency funds, euro issues, internationally acclaimed financial instruments, Foreign Currency Convertible Bonds, Depository Receipts which includes American Depository Receipts, Global Depository Receipts etc.

All the above sources of finance directly enable any organization to access international financial markets. But we should not forget the basics of Co-operative Organization. Each and every co-operative organization is established by the members for their own benefits and growth. It is for mutual help. Business is obvious the motive behind the organization but only secondary.

Besides, each and every co-operative organization is guided by the laws of the land. Every State has its own Co-operative Societies Act to govern the societies in that State and protect the interest of members of the organization. The same role is diligently performed by the Multi State Co-operative Societies Act, 2002.

Various Acts governing the co-operative sector in India restricts the investments made by co-operative sector. Most of the investments in international finance are restricted by the laws applicable to co-operative sector. Borrowings from different sources are also restricted by the different enactments.

In such a scenario, the investments or external commercial borrowings are allowed by these laws can be made by co-operative organization. But guidelines of Reserve Bank of India and Securities and Exchange Board of India have to be followed.

After complying with all the above enactments and guidelines, co-operative organization must see whether their own bye laws allow them to go for international transaction. Here one thing must be taken into consideration that bye law of any co-operative organization should not and cannot override any pronouncement of law or guidelines issued by the constitutional authorities established in India.

Chapter 11

Various Types of Finances for Non Profit Organizations

Nonprofit organizations rely to a great degree on contributions from outside sources to fund their programs and day-to-day operations. Effective fundraising is vital to the survival and growth of nonprofits. In addition to traditional funding sources, such as individual and institutional donors, modern firms can take advantage of creative financing solutions for nonprofit organizations, such as earned income ventures and cause marketing partnerships.

Gifts and Donations:

Donations generally come from individuals (e.g. from a fundraising appeal or given as a legacy), from companies, or from charitable trusts and foundations. Unless they have been given in response to a particular appeal you generally have considerable freedom in how to apply them. Gifts and donations are a particularly important source of income for charities and can attract tax relief. Raising funds however can be time-consuming and costly – and you could even lose money.

Key issues for members of the charity or nonprofit board body to consider are:

- Is your fundraising effective and economic? Have you set cost: income ratios for your fundraising (recognising that some types of fundraising is more expensive than others) and are you achieving them? Are you claiming back tax such as Gift Aid?
- Is your fundraising legal? The rules about fundraising can be detailed and complex and you may need to seek advice. There are for example rules on data protection, the use of professional fundraisers, and for house to house collections and lotteries.
- Is your fundraising ethical? Do you comply with the Institute of Fundraising's Codes of Fundraising Practice, have you signed up to the self-regulatory scheme for fundraising?
- Are your fundraising activities likely to damage your reputation in any way? Do you have policies for example on corporate donations?

- Have you made clear what the appeal is for, and what you will do if you raise more or less than target? Have you ensured that the money will be spent on the purpose for which it was given?

The Institute of Fundraising has developed its Codes of Fundraising Practice and Code of Conduct to provide a guide to the law and best practice in relation to fundraising activity throughout the United Kingdom. It has also produced The Trustees Guide to Fundraising.

The Charity Commission sets out its advice in Charities and fundraising.

Donation is considered to be one of the very important sources of finance by the Non Profit Sector. Donation is mainly used for charitable purposes. Donations are tax deductible under section 80 G of Income Tax Act, 1961.

- **Institutional Donors:** Foundations and large granting organizations, such as the Gates Foundation and United Way, can be large sources of long-term income for nonprofit organizations. Large granting organizations typically provide grants to nonprofits whose mission and impact matches their areas of specialization. Churches and other religious organizations can be a significant source of funding for nonprofits with humanitarian missions.

- **Individual Donors:** Individual donors can provide a large portion of a nonprofit's income, even though the amount earned from each individual may pale in comparison with other sources. Individual donors must be fully sold on the effectiveness and impact of your organization, and they must be treated like valuable customers rather than simply a source of funds. Successful nonprofits seek ways to enhance their relationships with individual donors by offering service and advocacy opportunities at a grassroots level. You can turn donors into lifelong partners if you provide them with meaningful experiences and a chance to be involved in your organization's mission.

- **Government Aid:** Central and State Governments offer grant funds to nonprofit organizations with a wide range of missions and impact areas. Government funds can come with more strings attached than funds from other sources; fund spending may be strictly controlled, and you may be required to submit regular audits of your company's finances and operations for ongoing contributions.

- **Earned Income Ventures:** Non-profits around the world have felt the impact of the global recession of 2008 as donation sources have dried up and funding has become less reliable. Today's nonprofits are realizing more than ever the importance of creating earned income ventures to sustain their operations in tough times. Although earned income traditionally makes up a small percentage of nonprofit income, a profit-making component can help to ensure consistently reliable income levels. The most basic form of earned income venture is a profit-making business run by the nonprofit, which channels its profits directly into the organization. A Better Way Ministries in Newnan, Georgia, a drug rehabilitation and gospel outreach program, for example, employs the men in its care in a number of small, profitable companies, including an auto detailing company, a bread company and a moving company. The money generated by these satellite companies enables the parent organization to earn income while helping the program recipients to earn an income during the program. Cause marketing is a less hands-on venture that can provide a large return on a small investment. Nonprofits can allow corporations or events to leverage their name and logo in advertising campaigns in return for a contribution or profit-sharing agreement.

- Board Contributions: Smaller nonprofit organizations can look to board members for initial contributions, experienced board members are likely to be highly committed to your organization's mission, and they have a vested interest in its successful launch and growth. Tapping your board of directors for capital contributions in addition to guidance and market resources can give your nonprofit an early boost.

Grant Funding:

Grants are typically made by the public sector or by charitable trusts and foundations. The money does not have to be repaid and is usually exempt from tax. Many grant funders will only fund organizations with charitable status. Some grant makers prefer not to fund organizations that have built up significant reserves or generate cash surpluses. This can disadvantage those with a business-like approach to running a sustainable social enterprise. Grants almost always come with conditions, for example:

- particular outputs or outcomes
- achieving agreed milestones
- unspent monies are returned to the funder
- reporting requirements on the progress of the project or use of the money

Before pursuing grant funding the charity or nonprofit board should consider:

- Is this an activity consistent with our aims and strategy – or is this grants encouraging us to drift from our mission?
- Can we meet the grant conditions?
- Will the cost of seeking grant monies outweigh the benefits?
- How will the activity be maintained or wound up after grant funding ends?

A guide to grants is available from the Finance Hub

Finances from Foreign Sources: In India, lots of money is coming from foreign donors for carrying out charitable and religious activities. The funds coming from abroad are mainly in the form of donations, gifts and aids from different institutions, banks and governments. But each and every organization should confirm the authenticity of the funds coming to the organization as it may be an unaccounted money. Government of India has framed very stringent rules for funds coming to India for charitable and religious purposes.

Government of India has framed Foreign Contribution Regulation Act for controlling and monitoring the funds, receipts of funds from foreign sources. Government of India has amended the act many a times. For access to the International funds, Non Profit Organization has to understand and follow the Rules and regulations under Foreign Contribution Regulation Act and rules framed there under.

Foreign Contribution Regulations Act:

- The Foreign Contribution (Regulation) Act, 2010 (42 of 2010).
- The replaced Foreign Contribution (Regulation) Act, 1976 w.e.f. from 1.5.2011.
- The FCRA, 2010 has a much broader applicability. It is applicable to all Individual, Hindu Undivided Families (HUF), Associations and Companies registered under Section 25 of Companies Act, 1956.
- Under the earlier Act, the term person was not defined and generally the Act referred to the term “Association”.
- The law was amended essentially to remove the inadequacies and practical difficulties in the administration of Act.
- Provisions of Repealed FCRA, 1976 have generally been retained in FCRA, 2010 but it is an improvement over the repealed Act as more

stringent provisions have been made in order to prevent misutilization of foreign funds received by the associations.

Objectives of the Act:

- Regulate the acceptance and utilization of foreign contribution and foreign hospitality by persons or associations working in the important area of National Life.
- To ensure that foreign contribution and foreign hospitality is not utilized to affect or influence electoral politics, public service, judges and other people working the important areas of National Life like journalists, Printers and Publishers of Newspapers.
- To regulate the flow of Foreign Funds and preventing from use of such funds to the activities detrimental to National Interest.

Various types of persons receiving Foreign Funds:

- Foreign Funds are mainly received by NGOs and Charitable Organizations.
- All NGOs or Charitable Organizations having a definite cultural, economic, religious or social programme are eligible for registration under FCRA.
- Once FCRA registration is obtained, such organization can receive Foreign Funds without obtaining any further approval subject to other formalities of FCRA, 2010.
- Foreign Funds and Material can be received only under two circumstances:
- Organization has obtained Permanent Registration From FCRA department
- Organization obtains Prior Permission under FCRA Department on case to case basis.

Time limit for making application for registration under FCRA

- No specific time limit has been provided under FCRA for making an application, unlike Income Tax Act, which requires an organization to apply within one year from its creation or registration under section 12A. Normally FCRA is granted after 3 years of active existence; therefore, the application should be made after three years though nothing in the Act prevents from making such application earlier.

- Supreme Court on the Issue: Supreme Court decision in STO vs. K.I. Abraham [1967] 20 STC 367, where it was held that the rule making authority had no power to prescribe any time restriction. In fact, the FCRA Rules also do not provide any restrictive time limit. It is only the requirement of Form FC- 4 as well as Form FC-3, which requires 3 years audited statements and activity reports. Such requirements are directory and general in nature and therefore, should not be construed as a mandatory requirement of the FCRA.

Restriction on receipt of Foreign Contribution: No Person shall deliver any amount of money which has accepted foreign contribution to any other person if he believes that such person may pass on such money to a political party.

Restriction on Transfer of Contribution: No person shall transfer foreign contribution that is registered or granted prior permission under this act to any other person who is not registered or granted prior approval under this Act.

He can transfer a part of such contribution to any other person who has not granted a certificate with prior approval of Central Government.

Use of Foreign Contribution: Foreign Contribution has to be used for the purpose for which contribution has been received.

Restriction on use of Foreign Contribution:

- Contribution and Income generated from such contribution should not be utilized for speculative business.
- A person receiving Foreign Contribution should not spent more than 50% of sum for administrative expenses.
- Administrative Expenses may be prescribed by Central Government from time to time.

Business or Consultancy Receipts of Charitable Organization:

- The new Act excludes consultancy or commercial receipts from the purview of foreign Contribution.
- As per the new provisions, any fee or cost against business, trade or commerce shall not be considered as foreign contribution. In other words, such receipts can be treated as local income.
- Explanation3 to section 2(h)(iii): “Any amount received, by any person from any foreign source in India, by way of fee (including fees

charged by an educational institution in India from foreign student) or towards cost in lieu of goods or services rendered by such person in the ordinary course of his business, trade or commerce whether within India or outside India or any contribution received from an agent of a foreign source towards such fee or cost shall be excluded from the definition of foreign contribution within the meaning of this clause."

Trading Activities:

Many non-profit organizations earn income by selling goods and services to members, service users the general public or other organizations. Some organizations earn all their income this way. You have flexibility about how to spend your earned income.

Examples of trading by non profits include:

- selling tickets to events
- selling publications or products
- hiring out a venue
- selling in-house expertise to interested parties e.g. publishing, training, consultancy

Charities can trade. However, if the trading activity is significant and is not related to your primary purpose there are charity and tax law implications and you should seek specialist advice. You may need to set up a separate trading arm.

Trading is likely to pose particular challenges for charities. Questions to be considered include:

- Does your governing document allow you to create and invest in a trading subsidiary?
- Will the proposed trading involve significant risk to a charity's assets?
- Would investment in a trading subsidiary be in line with the charity's current investment policy?

Contracting Services:

A **contract** is a form of trading where there is a formal agreement between two parties. It means that each party has agreed to do something and that if either of them fails to do it they are covered both by the terms of the contract and by contract law.

A contract is a commercial agreement and the income from it may be liable for tax and VAT. An increasing number of non-profits are contracting with the public sector to deliver specific services. But there are potential pitfalls. Delivering public services may distract the organization from its primary aims or undermine its independence.

There is also a danger that contracts are underfunded so that the organization can only provide a substandard service or has to use its own resources. Achieving Full Cost Recovery is essential to long term sustainability. And for charity trustees it is against the law to use charitable resources to subsidies public services.

Members of the charity or nonprofit board should consider:

- Does the contracted service fit your organisation's aims?
- Can you fulfil all the terms of the contract, and provide evidence that you have done so?
- What would be the consequence of not fulfilling the contract?
- Does the contract price cover all your costs?
- Have the risks been appraised and steps agreed to manage them?

Business activities can be a source of income for Non Profit Organization, but such activities should be limited. Business activities should not become the main occupation for Non Profit Organization. It is better that business activities should be incidental or ancillary to the main objectives or purposes of Non Profit Organization.