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Department : PG and Research Department of Commerce

Class : I B.Com.,

Subject : Business Economics (16CACCM1B)

Pending topics: Indifference curve analysis, Consumer's Equilibrium (II Unit)

Indifference curve analysis

What Is the Indifference Curve?

An indifference curve is a graph that shows a combination of two goods that give a consumer
equal satisfaction and utility, thereby making the consumer
indifferent Indifference curves are
heuristic devices used in contemporary microeconomics to demonstrate consumer preference and
the limitations of a budget. Recent economists have adopted the principles of indifference curves
in the study of welfare economics.

Indifference Map

An Indifference Map is a set of Indifference Curves. It depicts the complete picture of a consumer's

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preferences. The following diagram showing an indifference map consisting of three curves:

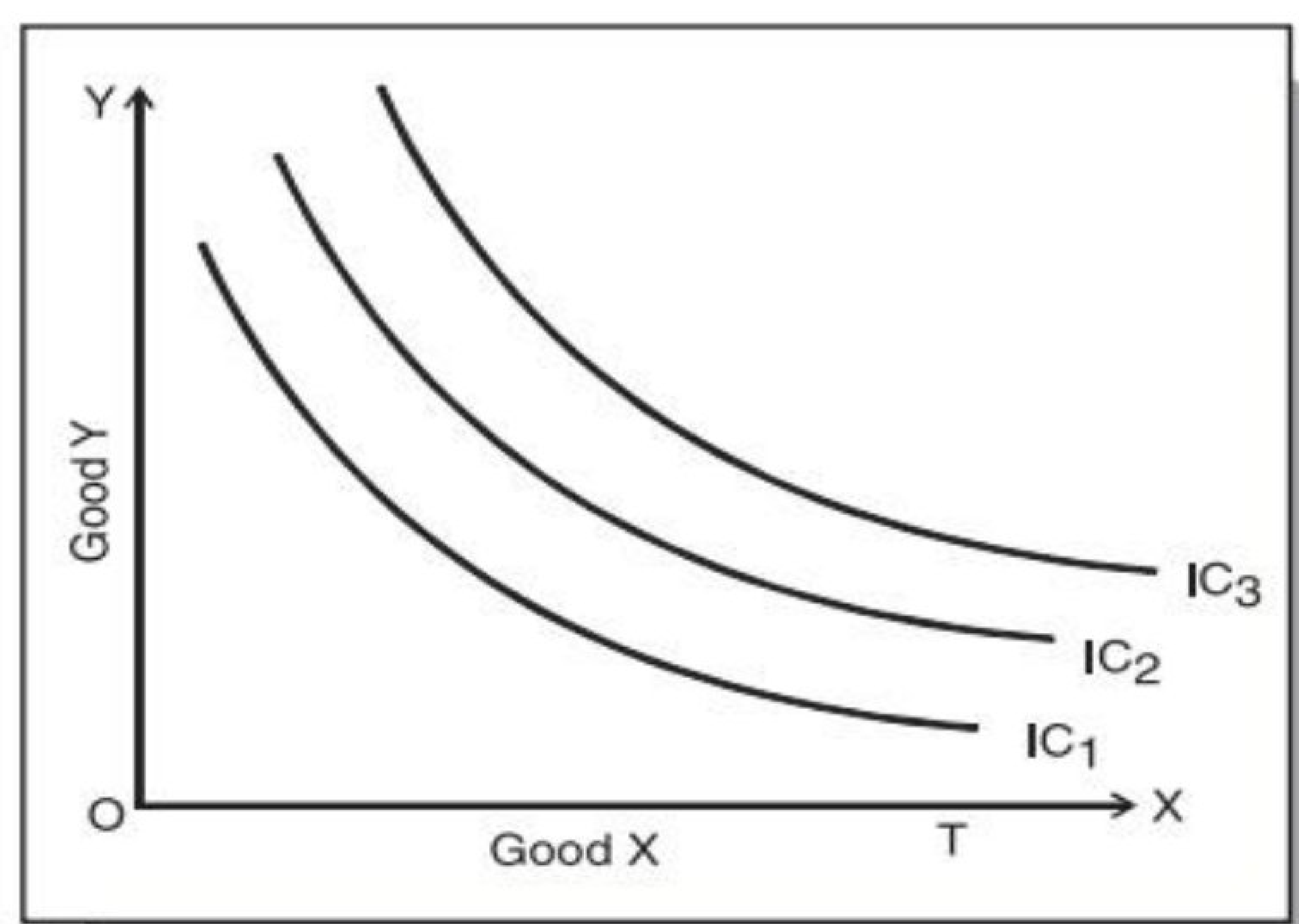

Fig. 2 : Indifference Map

We know that a consumer is indifferent among the combinations lying on the same indifference curve.

However, it is important to note that he prefers the combinations on the higher indifference curves

to those on the lower ones.

This is because a higher indifference curve implies a higher level of satisfaction. Therefore,

all combinations on IC1 offer the same satisfaction, but all combinations on IC2 give greater satisfaction

than those on IC1.

Q: What are the assumptions underlying the indifference curve approach?

Ans: The Assumptions are as follows,

*The consumer is rational. Also, he possesses full information about all the relevant aspects of

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the economic environment in which he lives.

*The consumer can rank combination of goods based on the satisfaction they yield. However, he can't quantitatively

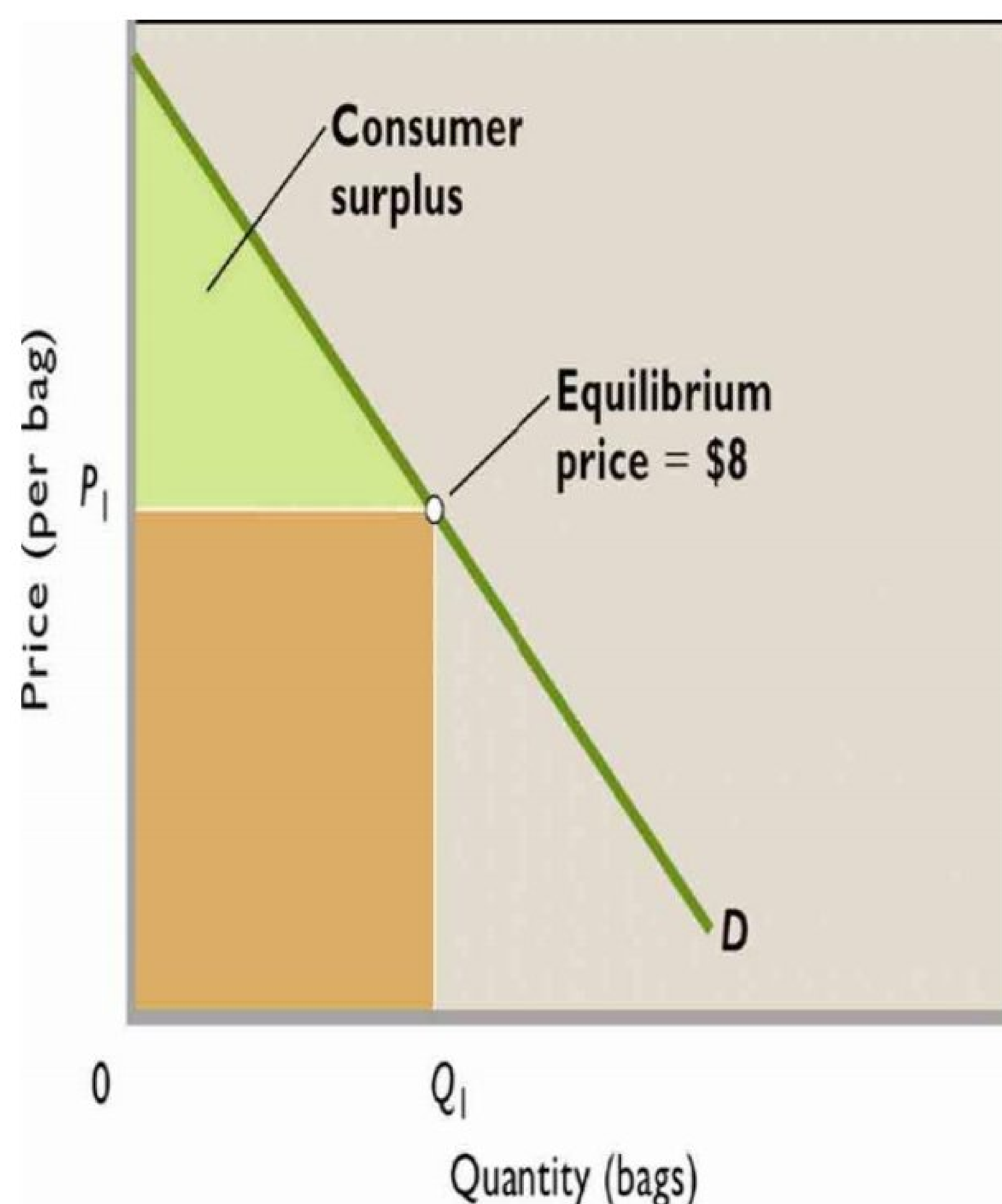
express how much he prefers a certain good over the other.

*If a consumer prefers A over B and B over C, then he prefers A over C.

*If a combination X has more commodities than the combination Y, then X is preferred over Y.

Consumers Equilibrium

A consumer is in equilibrium when he derives maximum satisfaction from the goods and is in no position to rearrange his purchases. A consumer is in equilibrium when given his tastes, and price of the two goods, he spends a given money income on the purchase of two goods in such a way as to get the maximum satisfaction, According to Koulsayiannis, "The consumer is in equilibrium when he maximises his utility, given his income and the market prices."



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Its Assumptions:

The indifference curve analysis of consumer's equilibrium is based on the following assumptions:

(1) The consumer's indifference map for the two goods X and Y is based on his scale of preferences for them which does not change at all in this analysis.

(2) His money income is given and constant. It is Rs. 10 which he spends on the two goods in question.

(3) Prices of the two goods X and Y are also given and constant. X is priced at Rs. 2 per unit and Y at Rs. 1 per unit.

(4) The goods X and Y are homogeneous and divisible.

(5) There is no change in the tastes and habits of the consumer throughout the analysis

(6) There is perfect competition in the market from where he makes his purchases of the two goods.

(7) The consumer is rational and thus maximises his satisfaction from the purchase of the two goods.

Class : III B.Com.,

Subject (16MBECM3) : Human resource management

Syllabus : Fully completed

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Subject : Insurance management(16MBECM5)

Syllabus : Fully completed

Subject : Financial services(16CCCCM15)

Syllabus : 3 units completed

Pending : 2 units

Topics : Venture capital (Unit IV)

Factoring (Unit V)

Venture capital (Unit IV)

What is Venture Capital?

It is a private or institutional investment made into early-stage / start-up companies (new ventures). As defined, ventures involve risk (having uncertain outcome) in the expectation of a sizeable gain. Venture Capital is money invested in businesses that are small; or exist only as an initiative, but have huge potential to grow. The people who invest this money are called venture capitalists (VCs). The venture capital investment is made when a venture capitalist buys shares of such a company and becomes a financial partner in the business.

Venture Capital investment is also referred to risk capital or patient risk capital, as it includes the risk of losing the money if the venture doesn't succeed and takes medium to long term period for the investments to fructify.

Features of Venture Capital investments

- High Risk
- Lack of Liquidity
- Long term horizon
- Equity participation and capital gains
- Venture capital investments are made in innovative projects
- Suppliers of venture capital participate in the management of the company

Methods of Venture capital financing

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- Equity
- participating debentures
- conditional loan

THE FUNDING PROCESS: *Approaching a Venture Capital for funding as a Company*

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The venture capital funding process typically involves four phases in the company's development:

- Idea generation
- Start-up
- Ramp up
- Exit

Step 1: Idea generation and submission of the Business Plan

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The initial step in approaching a Venture Capital is to submit a business plan. The plan should include the below points:

- There should be an executive summary of the business proposal
- Description of the opportunity and the market potential and size
- Review on the existing and expected competitive scenario
- Detailed financial projections
- Details of the management of the company

There is detailed analysis done of the submitted plan, by the Venture Capital to decide whether to take up the project or no.

Step 2: Introductory Meeting

Once the preliminary study is done by the VC and they find the project as per their preferences, there is a one-to-one meeting that is called for discussing the project in detail. After the meeting the VC finally decides whether or not to move forward to the due diligence stage of the process.

Step 3: Due Diligence

The due diligence phase varies depending upon the nature of the business proposal. This process involves solving of queries related to customer references, product and business strategy evaluations, management interviews, and other such exchanges of information during this time period.

Step 4: Term Sheets and Funding

If the due diligence phase is satisfactory, the VC offers a term sheet, which is a non-binding document explaining the basic terms and conditions of the investment agreement. The term sheet is generally negotiable and must be agreed upon by all parties, after which on completion of legal documents and legal due diligence, funds are made available.

Types of Venture Capital funding

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

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

- *Seed money: Low level financing for proving and fructifying a new idea*

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

A) Early Stage Financing:

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

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

B) Expansion Financing:

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

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

C) Acquisition or Buyout Financing:

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

Advantages of Venture Capital

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

Disadvantages of Venture Capital

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

Exit route

There are various exit options for Venture Capital to cash out their investment:

- IPO
- Promoter buyback
- Mergers and Acquisitions
- Sale to other strategic investor

Factoring (Unit V)

Definition:

Factoring implies a financial arrangement between the factor and client, in which the firm (client) gets advances in return for receivables,

from a financial institution (factor). It is a financing technique, in which there is an **outright selling of trade debts by a firm to a third party,**

i.e. factor, at discounted prices.

Factoring is a financial alternative, in financing and management of account receivables. It states the terms and conditions of the sale in the factoring agreement.

In finer terms factoring is a relationship between the factor and the client, in which the factor purchases the client's account receivables and pay up to 80% (sometimes 90%) of the sum immediately, at the time of entering into the agreement. The factor pays the balance sum, i.e. 20% of the amount which

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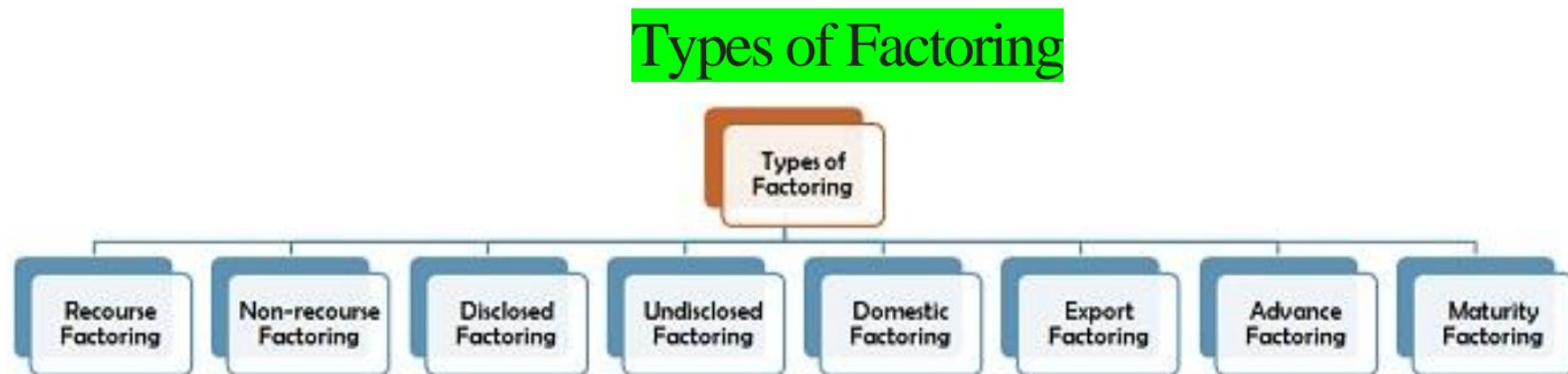
includes finance cost and operating cost, to the client when the customer pays the obligation.

Types of Factoring



- **Recourse and Non-recourse Factoring**: In this type of arrangement, the financial institution, can resort to the firm, when the debts are not recoverable. So, the credit risk associated with the trade debts are not assumed by the factor.

  On the other hand, in non-recourse factoring, the factor cannot recourse to the firm, in case the debt turn out to be irrecoverable.

- **Disclosed and Undisclosed Factoring**: The factoring in which the factor's name is indicated in the invoice by the supplier of the goods or services asking the purchaser to pay the factor, is called disclosed factoring.

  Conversely, the form of factoring in which the name of the factor is not mentioned in the invoice issued by the manufacturer. In such a case, the factor maintains sales ledger of the client and the debt is realized in the name of the firm. However, the control is in the hands of the factor.

- **Domestic and Export Factoring**: When the three parties to factoring, i.e. customer, client, and factor, reside in the same country, then this is called as domestic factoring.

  Export factoring, or otherwise known as cross-border factoring is one in which there are four parties involved, i.e. exporter (client), the importer (customer), export factor and import factor. This is also termed as the two-factor system.

- **Advance and Maturity Factoring**: In advance factoring, the factor gives an advance to the client, against the uncollected receivables.

  In maturity factoring, the factoring agency does not provide any advance to the firm. Instead, the bank collects the sum from the customer and pays to the firm, either on the date on which the amount is collected from the customers or on a guaranteed payment date.

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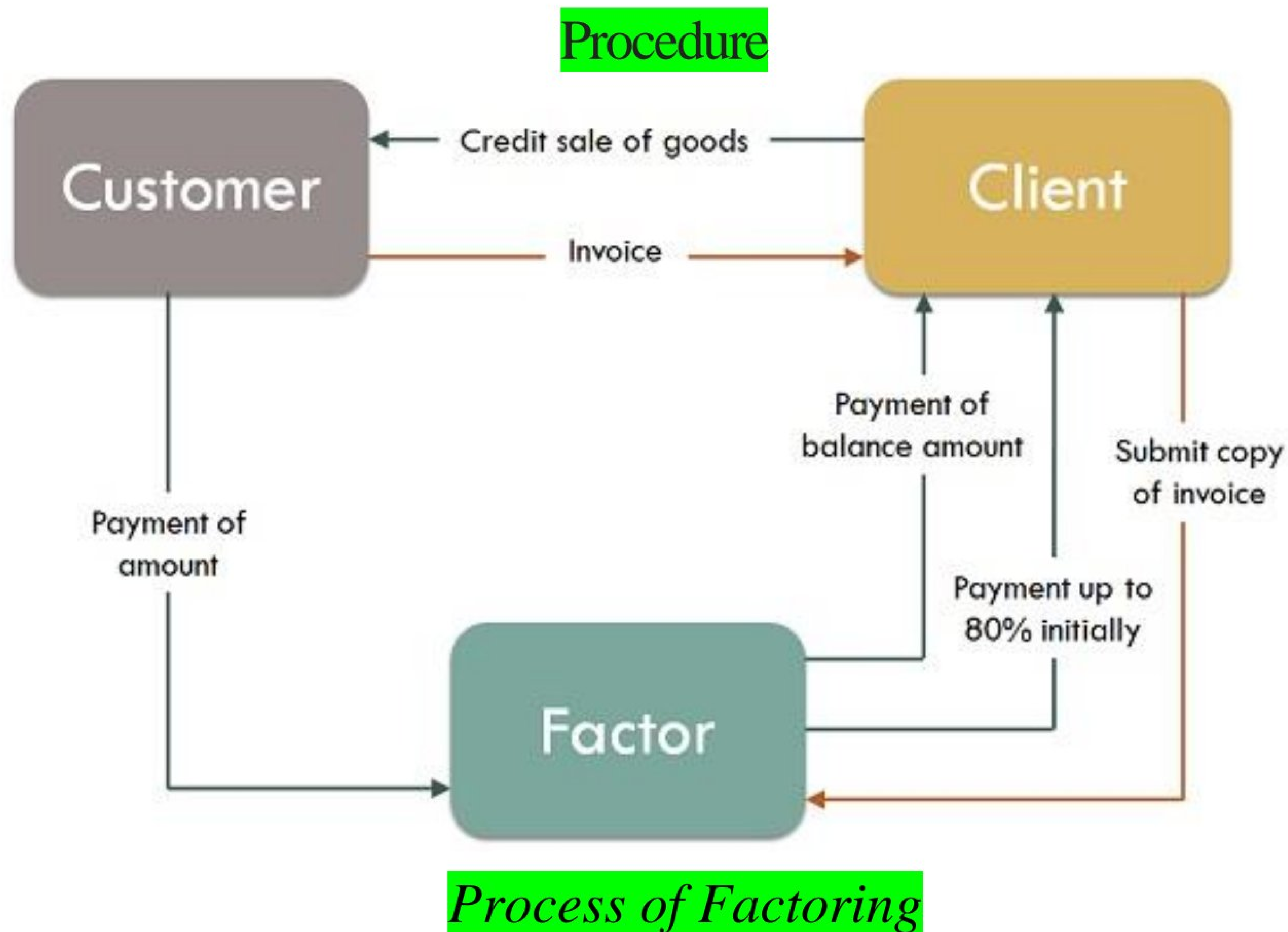
Based on the factoring type, the collection of the debt is performed by the factor or the client, as the case may be.

Procedure



Process of Factoring

1. Borrowing company or the client sells the book debts to the lending institution (factor).
2. Factor acquires the receivables and extend money against the receivables, after deducting and retaining the following sum, i.e. an adequate margin, factor's commission and interest on advance
3. Collection from the customer is forwarded by the client to the factor and in this way, the advance is settled.
4. Other services are also provided by the factor which includes:

- Finance
- Collection of debts
- Maintenance of debts
- Protection of Credit Risk
- Maintenance of debtors ledger
- Debtors follow-up
- Advisory services

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The factor gets control over the client's debtors, to whom the goods are sold on credit or credit is extended and also monitors the client's sales ledger.

9 main Mechanism of Factoring

The mechanism of factoring can be explained:

Mechanics of Factoring shown in figure is explained below:

1. Firstly, the customer places an order with the Client. (It may be noted that the client is the seller and customer is the buyer of goods).

2. Then the client enters into Factoring arrangement with the Factor. The pre-payment limit, service charges, and discount charges and other terms and conditions of the arrangement are agreed upon. The Client has to obtain a "LETTER OF DISCLAIMER "from the bank holding charge on his receivable.

This is required because in many cases the receivables may have been assigned to the bank for credit facility extended by it. After obtaining this letter, the Client executes the Factoring documentation.

3. The client dispatches the goods or services to the customer on credit on open account basis and then sends the corresponding invoice to the customer directly. From then onwards, the client passes all credit sales invoices to the Factor. While the original invoice and document of title to goods like lorry receipt to the Customer, copies of these documents are handed over to Factor for Purchase.

4. The original as well as copies of invoices sent to customer, contain a printed Notice of Assignment addressed to the customer, directing the customer to make all payments to the Factor.

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5. On receiving a copy of the invoice, the Factor purchases the invoice subject to the overall limit and the Customer limit. The Factor arrives at a sub-limit for each customer of the client within the overall limit.

The drawing power is calculated taking into account the prescribed margin (usually around 20%). The prepayment limit is generally around 80%-85% of the eligible debt. The Client is now free to draw any amount up to the drawing power.

For the Client to draw money, the Factor issues a cheque favoring the Client's Bank A/c. Realization are handled by the Factor directly under advice to the client. Outstation cheques are also collected/ discounted by the Factor.

6. Periodical statements and MIS (Management Information System) reports are furnished to the Client and the Customer.

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7. If monthly instalments are not paid within the due date, follow-up letters are sent.

8. When the payment is cleared by the Customer to Factor, a notice is sent by the Factor to the Client.

9. This is followed by the release of retention margin held by the Factor to the Client.

For rendering the services of collection and maintenance of sales Ledgers, the service charges usually vary between 0.4% to 1% of the invoice value, depending on the volume of operations. This service charge is collected at the time of purchase of invoices by the Factor.

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For making an immediate part payment to the Client, the Factor collects discount charges from the Client. The discount charges are comparable to bank interest rates at these charges are collected monthly.

Factoring and Services

Factoring has three key elements; the Client has the option to select a combination of these components to suit his financial needs.

Bill Discounting Vs Factoring

The term **factoring** includes entire trade debts of a client. On the other hand, **bill discounting** includes only those trade debts which are supported by account receivables. In short, bill discounting, implies the advance against the bill, whereas factoring can be understood as the outright purchase of trade debt.

So, there exist a fine line of differences between bill discounting and factoring, which are explained in the article provided below.

BASIS FOR COMPARISON	BILL DISCOUNTING	FACTORING
Meaning	Trading the bill before it becomes due for payment at a price less than its face value is known as Bill Discounting.	A financial transaction in which the business organization sells its book debts to the financial institution at a discount is known as Factoring.
Arrangement	The entire bill is discounted and paid, when the transaction takes place.	The factor gives maximum part of the amount as advance when the transaction takes place and the remaining amount at the time of settlement.
Parties	Drawer, Drawee and Payee	Factor, Debtor and Client

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BASIS FOR COMPARISON	BILL DISCOUNTING	FACTORING
Type	Recourse only	Recourse and Non Recourse
Governing statute	The Negotiable Instrument Act, 1881	No such specific act.
Financier's Income	Discounting Charges or interest	Financier gets interest for financial services and commission for other allied services.
Assignment of Debts	No	Yes

Factoring in India

Factoring service in India is of recent origin. It owes its genesis to the recommendations of the Kalyanasundaram Study Group appointed by the RBI in 1989. Pursuant to the acceptance of these recommendations, the RBI issued guidelines for factoring services in 1990. The first factoring company – SBI Factors and Commercial Ltd (SBI FACS) started operation in April 1991. This article highlights the important aspects of the factoring services in India.

The main recommendations of the Committee/Group are listed as follows:

The main recommendations of the Committee/Group are listed as follows:

(1)Taking all the relevant facts into account, there is sufficient scope for introduction factoring services in India which would be complementary to the services provided by banks.
(2) The introduction of export factoring services would provide additional facility to exporters.
(3) While quantification of the demand for factoring services has not been possible, it is assessed that it would grow sufficiently so as to make factoring business a commercially viable proposition within a period of two/three years.
(4) On the export front, there would be a fairly good availment of various services offered by export factors.

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(5) With a view to attaining a balanced dispersal of risks, factors should offer their services to all industries and all sectors in the economy.
(6) The pricing of various services by factors would essentially depend upon the cost of funds. Factors should attempt a mix from among the various sources of funds to keep the cost of funds as low as possible, in any case not exceeding 13.5 percent per annum, so that a reasonable spread is available.
(7) The RBI could consider allowing factoring organizations to raise funds from the Discount and Finance House of India Ltd, as also from other approved financial institutions, against their usance promissory notes covering receivables factored by them, on the liens of revised procedure under bills discounting scheme.
(8) The price for financing services would be around 16 per cent per annum and the aggregate price for all other services may not exceed 2.5 percent to 3 percent of the debts services.
(9) In the beginning only select promoter institutions/groups of individuals with good track record in financial services and competent management should be permitted to meter into this new field.
(10) Initially the organizations may be promoted on a zonal basis.

Forfaiting

Forfaiting in French means to give up one's right. Thus, in forfaiting the exporter hands over the entire export bill with the forfaiter and obtains payments. The exporter has given up his right on the importer which is now taken by the forfaiter. By doing so, the exporter is benefited as he gets immediate finance for his exports. The risk of his exports is now borne by the forfaiter. In case if the importer fails to pay, recourse cannot be made on the exporter.

Forfaiting process or Parties involved in forfaiting

1. Before resorting to forfaiting, the exporter approaches the forfaiting company with the details of his export and the details of the importer and the importing country.

2. On approval by the forfaiter, along with the terms and conditions, a sale contract is entered into between the exporter and importer.
3. On execution of the export, the exporter submits the bill to the forfaiter and obtains payment. In this way, the three parties involved in the forfaiting process are the exporter, the importer and the forfaiter.

4. If the exports are done against Document Acceptance Bill, it has to be signed by the importer and since the importer's bank has guaranteed through the L/C, it will be easy for the forfaiter to collect payment.

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5. All the trade documents, connected with exports, are handed over by the exporter to his bank which in turn hands over the documents to the importer's bank.

6. The proof of all these documents will be submitted by the exporter to the forfaiter who will make payment for the export.

7. The cost of forfaiting is included in the bill. The exporter may not lose much as the interest will be included in the invoice and recovered from the importer. However, the forfaiter is exposed to the risk of fluctuations in the exchange rate, interest rate and commercial risk, and to cover these risks, he charges suitably.

Advantages of forfaiting

The following are some of the advantages of forfaiting.

1. It provides immediate funds to the exporter who is saved from the risk of the defaulting importer.

2. It is an earning to commercial banks who by taking the bills of highly valued currencies can gain on the appreciation of currencies.

3. The forfaiter can also discount these bills in the foreign market to meet more demands of the exporters.

4. There is very little risk for the forfaiter as both importer's bank and exporter's banks are involved.

5. Letter of Credit plays a major role for the forfaiter. Moreover, he enters into an agreement with the exporter on his terms and conditions and covers his risks by separate charges.

6. As forfaiting provides 100% finance to exporter against his exports, he can concentrate on his other exports.

Disadvantages or Drawbacks of Forfaiting

The following are some of the disadvantages of forfaiting.

1. Forfaiting is not available for deferred payments especially while exporting capital goods for which payment will be made on a deferred basis by the importer.

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2. There is discrimination between Western countries and the countries in the Southern Hemisphere which are mostly underdeveloped (countries in South Asia, Africa and Latin America).

3. There is no International Credit Agency which can guarantee for forfaiting companies which affects long-term forfaiting.

4. Only selected currencies are taken for forfaiting as they alone enjoy international liquidity.

Forfaiting in India

For a long time, Forfaiting was unknown to India. Export Credit Guarantee Corporation was guaranteeing commercial banks against their export finance. However, with the setting up of export-import banks, since 1994 forfaiting is available on liberalized basis.

The **exim bank** undertakes forfaiting for a minimum value of Rs. 5 lakhs. For this purpose, the exporter has to execute a special Pronote in favor of the exim bank. The exporter will first enter into an agreement with the importer as per the quotation given to him by the exim bank. The exim bank on its part, gets quotation from the forfaiting agency abroad. Thus, the entire forfaiting process is completed by exporter agreeing to the terms of the exim bank and signing the Pronote.

Forfaiting business in India will pick up only when there is trading of foreign bills in international currencies in India for which the value of domestic currency has to be strengthened. This would be possible only with increasing exports. At present, India's share stands at 1.7 percent in the world exports. Perhaps, this will bring a push to the forfaiting market.

Forfaiting Vs Export Factoring

Forfaiting is similar to cross border factoring to the extent both have common features of non-recourse and advance payment. But they differ in several important respects:

(1)A forfaiter discounts the entire value of the note/bill. The implication is that forfaiting is hundred per cent financing arrangement of receivables finance. But the extent of advance receivables financing with a factoring arrangement is only partial ranging between 75–85 per cent. The balance is retained by the factor as a factor reserve which is paid after maturity.

2) The availing bank which provides an unconditional and irrevocable guarantee is a critical element in the forfaiting arrangement. The forfaiter's decision to provide financing depends upon the financial standing of the availing bank. On the other hand, in a factoring deal, particularly non-recourse

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type, the export factor bases his credit decision on the credit standards of the exporter and participates in the credit extension and credit protection process.
3) Forfaiting is a pure financing arrangement while factoring also includes ledger administration, collection and so on.
4) Factoring is essentially a short term financing deal. Forfaiting finances notes/ bills arising out of deferred credit transaction spread over 3 -5 years.
5) A factor does not guard against exchange rate fluctuations; a forfeiter charges a premium for such risk.

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Subject : Human resource management (P16MC23)

Syllabus : Fully completed.

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