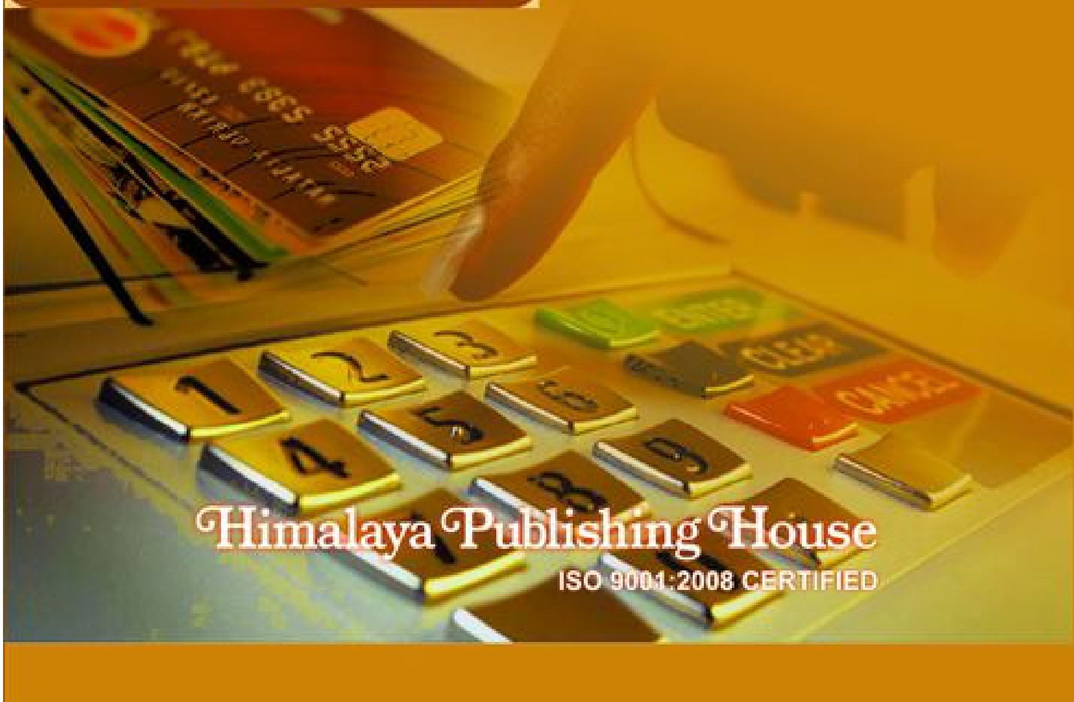
Modern Banking and Working Capital Management

(TEXT AND CASES)

Dr. DHIRAJ SHARMA



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AND
WORKING CAPITAL MANAGEMENT
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Dedicated to my mother,
Smt. Dev Ichhya Sharma
with love, affection and respect

Foreword

During last two decades Indian financial system in general and banking in specific has witnessed more developments than during the entire period of post independence. Quite obviously, the only way to discuss and understand banking is in the most updated and modern terms. Thus, it seems reasonable to me that the author has entitled the present book 'Modern Banking and Working Capital Management'. This book deals with both Banking and Working Capital areas independently by focusing on the necessary foundations and fundamentals of each area and at the same time not ignoring their inter-relationships - thus also providing the basic and procedural knowledge about their integration and applications.

Our financial system comprises of commercial banks, cooperative banks, non-banking financial companies, insurance companies, provident and mutual funds, and the newly emerging pension funds, with overall assets close to 140 per cent of GDP. Commercial banks, comprising of 60 per cent of the total financial assets, dominate the financial system. Although banking sector reforms have created a high competitive and dynamic environment for commercial banks but at the same time, these reforms have created glaring issues that should be tackled very carefully in this era of hyper technology and globalization. No doubt, the reform process has changed the relationship between the central bank and commercial banks from one of micro regulation to that of macro management. With the focus on deregulation and liberalization coupled with enhanced responsibilities for banks, the banking sector is faced with several new challenges. Consistent with the shift to functioning in a competitive economy and to the adoption of prudential best practices, the major challenges facing the banking sector are the deployment of funds in quality assets and the management of revenues and costs. Concurrently, the issues of corporate governance and appropriate disclosures for enhancing market discipline cannot be ignored. Further, the major issue is that a large chunk of our population does not have any access to financial services, especially in remote areas. Small and medium enterprise financing and microfinance are not well developed yet.

The present book is timely and appropriate as it exhaustively deals with Indian banking taking into consideration the most recent developments such as technology induction, Basel norms and so on. At the same time, the book focuses on corporate world's major requirement that is working capital financing and management. Therefore, managing the working capital can make the difference between business survival and business failure. Further, financing working capital can be very costly, so the proper management of working capital is of vital importance.

Modern Banking and Working Capital Management revolves around the above said theme. I do not think that there are many books available in the market that deal with both inter-twined disciplines and their intricacies. In fact, this is the first book that I have come across which truly fills up the gap in the availability of financial literature providing detailed insights into the areas concerning banking and working capital management. Dr. Dhiraj Sharma, a young professional with excellent academic record deserves all the appreciation for his efforts in writing such a comprehensive and useful text. In my personal opinion, for the professionals and the students of banking & finance this book will be extremely invaluable. I congratulate the author for bringing out such a comprehensive text that deeply enriches the existing financial literature.

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and Registrar, Punjabi University,
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Preface

Robert Frost's quotable quote, "A bank is a place where they lend you an umbrella in fair weather and ask for it back when it begins to rain" seems to be true for many of the Indian banks but all over the world, bank credit has become a major source of financing the working capital requirements of the industry. Indian commercial banks have been making in larger measure, term finance to industry and providing investment banking services apart from setting up subsidiaries in such diverse areas as mutual funds, securities trading, factoring etc. After independence, India had only the traditional commercial banks. The banks in India were not keen to provide medium and long-term finance to industry and other sectors for their fixed asset formation. The banks were willing to fund basically the working capital requirements of the credit-worthy borrowers on the security of tangible assets. Since the government was keen to stimulate setting up of a wide range of new industrial units as also expansion / diversification of the existing units it decided to encourage setting up of financial intermediaries that provided term finance to projects in industry. Thus, emerged a chain of national and state level development financial institutions (DFIs) for meeting requirements of medium and long-term finance of all range of industrial units, from the smallest to the very large ones. Reserve Bank of India and Government of India nurtured DFIs through various types of financial incentives and other supportive measures. The main objective was to provide long-term finance to the industry, which the then existing commercial banks were not interested to provide because of high risk. The financing requirements of Indian corporate, whether from the DFIs or from the banks, are now being seen as an integrated operation. Non-banking financial companies (NBFCs) have proliferated in India in areas like consumer finance, hire purchase, equipment leasing and housing finance. However, banking policies and practices in India are different from those prevalent in the developed countries. In India, for the banks to decide to lend funds for financing the working capital, a firm's creditworthiness is not judged by the strength of the current ratio and the net working capital. The major factor considered is the current assets charged in favour of the bank as security against borrowing. Moreover, this is also not followed strictly.

This book is about Banking and Working Capital Management - two independent areas yet inter-dependent and inter-related in many ways. The corporate sector and industry cannot be divorced from the banking system and the opposite of this is also true. The banking system of a country is always the strength and backbone of their industries. The industries survive and expand largely on the basis of funding from the banking system. And similarly, the balance sheets of corporate are mirrored in the balance sheets of the banking system and their financial condition affects that of the banking system. Thus, the downfall of industries in a country would eventually lead to downfall of banks. Moreover, banks contribute towards economic development by various means of financing, credit creation and allocating their resources to such businesses and industries that are ultimately the drivers of national economic development. Many profitable companies fail each year because their management teams fail to manage working capital effectively. These companies may be profitable, but they are not able to pay their current obligations. The funds invested in working capital are often high in proportion to the total assets employed, so it is vital that these funds are used in an efficient and effective way, but most companies concentrate their managerial efforts on controlling profits only. They try to increase sales revenue, reduce their production cost and control their overheads. Operational budgets are drawn up, standard costs are set and considerable efforts are made on identifying and rectifying variances of actual results against these budgets and standards. However, a few companies worry about managing equally important part of their business - the area of working capital management. The management of working capital is, therefore, important to the financial health of businesses of all sizes. It is a critical factor in the sustainability and viability of any business.

PEDAGOGICAL FEATURES OF THE BOOK

The book provides a framework for systematically thinking about most important short term financial management problems that business firms are likely to confront. For this, the book provides a conceptual understanding of the basic financial theory, rather than just an introduction to the tools, techniques and formulas of working capital management.

For the students, it is all too easy to lose sight of the logic that drives finance and focus instead on memorizing formulas and procedures. As a result, students have a difficult time understanding the interrelationships among the topics covered. Moreover, later in life when the problems encountered do not match the textbook material, students may find themselves unprepared to abstract from what they had learned. To overcome this problem, the first chapter provides basic theory of finance, which serves as a springboard for the subsequent chapters and topics that follow. In essence, the student is presented with a cohesive, interrelated perspective from which future problems can be approached. The book uses a number of pedagogical tools to heighten the reader's interest level and to provide a well organized thought to study and to learn.

Chapter Objectives:

Every chapter has major learning objectives to guide the reader.

Examples and Illustrations:

Wherever some analytical framework is discussed - suitable solved examples are provided to make the concept understandable. The book is also peppered with appropriate diagrams, charts, and tables.

Boxes:

In most of the chapters some additional details and information is provided in the boxes useful for reader's understanding.

Questions:

Questions provided at the end of each chapter are specifically relevant for the students preparing for their course work.

Case Studies:

The book provides a number of practical cases which substantiates and makes clear the conceptual framework with reference to the corporate practices.

Chapter Summaries:

Chapter summary provided at the end of each chapter is helpful for a quick glance and also reinforces the major points highlighted in the chapter.

References and Bibliography:

References and bibliography provided at the end of each chapter are useful for the reader for further consultation and additional information.

Glossary of Key Terms:

In the last chapter of the book, a comprehensive glossary of key terms and concepts is provided which makes the terms and concepts more coherent and clear in the mind of the reader.

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The publishers deserve special appreciation for their cooperation and the timely publication of this book.

For further improvements, readers' valuable suggestions and recommendations are welcome. I hope that the readers will share my enthusiasm for this vast knowledge area of banking and working capital by providing me their honest feedback.

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Contents

CHAPTER – 1

BASICS OF FINANCE

Brief Contents

CHAPTER OBJECTIVES

After reading this chapter, you will be able to understand the following:

- Investment decision
- Financing decision
- Dividend decision
- Working capital decision
- Objectives of finance function
- The agency problem
- Functions of a Finance Manager
- Approaches to finance function
- Indian financial scenario
- Financial Management in Indian Public Sector
- Indian financial system
- Financial reforms
- Corporate governance
- Integrated Financial Management System (IFMS)
- Financial Management in a small firm

INTRODUCTION

Finance is the study of money management, the acquiring of funds (cash) and the directing of these funds to meet particular objectives. Good financial management helps businesses to maximise returns while simultaneously minimising risks. It is essential to define the objectives and functions of financial management before identifying its major element – Short-term financial management or Working capital management. This chapter discusses the fundamental facets of corporate finance.

Financial management is concerned with the maintenance and creation of economic value or wealth. Value creation occurs when we maximise the share price for equity shareholders. Financial management is the area of finance dealing with monetary decisions that business enterprises make and the tools and analysis used to make these decisions. The primary goal of Financial management is to maximise shareholder value while managing the firm's financial risks. The main concepts in the study of finance function are applicable to the financial problems of all kinds of firms. The discipline can be divided into long-term and short-term decisions and techniques. Capital investment decisions are long-term choices about which projects receive investment, whether to finance that investment with equity or debt and when or whether to pay dividends to shareholders. On the other hand, short-term decisions deal with the short-term balance of current assets and current liabilities; the focus here is on managing cash, inventories, and short-term borrowing and lending (working capital management).

INVESTMENT DECISION

Long-term Investment decisions or Capital budgeting decisions are long-term finance decisions relating to fixed assets and capital structure. Decisions are based on several inter-related criteria. Financial management seeks to maximise the value of the firm by investing in projects which yield a positive net present value when valued using an appropriate discount rate in consideration of risk. These projects must also be financed appropriately. If no such opportunities exist, maximising shareholder value states that management must return excess cash to shareholders (i.e., dividends). Capital investment decisions thus have implications on financing and dividend decision.

The firm must allocate limited resources between competing opportunities or projects in a process known as capital budgeting. Making this investment, or capital allocation, decision requires estimating the value of each opportunity or project, which is a function of the size, timing and predictability of future cash flows. Each project's value will be estimated using a discounted cash flow (DCF) valuation and the opportunity with the highest value, as measured by a project evaluation technique such as net present value (NPV) will be selected. This requires estimating the size and timing of all of the incremental cash flows resulting from the project. Such future cash flows are then discounted to determine their present value. These present values are then summed and this sum net of the initial investment outlay is the NPV. The NPV is greatly affected by the discount rate. Thus, identifying the proper discount rate or hurdle rate is critical to make an appropriate decision. The hurdle rate is the minimum acceptable return on an investment — i.e., the project appropriate discount rate. The hurdle rate should reflect the risk of the investment, typically measured by volatility of cash flows and must take into account the project-relevant financing mix. Managers use models such as the CAPM or the APT to estimate a discount rate appropriate for a particular project and use the weighted average cost of capital (WACC) to reflect the financing mix selected. A common error in choosing a discount rate for a project is to apply a WACC that applies to the entire firm. Such an approach may not be appropriate where the risk of a particular project differs markedly from that of the firm's existing portfolio of assets.

In conjunction with NPV, there are several other measures used as selection criteria in Financial management. These include discounted Pay back Period, IRR, Profitability Index, and ROI. Alternatives to NPV include MVA / EVA and APV. In many cases, for example R&D projects, a project may open (or close) various paths of action to the company, but this reality will not be captured in a strict NPV approach. The firm may therefore employ tools which place an explicit value on these options. So, in a DCF valuation the most likely or average cash flows are discounted, here the flexible and staged nature of the investment is modelled and hence all potential pay offs are considered. The difference between the two valuations is the flexibility inherent in the project. The two most common tools are Decision Tree Analysis (DTA) and Real Options Analysis (ROA).

Given the uncertainty inherent in project forecasting and valuation, analysts will assess the sensitivity of project NPV to the various inputs or assumptions to the DCF model. In sensitivity analysis the analyst will vary one key factor while holding all other inputs constant (other things being equal) *ceteris paribus*. The sensitivity of NPV to a change in that factor is then observed and is calculated as a slope: Δ NPV / Δ Factor. The analysts may also run scenario based forecasts of NPV. Here, a scenario comprises a particular outcome for economy-wide or global factors such as exchange rates, commodity prices, etc., as well as for firm-specific factors. The analyst may specify various revenue growth scenarios, e.g., worst case scenario or best case scenario where all key inputs are adjusted so as to be consistent with the growth assumptions, and calculate the NPV for each. The application of this methodology is to determine an unbiased NPV, where the firm determines a subjective probability for each scenario – the NPV for the project is then the probability-weighted average of the various scenarios.

A further advancement in this area is to construct stochastic or probabilistic financial models. The most common method used is Monte Carlo Simulation to analyse the project's NPV. This method was introduced by David B. Hertz in 1964. Today analysts are even able to run simulations in spreadsheet based DCF models. Here, the cash flow components that are impacted by uncertainty are simulated, mathematically reflecting their random characteristics. In contrast to the scenario approach above, the simulation produces several random but possible outcomes or trials or 'What If' Scenarios. The output is then a histogram of project NPV and the average NPV of the potential investment – as well as its volatility and other sensitivities – is then observed. This histogram provides information not visible from the static DCF. For example, it allows for an estimate of the probability that a project has a Net Present Value greater than zero. Apart from considering the financial parameters required for the successes of a project, equally important are analysing the non-financial determinants which despite all the good financial calculations may otherwise endanger the survival of the project (see Annexure I).

FINANCING DECISION

The goals of Financial management require that any corporate investment be financed appropriately. The sources of financing are, generically, capital as well as debt sourced form outside investors. Since both hurdle rate and cash flows (and hence the riskiness of the firm) will be affected, the financing mix will impact the valuation of the firm as well as long-term financial management decisions. There are two interrelated decisions.

Thus, the management must identify the optimal mix of financing — the capital structure that results in maximum value. Financing a project through debt results in a liability or obligation that must be serviced, thus entailing cash outflow implications independent of the project profitability or success. Equity financing is less risky with respect to cash flow commitments, but results in a dilution of share ownership, control and earnings. The cost of equity is also typically higher than the cost of debt and so equity financing may result in an increased hurdle rate which may offset any reduction in cash flow risk.

The management must attempt to match the long-term financing mix to the assets being financed as closely as possible, in terms of both timing and cash flows. Managing any potential asset-liability mismatch or duration gap brings matching the assets and liabilities according to maturity pattern (Cashflow matching) or duration. Managing this relationship in the short-term is a major function of working capital management, as discussed below. Other techniques, such as securitization or hedging using interest rate or credit derivatives, are also common.

One of the main theories of how firms make their financing decisions is the **Pecking Order Theory**, which suggests that firms avoid external financing while they have internal financing available and avoid new equity financing while they can bring in new debt financing at reasonably low interest rates. Another major theory is the **Trade-Off Theory** in which firms are assumed to trade-off the tax benefits of debt with the bankruptcy costs of debt when making their decisions. An emerging area in finance theory is right-financing whereby investment banks and companies can enhance investment returns and firm value over time by determining the right investment objectives, policy framework, institutional structure, source of financing (debt or equity) and expenditure framework within a given economy and under given market conditions. Another theory is the **Market timing hypothesis** which states that firms look for the cheaper type of financing regardless of their current levels of internal resources, debt and equity.

DIVIDEND DECISION

Whether to issue dividends, and to what extent, is judged mainly on the basis of the company's unappropriated profits and its earning prospects for the coming years. The amount is also often calculated based on expected free cash flows, i.e., cash remaining after all business expenses, and capital investment needs have been met. If there are no positive NPV opportunities, i.e. projects where returns exceed the hurdle rate ($r > k$), then – finance theory suggests – management must return excess cash to investors as dividends. This is the general case, however there are exceptions. For example, shareholders of a **Growing firm**, expect that the company will retain earnings so as to fund growth internally. In other cases, even though an opportunity is currently negative NPV or where ($r < k$), management may consider potential payoffs and decide to retain cash flows.

The management must also decide on the form of the dividend distribution, generally as cash dividends or via a **share buyback**. Various factors may be taken into consideration: where shareholders must pay tax on dividends, firms may choose to retain earnings or to perform a stock buyback, in both cases increasing the value of shares outstanding. Alternatively, some companies will pay stock dividends rather than in cash (to save liquidity). Even companies find it useful to pay Debentures as dividends as it increases their gearing ratio (See Annexure II). Today, it is generally accepted that dividend policy is value neutral – i.e., the value of the firm would be the same, whether it issued cash dividends or repurchased its stock (Modigliani-Miller Approach). In India, the dividends are governed by the provisions of Company Act, 1956. Some of the important provisions concerning dividends paid by companies are as follows:

- The Act prescribes a minimum retention of profits into Reserves before payment of dividend, unless dividends are paid out of company's accumulated free reserves.
- The companies can declare or pay dividends after providing for depreciation on fixed assets in the manner as prescribed by the Act.
- The dividends can be recommended only by the Board of Directors and require approval from the shareholders.
- The dividends once declared must be paid out within 42 days of such declaration.

WORKING CAPITAL DECISION

Decisions relating to working capital and short-term financing are referred to as working capital management. This part of financial management is the subject matter of this book and will be detailed in the subsequent chapters. However, a brief introduction to the topic is given here too.

Working capital management involves managing the relationship between a firm's short-term assets and its short-term liabilities. The goal of financial management is the maximisation of firm value. In the context of long-term, capital investment decisions, firm value is enhanced through appropriately selecting and funding NPV positive investments. These investments, in turn, have implications in terms of cash flows and cost of capital. The goal of Working Capital (i.e. short-term) management is therefore to ensure that the firm is able to operate and that it has sufficient cash flows to service long-term debt and to satisfy both maturing short-term debt and upcoming operational expenses. In doing so the firm value is enhanced when the return on capital exceeds the cost of capital ($r > k$).

Working capital is the amount of capital which is readily available to an organisation. That is, working capital is the difference between resources in cash or readily convertible into cash (Current Assets) and cash requirements (Current Liabilities). As a result, the decisions relating to working capital are always current, i.e., short-term, decisions. In addition to time horizon, working capital decisions differ from capital investment decisions in terms of discounting and profitability considerations; they are also reversible to some extent.

Working capital management decisions are therefore not taken on the same basis as long-term decisions and working capital management applies different criteria in decision making: the main considerations are: (1) liquidity (cash inflows) and (2) profitability (return on capital employed).

The most widely used measure of cash flow is the Net Operating Cycle, or Cash Conversion Cycle. This represents the time difference between cash payments for raw materials and cash collection for sales. The cash conversion cycle indicates the firm's ability to convert its resources into cash. Because this number effectively corresponds to the time that the firm's cash is tied up in operations and unavailable for other activities, management generally aims at a low net count. Another measure is gross operating cycle which is the same as net operating cycle except that it does not take into account the creditors deferral period.

In this context, the most useful measure of profitability is Return on capital employed (ROCE). The result is shown as a percentage, determined by dividing relevant income for the 12 months by capital employed; Return on equity (ROE) shows this result for the firm's shareholders. As stated above, firm value is enhanced when the return on capital, exceeds the cost of capital ($r > k$). ROCE measure is therefore useful as a management tool, in that they link short-term policy with long-term decision making.

Management of Working Capital Components

The management uses a combination of policies and techniques for the management of working capital elements. These policies aim at managing the current assets (generally cash and cash equivalents, inventories and debtors) and the short-term financing.

Cash Management

This identifies the cash balances which allows for the business to meet day to day expenses, but reduces cash holding costs.

Inventory Management

This identifies the level of inventory which allows for uninterrupted production but reduces the investment in raw materials – and minimises reordering costs – and hence increases cash flow.

Receivable Management

This identifies the appropriate credit policy, i.e., credit terms which will attract customers, such that any impact on cash flows and the cash conversion cycle will be offset by increased revenue and hence Return on Capital (or vice versa); see Discounts and allowances.

Short-term Financing Policy

This identifies the appropriate source of financing, given the cash conversion cycle: the inventory is ideally financed by credit granted by the supplier; however, it may be necessary to utilize a bank loan (or overdraft) or to convert debtors to cash through factoring services.

To sum-up, the Finance function is concerned with the activities involving planning and control by which an organisation administers financial resources in order to maintain its market share, increase its profitability and to maximise the organisation's rate of return on equity. Financial management deals with financial decisions such as when to introduce a new product, when to invest in new assets, when to replace existing assets, when to borrow from banks, when to issue stocks or bonds, when to extend credit to a customer and how much cash to maintain.

OBJECTIVES OF FINANCE FUNCTION

The management of a company strives to achieve a number of objectives, some of which conflict with each other. Such conflicts arise because the firm has a number of constituents, such as stockholders, employees, customers, creditors, suppliers and the local community, whose desires do not necessarily coincide. It is management's responsibility to satisfy such differing desires. Hence, the conflicting objectives confronting management raise the problem of setting priorities. In addition, it is essential for management to set priorities for the most efficient use of a company's scarce resources. Setting priorities in an organisation is particularly important and difficult because it has highly diversified groups of individuals and firms.

There is a difference of opinion amongst economists and Financial Managers as to what should be the main objective of financial management in a firm. The economists feel that wealth maximisation should be the main objective while Financial Managers in general opine that profit maximisation should be the objective. For a better understanding of the goals, let us discuss each goal in detail.

Profit Maximisation

In Economics, profit maximisation means maximising Total Revenue. In Finance, it is a little different. It is the maximisation of the firm's net income i.e. Revenue minus Expenses. Business enterprise aims at earning profit and hence it may be argued that profit maximisation is the directing goal of the enterprise, which in turn is the responsibility of financial management. The Finance Manager makes available need-based funds at a competitive cost and oversees its effective deployment. The commercial firm is thereby enabled a smooth and unhindered operations yielding optimum business results. Profit earning is the purpose of the business. Earning profit sustains its continued existence. The destination of financial management centers therefore towards the goal of earning profit or earning maximum profit.

In this objective, the firm takes steps to ensure that the company makes maximum amount of profits at the end of the year. Profit is the difference between the sales price and the costs. So profit maximisation can be done by getting the maximum sales price and by spending the least amount of money. The sales price is determined by the demand and supply forces of the market, so a firm does not have any control over it. The business firm can only control the costs which mainly comprise of two elements - cost of goods sold and the efficiency of operation. Again the purchase price being determined by the market forces, the firm cannot control it. In that case the profit maximisation can be achieved only by working at the maximum operational efficiency.

Profit maximisation assumes perfect competition in the market place, which for all practical purposes does not exist. Profit maximisation objective ignores many real-world complexities that Financial Managers must address in their decisions. Business Managers must deal every day with two major factors not considered by the goal of profit maximisation: uncertainty and timing. Profit maximisation does not reflect -- the timing of profits and the riskiness of different operating plans. However, both of these factors are reflected in stock price maximisation. Thus, profit maximisation would not necessarily lead to stock price maximisation. Projects and investment alternatives are compared by examining their expected values or weighted average profits. In considering investment opportunities available for funds in hand, we are not indifferent to the timing of the returns. A firm always likes to have profits in the current year instead of receiving them on a distant future date. Business involves risk factor and highly speculative decisions may in the initial stages return very attractive profits. Whether one project is riskier than another does not enter into these calculations. Projects differ a great deal with respect to risk characteristics and to ignore these differences can result in incorrect and fatal decisions. Thus the real-world factors of uncertainty and timing force us to look beyond a simple goal of profit maximisation as a decision criterion.

The term Profit itself is somewhat vague and ambiguous. Is it short-term profit or long-term profit? Short-term profits may endanger the long-term survival. Is it before tax profit or after tax profit? In the case it is profit after tax, the profit can be enhance by tax manipulation rather than better performance. Is it total operating profit or the percentage profit per share? The profit maximisation does not consider the time value of money. The profit made today and the profit made after one year is treated to be the same. In an inflationary economy, a rupee today is much more valuable than one rupee one year after. Do we maximise profits over the current year, or do we maximise profits over some longer period? A Financial Manager could easily increase current profits by eliminating research and development expenditures and cutting down on routine maintenance. In the short-run, this might result in increased profits, but this clearly is not in the best long-run interests of the firm. If we are to base financial decisions on a goal, that goal must be precise, not allow for misinterpretation and deal with all the complexities of the real world.

Profit maximisation may benefit the shareholders, but the business thrives successfully only when different stakeholders (Stakeholders include creditors, employees, and customers) are made happy with its policies and functions. They are the employees, the customers, and the credit institutions. Others to be taken care of are rating agencies, the stock exchanges, the Government etc., The business enterprise has also specific social obligations to the society at large. Profit maximisation at the cost of social and ethical standards is a shortsighted policy. The objective of profit maximisation cannot be achieved if any one of the other stakeholders withdraws or even reduces the level of support. Similarly certain steps like periodical shutdown of the plant for maintenance are required in the interest of their better upkeep. A firm, in order to maximise its profits, should not minimise expenditure on such items like advertisement and publicity; vendor development; after sale service, employee training and development. Good public relations with influential stakeholders like bankers, suppliers, government officials; etc. are equally important to promote the all round progress of the firm. In case of a small firm where the owner is single, the sole aim remains enhancing his individual wealth and personal power which is satisfied by the goal of profit maximisation. But in case of a limited company, the single owner is replaced by professional managers who are salaried employees and equity shareholders. The business firm also has to deal with other interested parties which are the government, customers, employees and the society. Therefore, profit maximisation is not the final objective of corporate.

Wealth Maximisation

It is believed that the primary goal of financial management is the maximisation of shareholder's wealth. Not only will this goal be in the best interest of the shareholders, but it will also provide the most benefits to society. This will come about as scarce resources are directed to their most productive use by business competing to create wealth. A business firm should also attach importance for its social responsibilities, business ethics etc. which is totally ignored in the profit maximisation goal of the firm. Social responsibility is the concept that businesses should be partly responsible for the welfare of society at large. Wealth maximisation does not preclude the firm from being socially responsible. Business ethics can be thought of as a company's attitude and conduct toward its employees, customers, community and stockholders. A firm's commitment to business ethics can be measured by the tendency of the firm and its employees to adhere to laws and regulations relating to such factors as product safety and quality, fair employment practices and the like. The wealth maximisation objective is consistent with maximising the owners' economic welfare. As for the shareholders the wealth created by the firm reflects in the market value of the share. Thus the fundamental objective of the Financial Manager is to maximise the market value of the shares of the company.

Wealth maximisation means maximising the net present value of a course of action.

Net present value = Net present value of cash inflows - Net present value of costs

The financial action which generates positive net present value adds to the wealth of the firm and thus is desirable. If there are a number of mutually exclusive projects, then the project that gives the maximum net present value should be chosen.

The goal of profit maximisation merely maximises the net income (earnings) of the firm. Because of factors such as risk, timing of earnings, number of shares outstanding and so on, profit maximisation does not necessarily lead to shareholder wealth maximisation. A better approach is to accept wealth maximisation as the primary objective of the business firm. The risk and timing associated with expected earnings per share and cash flows are considered in order to maximise the price of the firm's common stock. Thus the objective of wealth maximisation solves the two problems faced in profit maximisation. It considers the time value of money and secondly it considers the risks involved in going for the various alternatives. Wealth maximisation is reflected in the earnings per share of the firm and the market price of its shares. If the shares of the firm are traded in stock exchange, a good performance of the firm results in the price at which the shares are traded. When the firms shares attracts a good price, the owners or shareholders are better off, because the market value of their investment appreciates. The market price of a stock represents the judgement of all market participants, as to what the value of the particular firm is. The market price serves as a performance index of the firm's progress. It indicates how well management is doing on behalf of the stakeholders. The modern thinking on management goes further and considers wealth as consisting not only physical or tangible assets, but also intangible assets, like human capital, knowledge capital and relations capital.

The goal of maximisation of shareholder wealth is nothing more than modified goal of profit maximisation which is required to deal with the complexities of the complicated business environment. The goal of wealth maximisation means maximisation of shareholders' wealth which means the maximisation of the market value of the shareholders' stock. Investors react to poor investment or dividend decisions by causing the total value of the firm's stock to fall and they react to good decisions by pushing up the price of the stock. In effect, under this goal, good decisions are those that create wealth for the shareholder. Unlike profit maximisation, stockholder wealth maximisation is a long-term goal. Companies and consequently the stockholders, prosper by management making decisions which will produce long-term increases in earnings. But there are many practical problems in following this goal and in using changes in the company's market share price to evaluate financial decisions. The price of a firm's stock fluctuates often for no apparent reason. However, in the long run, the value of the firm is reflected through its stock price. Although, wealth maximisation is generally accepted as the primary goal of a company, in some places, however, the goal of a company is to maximise corporate wealth. Corporate wealth includes not only the company's stockholder wealth but also its marketing, technical and human resources. In this approach, a company should treat shareholders at par with other corporate constituents. In other words, management strives to increase the corporate wealth for the benefit of all constituents.

There are a number of reasons for management to focus on stockholder wealth maximisation. Managers are also concerned with their salaries and perks. Usually, these are tied to improved return on investments (ROI), return on equity (ROE), return on assets (ROA), or return on net assets (RONA). Since the shareholders are the owners of the company, management has a fiduciary obligation to act in their best interests. Moreover, the owners or shareholders provide the risk capital that protects the welfare of other constituents. The wealth maximisation approach provides the protection from a hostile takeover or a forced corporate restructuring. The another reason in favour of this goal is that, if a company enhances shareholder value, it is easier for the company to attract additional equity capital. The share price reflects the market's evaluation of the firm's prospective earnings stream over time, the riskiness of this stream, the dividend policy and quality aspects of the firm's future activities. Quality aspects of future activities include stability, diversification and growth of sales. Therefore, shareholders' wealth maximisation can be accepted as the primary objective of financial management.

THE AGENCY PROBLEM

Agency problem deals with the conflict of interest between managers and shareholders. There exists a relationship between shareholders and managers that is known as the Agency Relationship. This occurs when one party (principal) hires another (agent) to act on their behalf. So, the possibility of conflicts of interest between the parties is termed as the agency problem. Shareholders (principals) and management team (agents) work under a contract-- Contract that the management team will run the firm for the shareholders under the direction of the Board of Directors. Board of Directors (agents) act on behalf of the shareholders (principal). Shareholders delegate decision-making authority to managers on the condition that the agents will act in the stockholders' best interest. Problems can arise when directors or managers do not act in the best interests of their shareholders, choosing instead to satisfy their own personal goals. Because the stockholders of most companies today are well diversified, the control of these companies is separated from ownership. This situation allows managers to act in their own best interest rather than in the best interest of the stockholders. Thus, some managers may be concerned with their own welfare, such as their own gain, position, power and prestige. Therefore, the management decisions may be concerned with the welfare of managers only, ultimately resulting in lower stockholder wealth.

On the other hand, management may be keen on developing the company through its qualified managers while shareholders are interested in their returns only. So, there exist problems of differential of interests where investment, cash flows, financial management and reporting are concerned. These mechanisms are considered to be the lifeblood of an organisation yet they have often been subjected to agency issues. What are the basic reasons behind it? Why managers' interest diverge from shareholders? Following are some of the major reasons for agency problem:

- Management's perks and salaries may not be linked to performance.
- Executives may be very highly paid.
- Management may be concerned with another stakeholders.
- The Board of Directors may not be able to exercise proper control.
- No one, among owners, has an incentive to oversee managers.
- Excess expenditure on items of perks which do not increase the value of the company's stock and benefit others.

It is the existence of asymmetry of information, which makes it difficult for shareholders to monitor managerial decisions and gives the opportunity for managers to follow their own welfare maximising decisions. The term information asymmetry is used when Management knows more about the company than outsiders including shareholders, debt holders, creditors, customers and employees. Each firm has a different level of information asymmetry and a different cost of lower information asymmetry depending upon many things including corporate policy, competitive pressures and level of business complexity. This problem applies to all the contracts of a firm, not just the contract between principals and agents.

Agency costs are the incentives and monitoring costs incurred by the principal and losses due to the divergence of the agent's decisions relative to the principal. There are two types of agency costs: direct and indirect. Direct costs come about in compensation and perquisites for management. Indirect costs are the result of monitoring managers and of poor decisions by management. Factors, such as a compensation system that is based on management performance (bonuses tied to profits, stock option plans) as well as the possibility of being removed from office (voted out of office, an unfriendly tender offer by another firm) serve to keep management's focus on stockholders' interests. Moreover, in the long-run, management's own growth, including survival, will largely depend on the value of the firm.

The agency problem can be overcome by voting mechanisms and managerial incentives. Through voting shareholders can change and appoint the board of directors. Thus, shareholders control Board of Directors, who in turn selects the management team.

The performance of managers can be monitored by reviewing management perquisites, auditing financial statements and limiting management decisions. Incentives can also be used to motivate the managers to work efficiently. Managerial incentives include the performance plans linked to accounting income or equity participation in the shape of executive stock options and performance shares. Performance shares are shares of the firm's stock given to executives on the basis of performance as measured by earnings per share, return on assets, return on equity and so on. Executive stock options are performance-based incentive plans which allow managers to purchase stock at some time in the future at a given price.

From an agency perspective ownership acts as an incentive to make value creating decisions rather than maximising personal benefits. Collective ownership may be an incentive for managers to become wholly committed and devote more effort and time to profitable and innovative projects. This way another solution to this problem can be Management Buyout. The reuniting of ownership and control via a Management Buyout may result in a lowering of agency costs. The equity incentive can in many cases be a key motivator for the management team to make a success of the new venture and ultimately control their own future. Many management buy outs are heavily leveraged and the existence of this debt can in many cases put an onus on managers to achieve targets in order to service this debt. Additionally, many third party institutions such as venture capitalists hold substantial amounts of debt and equity in the new company and thus retain a strong desire to monitor its performance.

FUNCTIONS OF A FINANCE MANAGER

The main job of Financial Manager is to procure money for the firm at the cheapest rates and utilize it to the best possible use and to keep proper records of the money transactions. The functions of a Finance Manager, in a business organisation, are oriented towards realisation of the firm's overall objectives. These can be summarised as under:

- Mobilisation of required funds
- Deployment of the funds into various profitable projects and activities
- Long-term and short-term investment decisions
- Plowing back of profits and Dividend policy decision
- Deciding Risk-Return criteria for the firm
- Getting market information
- Co-coordinating with other departments

Mobilisation of funds requires the accurate estimation of the cost of the project or investment undertaken. This also involves finding the cost-effective means of finance. The finance mix is then planned for lowest cost of capital by choosing among the different mix of equity, debentures, Bank credit, Term Loans etc. Working capital needs are also assessed thoroughly. This is termed as capital structure decision. After mobilizing the funds, the Finance Manager is responsible for its proper allocation and use. In a manufacturing organisation the two major functions of the organisation are Production and Sales. The Finance Manager supports the manufacturing by making money available for purchase of raw material, purchase of machinery and payments for personnel employed while it supports the sales by making money available for advertising campaigns, marketing infrastructure and sales and service functions.

However, the above discussed functions are very traditional. Let us now discuss the recent developments with reference to the functions of the Finance Manager. The Finance Manager, in addition to the above mentioned operations, takes care of treasury operations i.e. short-term productive investment of surplus funds in the money market; tax-planning; maintenance of the market price of share; fighting against hostile take-over etc. The Finance Manager's role of has changed a lot in recent years. Now the Finance Manager in a business organisation is assuming the role of a strategic planner. In the past, the Finance Manager had to be an accounting man. Now the conceptual and managerial skills have become more important. The role of accounting and bookkeeping has become smaller and smaller within the organisation while the role of finance has increased. The role of accounting and book-keeping has reduced largely due to the technological innovations, computers and so on. The role of accounting, book keeping totaling and tallying is relegated to variety of machines. The job skills required by the Finance Manager have changed considerably. Instead of merely mobilizing and deploying funds among various projects, Finance Manager is now directly concerned with corporate strategy and business policy decisions. With the globalisation of markets and the world financial markets becoming one, the financial management is passing through the fundamental changes. The subject is becoming more vast and complicated.

APPROACHES TO FINANCE FUNCTION

Now the finance function is no more merely a support function. It has percolated into all aspects of corporate management and a business is made or lost through the finances. Managerial approach to finance evolved with the recognition of Corporate Finance as a distinct field of study at the turn of the 20^{th} century. Its evolution may be divided into two broad phases, i.e., traditional phase and modern phase. A transitional phase in between the two is also sometimes recognised.

Traditional Approach

In the start of 20^{th} century, the corporate finance was based on certain episodic events in the life cycle of the firm -- formation, issuance of capital, major expansion, merger, reorganisation and liquidation. The approach, known as the Traditional Approach, was not analytical but descriptive and institutional in nature. The sources of finance, the mechanism and institutions in the capital markets and legal framework of financial activities formed the basis of corporate finance. This approach followed the outsider's point of view i.e., corporate finance was viewed mainly from the perspective of the investment bankers, lenders and other outside parties. The brief Transitional Period which started during the 1940s, and continued through the early 1950s, the basic approach was emphasis on the day-to-day problems faced by financial managers in the area of funds analysis, planning and control. A limited analytical framework characterised this period.

Modern Approach

In the middle of 1950s, the modern approach came into being. This approach led to an accelerated pace of development with the infusion of ideas from economic theory and application of quantitative techniques. This approach views the discipline if finance in a broad sense and provides a conceptual and analytical framework for financial decision-making. The theme of financial management is considered to be a rational matching of funds to their uses in the light of appropriate decision criteria. The finance function covers both acquisition of funds as well as the efficient and wise allocation of funds to various uses. The approach of financial management has become more analytical and quantitative. Unlike traditional approach, this approach is dominated by insider's viewpoint i.e. the perspective of managerial decision-maker. The scope of the financial management has broadened and it is treated as an integral part of general management.

Since the beginning of the modern phase many significant and seminal developments have occurred in the fields of capital budgeting, capital structure theory, efficient market theory, option pricing theory, agency theory, arbitrage pricing theory, valuation models, dividend policy, working capital management and financial modeling. As the Managerial approach to Finance has turned into a subject of growing complexity, many more exciting developments are making finance a fascinating and challenging field.

INDIAN FINANCIAL SCENARIO

With the starting of Liberalisation Era from 1990s and the onset of Economic Reforms have changed the finance scenario in India. The emergence of financial services sector and SEBI as a watchdog for investor protection and regulating body of capital market is contributing towards the prominence of Finance Manager's job. The innovative tools of fund raising like zero coupon bonds, flexible bonds are some of the examples of developments during the recent years having a direct impact on the corporate financial policies.

In earlier years Financial Managers used to function in an environment, where sellers' market prevailed. Nearly monopoly was the state of Indian business. Finance was coming from traditional sources, i.e., Banks and Financial Institutions. The satisfaction of shareholders' was not the concern of the promoters, since most companies were closely held. But the situation is totally changed today. Because of opening of the economy and dismantling of tariff walls, the competition is getting intense. Markets are becoming buyers' market at a rapid rate. The development of Internet in the field of Information Technology has brought new challenges before Indian managers. Now the Indian concerns have not only to compete domestically, but also internationally.

As the Finance Manager has now global reach through computers, the finance function has become even more important. Also on the other hand as the repetitive work is delegated to lower levels - due to computers - the level of each employee in the company is improving. As each employee goes up the rung of organisation, it becomes imperative that he understand the financial consequences of his actions and thus today everyone in the organisation has to have a basic understanding of finance to enable them to make a positive contribution to the bottomline.

FINANCIAL MANAGEMENT IN INDIAN PUBLIC SECTOR

The objective of financial management is to provide information on which decision-makers can base wise and prudent judgements. In the Indian public sector organisations, however, financial management has been more concerned with compliance with legal requirements than it has been with providing inputs into decision-making. As a consequence, many key financial management decisions in the public sector tend to be based upon present political realities, rather than on a careful analysis of future outcomes. It is this mixture of politics, law and public scrutiny that makes governmental financial management so much more difficult and complex than financial management in the business world. As a result, governmental financial management can be much more challenging than it is in the private sector. However, it is very important that the objectives for public sector financial management be reformulated along the lines of private sector dynamics.

The scope of financial management in government or business includes funding, custodial, analytical and reporting functions, among other elements. The following tasks characterise financial management in both sectors:

- Analysing and assessing the financial impact of management decisions
- Ensuring the necessary cash flow to finance planned activities and operations
- Safeguarding resources through appropriate financial controls
- Providing a financial framework for planning future activities and operations
- Managing all types of information systems which controls the planned activities and operations
- Ensuring legality and regularity in the use of public funds

- Paying attention to concepts of efficiency and effectiveness and
- Reporting and interpreting the results of activities and operations measured in financial terms and thereafter audit and evaluation.

As the demands on government have increased, and as new revenue sources have been exhausted, there has been a shift in emphasis among the financial management functions.

India is a cash-poor country in relation to the accepted demand made on its government. Hence, the spotlight of financial management should be on getting and managing liquidity (cash) – for without cash, budgets have no relevance. The existence of uncontrollable external economic influences, the questionable reliability of traditional revenue sources and the high demand for more and more public services, have all acted to bring working capital management (especially cash and debt management) to the forefront of public sector interest. The fragmentation of the central financial management functions is another characteristic peculiar to the public sector. Although businesses commonly designate qualified individuals as Chief Financial Officers etc, but, is it possible in the case of India and can the government identify its own key financial executives? The basic financial management functions are often divided among agencies which compete for influence, instead of collaborating for the common goal. Usually, the financial information is not available or is not timely or is not reliable and sometimes, is not used in making the key decisions of government. A sense of financial management consciousness is direly needed in the Indian public sector. Government needs an appropriate financial management philosophy and a clear definition of the scope of the financial management function. Then, it must assure competent professional financial management leadership for that function and provide adequate staffing and support.

As the country develops, the need for coordinated professional financial management increases. Thus, there arises the need to integrate basic financial management functions and responsibilities into a coordinated single system under competent professional leadership. This can be done even without the extensive use of sophisticated computerised systems. However, increasingly new microcomputer technology and decreasing costs are bringing integrated financial management systems within the reach of our country.

INDIAN FINANCIAL SYSTEM

The financial system of a country consists of specialised and non-specialized financial institutions, of organised and unorganised financial markets, of financial instruments and services, which facilitate transfer of funds. Procedures and practices adopted in the markets and financial inter-relationships are also parts of this system.

The Indian financial system can be broadly classified into two sectors: Organised Sector and Unorganised Sector. The organised financial system is made up of a vast network of banks, other financial and investment institutions and a range of financial instruments, which together function in fairly developed capital and money markets. The commercial and cooperative banking structures mainly provide short-term funds. About 90% of such banking business is managed by 28 leading banks, which are in the public sector. In addition to commercial banks there is the network of cooperative banks and land development banks at State, district and block levels. There is an increasing trend of private banks and with nearly 65% of the total assets of the financial system held by banks, they play an important role in the Indian Financial Industry. There is a growing trend among Development Financial Institutions changing their traditional roles of providers of long-term finance to 'Universal Banking' institutions.

The unorganised financial system comprises of moneylenders, indigenous bankers, lending brokers, landlords, traders, etc. There are also a host of financial companies, investment companies, chit funds, etc. in the unorganised sector. These are not regulated by the Central Bank or the government in a systematic manner

In product or other service markets, purchasers part with their money in exchange for something in the present. In finance, money in the present is exchanged for a promise to pay in the future. However, in product or service markets, if the product sold is defective, the buyers often find out relatively soon. On the other hand, loan quality is not readily observable for quite some time and can be hidden for extensive periods. Moreover, banks and non-bank financial intermediaries can also alter the risk composition of their assets more quickly than most non-financial industries and banks can readily hide problems by extending loans to clients that cannot service previous debt obligations.

Theoretically, the financial market facilitates allocation of resources efficiently, which involves quick dissemination of information and reaction to it. The financial markets are susceptible to manipulation as some participants have information that others do not have and this is known as information asymmetry. To overcome this problem corporate governance is required to ensure that suppliers of finance to companies are assured that they get their return on their investment. Despite the existence of institutional and legal framework numerous financial scams continue to be reported both in developed and developing countries.

Financial Liberalization is a phenomenon that is almost pervasive in all over the world today. While liberalization has led to substantial benefits in terms of increased transparency, it has also given birth to the chances of corporate mis-governance. This implies that the mechanism by which legal institutions ensure that suppliers of funds receive the return on investment is not appropriate. Recent trends after the 1990s in India reveal how corporate governance has not been effective permitting unscrupulous and opportunistic individuals to manipulate the market in their favour, the case of Harshad Mehta Scam is an appropriate example in this regard. The process of financial market regulation ensures that important guidelines are issued regarding how primary dealers (brokers) should operate with regards to mode of operation, conduct, litigation, amount of business to be handled, management of risk, internal control etc.

The financial scandals and scams, occurring everyday in India, involve the manipulation of huge amounts of money. The occurrence of such scams and scandals can be attributed to a failure of corporate governance in finance, despite the existence of a functioning regulatory authority empowered with the legal sanctions.

Though, the Indian financial system is broad-based, yet it is inadequate and inefficient. The establishment of efficient financial systems will help India to grow, partly by mobilizing additional financial resources and partly by allocating those resources to best uses. In the future, we can hope that the Indian financial system will grow in size and complexity, different segments of the market will become closely linked and inter-dependent. Influencing only one market segment without affecting others will become increasingly difficult.

As is the case in many industrially advanced countries these days, the major link connecting the various segments is the interest rate. In order to influence the entire system, the monetary authorities will have to act on interest rates. There will be increasing specialisation and there can emerge financial system dealing in different financial products and services. The existence of healthy and sound financial institutions should be able to exercise control over investors and other borrowers to use resources in an efficient and productive manner in order to repay existing obligations and to raise new finances. Banks will begin to function increasingly under cooperative pressures. These pressures may work from within the banking system, as well as from non-banking financial institutions. With the increasing participation of private shareholders even in public sector banks, there will be greater accountability to shareholders, including the Government.

FINANCIAL REFORMS[1]

India has entered into 21st millennium and has largely completed the first phase of financial sector reforms and is in process of the second phase to meet new challenges. The first phase — liberalisation of interest rate and directed credit — began in the early 1990s, jointly with real sector deregulation. With prices in the real economy reflecting economic costs and with greater reliance on the private sector, it naturally became important to move from a financial system that was traditionally a system of centralised public finance, directed credit allocations to a system where financial institutions play a greater role in allocating resources based on their evaluation of risk and return.

Giving financial sector institutions a greater role in credit allocations brings many changes — not just freeing interest rates and credit allocations but giving more attention to legal, regulatory and supervisory issues and incentives. The changes involve not only individual institutions and sectors of the financial system, but also inter-sectoral issues, such as the roles of banks, development banks and the capital market. If these changes occur, the India will reap the benefits of a financial system appropriate to its development and to the changes that are taking place globally.

The Indian financial system is still dominated by the public sector. Lack of appropriate incentives in public sector financial firms add to the above mentioned problems. Public sector banks have 80% of commercial bank assets and are heavily involved in other financial institutions; development banks, among the largest institutions, are either government-owned or have much of their equity owned by public sector banks; the publicly owned Unit Trust of India (UTI) and the public banks' mutual funds are the largest players in the stock market; insurance was a government monopoly until recently. It is generally understood that in the case of public sector institutions where the owner is the Government itself, it typically lacks both the incentive and the means to ensure an adequate return on its investment. Political decisions, as opposed to the ROI criteria, are often important in determining resource allocation. Debt collection service may be low, relative to private financial firms. Political pressure and interference generates decisions that lead to economic instability. Managers and staff in public firms have little incentive to gather and use information to make investment decisions that maximise the risk adjusted rate of return.

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1. Data used here is taken from various RBI and other banking bulletins, annual reports and Internet uploads.

A public sector firm's competition to improve services and cut costs is very limited. Lenders, investors and depositors in public banks and mutual funds do not worry much about the use of their funds because there is a public guarantee that taxpayer will make good the promised returns.

All these problems suggest that resolving these issues are critical to the success of India's financial reforms. Improvements in the legal, regulatory and supervisory framework are a key to financial reforms. The legal and judicial system, the regulations and the supervision of the regulations are a major factor in the effectiveness of a financial system. For example, the quality of the legal and judicial framework affects the incentives to service debt promptly. The rules on minimum capital, risk weighting, exposure, lender of last resort and deposit insurance affect the size and nature of transactions in the system.

Good quality supervision ensures the rules are followed and that weak institutions are either made strong promptly or are sold-off. The role of regulation and supervision is to include the reduction of market risk and economic instability. A sound legal framework for collateral and loan recovery is also very important.

The pre-reform era from the mid 1960s to the early 1990s, Indian Governments treated the financial system as an instrument of public finance. A complex web of regulations fixed the details of deposit and lending rates and loan amounts, channeling credit to the government and priority sectors at below-market rates. Public institutions dominated the financial system; competition was limited -- between banks and between the banking sector, the capital market and international financial markets. When problems and irregularities occurred, regulations were changed to prevent the same in future, without much attention to their impact on the financial system as a whole. Despite the restrictions on deposit rates, India had a relatively strong financial system for a low-income country. The stock market was also large in terms of number of listings and market capitalisation.

On the lending side, financial repression was greater than on the deposit side. Substantial and increasing volumes of credit were channeled to the government at below-market rates through high and increasing cash reserve requirements (CRR) and statutory liquidity requirements (SLR), in order to fund a large and increasing government deficit at relatively low cost. In addition, 40% of advances were to offer to priority sectors, mainly agriculture and small-scale industry. An additional 10% went to export credit. And credit to fund food procurement was about 10% of advances during the 1980s. Thus, over 80% of portfolio allocations were fixed by sector. Moreover, interest rates and credit volumes on individual loans were regulated in minute detail. The public sector, through the CRR and the statutory liquidity requirement and agriculture received the largest average cross subsidies.

India's reforms of the early 1990s began in response to the balance of payments crisis of 1991-92; it also included a stabilization programme. The reforms specifically included financial reform. The financial reforms sought to improve resource mobilisation and allocate credit to its most efficient uses. The first Narasimham Committee Report (1991) provided a blueprint, particularly in the banking sector. The recommendations of this committee were largely carried out. From 1992 onwards, India gradually liberalised interest rates (except savings deposit rates). Deposit rates were liberalised by first setting an overall ceiling for term deposit rates. Trading of stocks and bonds was, however, relatively low. Also, the size of the debt market was difficult to measure. Although large volumes of government debt were bought, the buyers were largely the banks, which bought debt and held it to maturity to satisfy the statutory liquidity requirement, which at one point was 38.5% of deposits. Regulations kept the interest rates low on public sector debt. After 1992, rates on priority lending were also gradually allowed to be set more freely and the number of categories was reduced sharply. Finally, interest rates on Government debt were increasingly determined in auctions. However, the rules of the auction effectively allowed RBI to set the rate.

Additional measures liberalised credit allocation, improved regulation and supervision, liberalized the capital account and introduced more competition over the post-1992 period. These additional measures included: Reduced Cash Reserve and Statutory Liquidity Requirements, tightening of prudential norms and improvement of banking supervision. Recognition of non-performing assets gradually tightened, so that by March 1995 most loans with past due interest of more than two quarters were considered non-performing.

Non-bank financial corporations were allowed to grow under a regime of less directed credit requirements (lower cash reserve and statutory liquidity requirements, no priority lending requirement) and limited regulation and supervision. After reform, the growth of bank deposits, relative to GDP, resumed, though somewhat more slowly than in the 1980s. Deposits in non-bank financial companies (NBFCs), grew rapidly, by over 40% p.a. between 1992 and 1997.
However, a crisis[1] in one of the NBFCs in 1997 led to runs against many of them. The Government appropriately refused to extend deposit insurance to them. The weakest NBFCs were wound up and the remaining institutions are being more tightly regulated. How far they are tightly regulated is yet another issue for a debate. Recently, in November 2011 the promoters a company with a name of Gold Sukh vanished into thin air after taking public deposits exceeding ` 300 crore.

The reforms strengthened banking regulation and supervision, as mentioned above. Regarding non-performing assets, the tighter regulations led to recognition of the large volume of existing non-performing assets (NPAs). However, by 1998-99 the ratio of banks' NPAs to Total Assets had fallen to about 6%. Regarding the capital market, larger firms raised most of their funding through the capital market or private placements. Banks still provide much of these funds, but under competitive conditions that have depressed margins. The increased competition has been a major factor in the decline in banks' interest rate spreads and profit rates over the last few years.

Financial Sector Reforms were initiated as part of the overall structural reforms aimed at improving the productivity and efficiency of the economy. The Financial Sector Reforms recognise the fact that the Indian Banking System had over the years grown and that the geographical and functional coverage of the banking system have been truly impressive. However, questions have been raised from time to time on the viability of the banking institutions. Concerns have also been expressed about the deterioration in the quality of services provided by banks. It was with a view to these problems that Financial Sector reforms were initiated.

[1] CR Bhansali, the promoter of a NBFC ran away with `1000 crore collected as fixed deposits from public.

The major merit of these reforms has been the cautious sequencing of reforms and the consistent reinforcing nature of the various measures taken. Even as the new prudential norms are being introduced, the capital base of the banks has been strengthened and organisational improvements are being made consistently. Through FDI and Portfolio investments, the Foreign Exchange Reserve of India has steadily increased to reach a level of US$ 34.87 billion as of January 2000. The reforms have generated encouraging results, however, there is a great deal of economic development required before India is competitive in all aspects on an international level.

CORPORATE GOVERNANCE

Based on the theory of agency is the concept of Corporate Governance[1]. Corporate Governance is concerned with the methods and styles in which the suppliers of capital to business firm assure a return on their investments. In other words, corporate governance is an Agency perspective sometimes referred to as separation of ownership and management.

Corporate governance has a direct impact on the efficiency of a business firm, thus it also influences the effectiveness of a country's corporate governance system which in turn shapes economic performance at a country level. If managers are getting sound incentives, they will be more likely to use and allocate firm's resources and capital efficiently. If managers, however, have enormous discretion to act in their own interests rather than the interests of the firm's equity and debt holders, then this will adversely affect corporate governance. In particular, managers will allocate capital less efficiently and may behave in ways that favour their personal interests but damage overall firm's growth. Thus, the corporate governance is crucial for shaping capital allocation at the firm level and at the country level.

Most of the successful companies are treating shareholder value maximisation as their primary goal. It is through effective corporate governance only that today many companies are <u>doing</u> something that was not the rule of thumb in their respective industries. They are restructuring their business operations to enhance shareholder wealth. For example, multinationals like IBM, Unilever etc. are laying off thousands of workers, closing offices and quitting non-core businesses to maximise their investors' wealth. To maximise shareholder value, companies are avoiding over investments, increasing dividend rates, utilising assets, increasing mergers and acquisitions. These days most of the large business firms are linking a significant

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1 "Worldwide corporate debacles in recent times have amply demonstrated that undue emphasis on profits and market expansion at the cost of good governance is disastrous. Many corporate erroneously feel that profits and ethical corporate management practices are incompatible. For them wealth making can only be promoted through unethical practices. Corporate often ignore the interest of the public on whose money they have built their industrial empire. Small investors are often at the receiving end of corporate manipulation and mismanagement. The investing public becoming steadily more vigilant and investors both institutional and overseas mindful of governance benchmarks in place, corporate governance is used to evaluate a company's competitiveness, to attract investment and its overall potential world. Excellence in performance of the corporate sector can be achieved only through accountability, transparency, quality of information and by fulfilling their obligations towards society". *The Vice President, Bhairon Singh Shekhawat, in his speech at* `Corporate Excellence Awards 2002' *instituted by the Institute of Company Secretaries of India (ICSI), New Delhi, Dec. 31st 2002.*

portion of executives' pay to the company's market stock price performance. So when shareholders earn more profits, management also gets richer.

Agency theory, as discussed earlier, defines the corporate governance problem in terms how equity and debt holders influence managers to act in the best interests of the owners. To the extent that shareholders and creditors induce managers to maximise firm value, this will improve the efficiency with which firms allocate resources. These mechanisms, however, do not work well throughout the world. Small investors face problems exercising corporate governance because of informational asymmetries and poor legal, and regulatory systems. Corporate governance mechanisms are economic and legal mechanisms that can be altered through the political process only. Moreover, ensuring that capital allocation and lending practices are adequate is not simple in practice. The ability of authorities to influence managers is enhanced if regulators can impose penalties when there is evidence of fraud or of improper conduct. Similarly, the incentives of managers will clearly be enhanced if small shareholders can use an efficient court system that supports their rights.

SEBI implemented the recommendations of the Birla Committee through the enactment of Clause 49 of the Listing Agreements. This Clause 49 may well be viewed as a milestone in the evolution of corporate governance practices in India. They were applied to companies in the BSE 200 and S&P C&X Nifty indices and all newly listed companies, on March 31, 2001; to companies with a paid up capital of ` 10 crore or with a net worth of ` 25 crore at any time in the past five years, as of March 31, 2002; to other listed companies with a paid up capital of over ` 3 crore on March 31, 2003.

In March 2003, a committee was formed by SEBI to discuss the scope of Corporate Governance in India which was headed by Mr. Narayana Murthy, then CEO of Infosys. The Narayana Murthy committee worked on further refining the rules and Clause 49 was amended in 2004. The key features of this amended Clause are the following: (i) Composition of the Board of Directors; (ii) the composition and functioning of the Audit Committee; (iii) the governance and disclosures regarding subsidiary companies; (iv) Disclosures by the company; (v) CEO/CFO certification of financial results; (vi) Report on Corporate Governance as part of the Annual Report; and (vii) certification of Compliance of a company with the provisions of Clause 49.

The composition and proper functioning of the Board of Directors emerge as the key area of focus for Clause 49. It stipulates that non-executive members should comprise at least half of a board of directors. It defines an independent director and requires that independent directors comprise at least half of a board of directors if the chairperson is an executive director and at least a third if the chairperson is a non-executive director. It also lays down rules regarding compensation of board members; sets caps on committee memberships and chairmanships; lays down the minimum number and frequency of board meetings and mandates certain disclosures for board members. Clause 49 pays special attention to the composition and functioning of the Audit Committee, requiring at least three members on it, with an independent chair and with two-thirds made up of independent directors and having at least one financially literate person on it. It lays down the role and powers of the audit committee and stipulates the minimum number and frequency of the quorum at the committee meetings.

With regard to material non-listed subsidiary companies (i.e. turnover/net worth exceeding 20% of holding company's turnover/net worth), Clause 49 stipulates at least one independent director of the holding company to serve on the board of the subsidiary. The audit committee of the holding company should review the subsidiary's financial statements particularly investment plans. The minutes of the subsidiary's board meetings should be presented at the board meeting of the holding company and the board members of the latter should be made aware of all significant (likely to exceed in value 10% of total revenues/expenses/assets/liabilities of the subsidiary) transactions entered into by the subsidiary. The areas where Clause 49 stipulates specific corporate disclosures are: (i) related party transactions; (ii) accounting treatment; (iii) risk management procedures; (iv) proceeds from various kinds of share issues; (v) remuneration of directors; (vi) a Management Discussion and Analysis section in the Annual report discussing different heads of general business conditions and outlook; (vii) background and committee memberships of new directors as well as presentations to analysts. In addition a board committee with a non-executive chair should address shareholder/investor grievances. Finally the process of share transfer, a long-standing problem in India, should be expedited by delegating authority to an officer or committee or to the registrar and share transfer agents.

The committee also suggested that a company is a congregation of various stakeholders, namely, customers, employees, investors, vendor partners, government and society. A company should be fair and transparent to its stakeholders in all its transactions. This has become imperative in today's globalized business world where corporations need to access global pools of capital, need to attract and retain the best human capital from various parts of the world, need to partner with vendors on mega collaborations and need to live in harmony with the community. Unless a company embraces and demonstrates ethical conduct, it will not be able to succeed. Corporate governance is about ethical conduct in business. It stems from the culture and mindset of management and cannot be regulated by legislation alone. Therefore, corporate governance is beyond the realm of law. Corporate governance deals with conducting the affairs of a company such that there is fairness to all stakeholders and that its actions benefit the greatest number of stakeholders.

Companies need to recognize that their growth requires the cooperation of all the stakeholders and such cooperation is enhanced by the corporation adhering to the best corporate governance practices. In this regard, the management needs to act as trustees of the shareholders at large and prevent asymmetry of benefits between various sections of shareholders, especially between the managers and the shareholders. Therefore, corporate governance is a key element in improving the economic efficiency of a firm. Good corporate governance also helps ensure that companies take into account the interests of a wide range of communities within which they operate. Further, it ensures that their BOD is accountable to the shareholders. This helps assure that companies operate for the benefit of society as a whole. While large profits can be made taking advantage of the asymmetry between stakeholders in the short run, balancing the interests of all stakeholders alone will ensure survival and growth in the long run.

Corruption and Malpractices

It is a well known fact that corruption itself has become a part of our system, day by day it is eating up our reserves and values. It has become a very hot-topic since the anti-corruption campaign launched by Mr. Anna Hazare and his supporters. With reference to finance function, one of the most powerful anti-corruption devices is the establishment of sound financial management practices, with timely and efficient accounting systems combined with professional reviews by internal and independent auditors. To achieve this involvement of top-level management and political commitment is inevitable. Such a commitment is a missing element in our country today and that too, in both the public and the private sector.

One of the major objectives of a sound financial management system in business is to check and disclose internal flaws and crimes. Annual audit is one of the most common solutions prescribed for this. However, auditors' hands are tied where inadequate accounting practices hinders the audit trails which should permit auditors to find irregularities and determine who is responsible for them. Poor, disconnected and untimely accounting systems and disintegrated approaches to financial management provide opportunities for fraud. Auditors also serve to cover up the frauds and if fraud is discovered, they make it impossible to identify and punish those responsible. On the other hand, clear and transparent audit trails not only serve to find the guilty but they also provide a powerful prevention.

A sound system of financial management and accounting discloses and helps identify corrupt practices and corrupt people in the following ways:

- It provides sound information for the various anti-corruption agencies and watchdogs
- It forces a disciplined on-time approach to public activity and financial reporting.
- Sound financial management includes requirements that all transactions adhere to the same rules, eliminating the loopholes and alternative mechanisms which foster and cover up corrupt activities;
- It promotes the development of strong internal managerial controls. These include appropriate audit trails (requisites of sound financial management), which strengthen the probability that corrupt practices are discovered and identified as such, so permitting more prompt investigation;
- Managerial control is further strengthened with regards to oversight of discretionary power over resources and expenditures which are subject to a high degree of vulnerability.
- It facilitates audit. Professional and timely internal and independent audit which focuses on highest risk areas is made possible where financial management, especially accounting systems are adequate and
- It provides psychological control. The knowledge that internal managerial controls are in place, constantly being emphasized and improved and subject to selective audit review, is a powerful danger to the potentially corrupt.

So, the responsibility of a government is not limited to ensure the proper financial management of funds in accordance with standards and procedures. It extends over the whole of the government sector, including regions, districts and municipalities, as well as government institutions. This task can be extremely difficult where there is a large degree of decentralisation accompanied by shortages in management and audits or where ineffective democracy and subsidiary are a part of political culture.

The government should also ensure that strong financial management systems are introduced into public corporations that are subject to government regulation and agencies that are interfacing the public and private sectors. With fraud and corruption, legal and disciplinary measures are directly attached and there is a lot to do to improve our legal system.

INTEGRATED FINANCIAL MANAGEMENT SYSTEM (IFMS)

An Integrated Financial Management System (IFMS) is a very important tool of financial management. An IFMS consists of an inter-related set of sub-systems which plan, process, report resources and quantify them in financial terms. The basic sub-systems normally are accounting, budgeting, cash management, receivable management and their related internal controls. Other sub-systems, sometimes, included are collection and receivable management, acquisitions and supply management, information management, tax and customs administration, retirement or social security system administration etc., One of the most important elements of modern internal control in any organisation consists of an independent and professional internal audit function, which constitutes, an integral part of an IFMS.

The principal factor, which integrates the system, is a common, single, reliable database or several interconnected databases in which all data is expressed in financial terms. All of the sub-systems and all users of financial data, are required to participate in common data sharing. The validation, classification and recording of data is a function of the accounting sub-system which produces timely reports of classified data for use by all systems and others who use financial information.

An IFMS can be developed regardless of a specific organisational structure, but it is likely to function better where the four basic sub-systems - accounting, budgeting, cash management, and receivable management - are closely related within the organisational structure, under a common, professionally qualified financial management executive.

The failure to integrate financial management information results in:

- Fragmented and unreliable data;
- Duplications of data and difficult to reconcile;
- Failure to utilise actual results in the planning and budgeting processes;
- Failure to fully/publicly report results of operations and financial conditions;
- Hidden transactions;
- Undue emphasis on one of the component sub-systems (usually budgeting) which tends to dominate, duplicate and fades out the others.

Components of IFMS

The principal four components of an IFMS are accounting, budgeting, cash management and credit management. These component sub-systems of the IFMS must be permeated by sound internal managerial controls. Each of them must be supported by an environment of ethics and integrity, which must stem from the top levels of management.

Accounting

An accounting system is the collection of methods and records established to identify, assemble, analyse, classify, record and reports a firm's transactions. The system is created to safeguard and maintain accountability for the entity's assets and liabilities. The accounting sub-system is at the heart of the IFMS, because the other sub-systems depend on it for useful, timely and reliable data. If the accounting sub-system fails to produce timely data, the remaining sub-systems cannot function properly. In this case, substitute data is often sought, new ad hoc records are set up to produce indispensable data and management decisions are made without the information necessary to apply good judgement. Thus, sound development and maintenance of the accounting sub-system is absolutely necessary to the success of the IFMS and constitutes a very important factor in its integration.

Among other things, the accounting system allows for:

- Providing information to Programme Managers for use in making informed decisions;
- The independence of financial transactions based upon duly organised supporting documentation;
- Making it possible to report results in financial terms and where performance data is maintained, to report costs;
- Control over current year's disbursements and preparing future budgets based upon actual expenditures made and
- Providing periodic financial reporting and auditing.

It is very important that all accounting and budgeting classification or coding schemes be fully integrated into a single common classification which remains constant over a period of years. Changes in classifications from year to year impair the ability to compare data and to analyse trends.

The accounting system should maintain general ledger controls over all valuable resources which are independent of operations. Typical and repetitive transactions should be pre-coded according to type and amount entered and therefore appropriate accounting entries should be made automatically, reducing the need for accounting expertise while at the same time reducing the possibility that transaction data can be manipulated. Timely entry of transaction data at the point of origin permits internal auditors to pay immediate attention to areas and activities identified as being vulnerable to corrupt practices.

Budgeting

Budgeting is the process of stating in quantitative terms the planned activities of the organisation for given period of time. Budgets, the quantitative statements prepared with the help of accounting data, include such figures as projected income and expenditure. Budget execution data must be derived from the accounting system, and not separately recorded and processed. It is extremely important to highlight the fact that budgeting must be integrated with the other financial management areas.

Budgeting sub-system supports decision making by providing all the units and departments with regular reports and other information that help them to —

(a) control their area of responsibility and

(b) allocate their resources to pursue the organisation's goals. Managers of subunits also may use budgets to help track progress of their own units.

Budgetary principles require that all forecast revenues and expenditures of all types should be accounted for within the budget. This means that any use of special revenues from the general pool of revenues, should be minimised.

The budgetary sub-system should be designed in such a simple and practical manner as to facilitate smooth operation in co-ordination with the other IFMS sub-systems. It is essential to ensure that the budget made for a year does not over-run by a substantial margin the figures set in the budget itself.

A budgeting system often is closely related to the general ledger system. The computerized general ledger system should permit budget amounts be entered by account number. Actual amounts spend or received are registered by means of the general ledger system or by means of subsystems for account payable.

Periodically (weekly, monthly, annually) or on ad-hoc basis budgeted amounts and the actual expenditures should be compared and reported. Examples of budget reports are: current budget allocations compared with year-to-date income and expenditures; budget variances or differences between projected amounts and actual costs; current budget allocations compared to the previous year's allocations.

Cash Management

The objective of cash management is to collect, maintain and disburse funds in a way that minimises the risk of misuse, maximises profitable cash flow and supports the organisation's operations and mission. Cash is both a fundamental resource and the means by which the firm acquires other resources. To manage cash is to manage the firm's ability to purchase assets, service debt, pay employees and control operations. Thus, effective cash management directly correlates with the firm's ability to realize its mission, goals and objectives.

The cash management process combines:

- Cash management tools, such as cash budgets and cash forecasting, for controlling cash availability and maximizing the investment of idle funds
- Procedures for collecting, disbursing and investing cash
- Internal controls for safeguarding, recording and reporting cash

The cash management process has three major subsystems:

- Collection
- Disbursement
- Investment

These subsystems have very different control objectives. For example, the collection subsystem should reduce the time between point of collection and actual deposit. It is concerned with identifying the methods and procedures to be used to collect receipts and minimise collection delays.

The disbursement subsystem, on the other hand, should increase the time from point of disbursement to actual reduction of cash balances. In other words, this sub-system establishes payment dates and payment methods to maximise disbursement float (delay).

Investment subsystem identifies types and amounts of investments allowed, setting standards for dealers or brokers for investments. Therefore, compatibility and co-ordination between all the subsystems is necessary for overall cash management objectives to meet. Specific cash management policies should be developed for these subsystems.

Cash management seeks to ensure that the achievement of budgeted goals and objectives are not hindered by a lack of cash liquidity. Meeting cash management objectives requires forecasting the combined flow of funds and planning to meet financing needs, including short-term borrowing, as budgeted. The scarcity of financial resources has increased the problems posed by traditional practices of maintaining multiple idle accounts, with various banks and for multi-purposes. All the accounts having some minimum idle cash balance. Thus, in the modern and efficient financial management system it is obligatory to unite all cash flows in the 'single bank account'. Every financial inflow from any source should be deposited directly into the single cash depository account. In the same way, all disbursements should be drawn against the same account. The management should carefully plan and forecast their cash flows to avoid idle cash maintained in accounts and to ensure that liabilities are met when they fall due.

Receivable Management

Receivable or Debtors reflect money, goods or services which have been earned but not received. They are shown as assets on the balance sheet, allowing the asset to be recognized during the period in which the revenue is earned. It is important not to lose sight of the fact that receivable management cannot be isolated from the rest of the financial management system. Planning credit is just as essential as planning cash flow and these two sub-systems should be considered as one due to their close relationship. The basic phases of a receivables process are:

- Establish policies and procedures to control the granting of credit.
- Ensure that the system properly records, reports and safeguards receivables.
- Ensure the process provides for the analysis and aging of receivables.
- Collect due and past-due accounts.
- Monitor and re-evaluate the system.

The firm should ensure that reported receivables accurately reflect all receivables and provide the data necessary to forecast cash availability and analyse efficiency of the collection process while safeguarding assets. The cash management system relies upon the control system of the receivables process as surety that receivables are recorded and reported accurately. The data provided by the accurate recording of receivables is used to make aging schedule and analyze receivables to determine efficient and effective collection. Accounts receivable aging analysis is a review of amounts and percentage of outstanding accounts receivable falling into each of several defined billing periods. This analysis should be done at regular intervals.

Accounts receivable turnover analysis is used to measure the effectiveness of the management of accounts receivable. The commonly used turnover formulas used are turnover ratio and days sales outstanding ratio (DSO). Regardless of the method used, budgeted target turnover to compare to actual is helpful in planning and goal setting.

Internal Control

Internal controls are comprised of the plan of organisation and all methods and measures adopted within a firm to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency and encourage adherence to prescribed managerial policies[1]. Internal control, which is a type of managerial control, is of great importance within each of the IFMS sub-systems. Appropriate internal control measures should be integrated within each sub-system in such a manner that their application becomes an integral part of the normal processing of transactions. Internal control comprises all the coordinated measures and methods adopted within an entity to:

- Safeguard its resources;
- Promote the reliability and accuracy of financial and operational information;
- Promote efficiency in operations;
- Stimulate adherence to legal provisions, policies and standards; and to
- Achieve programmed goals and objectives.

Internal control measures and procedures should be installed and integrated within its operating procedures. Internal audit is a part of the internal control structure dedicated to measuring and evaluating the other internal controls. Thus, internal auditors must be professionally independent and should not participate in administrative functions or financial transactions. Exception reports can be designed to provide prompt feedback to managers in areas where weaknesses are becoming a trend.

FINANCIAL MANAGEMENT IN A SMALL FIRM

Financial management in the small firm is characterized by a different set of problems and opportunities than those confronted by a large industrial house. One obvious difference is that a

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[1] Defliese, Philip L. *Montgomery's Auditing*. New York: John Wiley & Sons, 1975.

majority of small firms do not normally have the opportunity to publicly sell issues of stocks or bonds in order to raise funds. The owner/manager of a small firm rely primarily on trade credit, bank financing, lease financing, and personal equity to finance the business. Therefore, a small business firm faces limited financing alternatives than those faced by the Financial Manager of a large company. On the other hand, many financial problems facing the small firm are very similar to those of larger companies. For example, the analysis required for a long-term investment decision such as the purchase of plant and machinery or the evaluation of lease-buy alternatives, is essentially the same regardless of the size of the firm. Once the decision is made, the financing alternatives available to the firm may be radically different, but the decision process will be generally similar.

One major area of particular concern for the smaller business firms lies in the effective management of working capital. Working capital is the deployment of current assets in the business and net working capital is defined as the difference between current assets and current liabilities and is often termed as 'circulating capital' of the business. Lack of control in this crucial area is a primary cause of business failure in both small and large firms.

The Finance Manager must continually be alert to changes in working capital accounts, the cause of these changes and the implications of these changes for the financial health of the company. One convenient and effective method to highlight the key managerial requirements in this area is to view working capital in terms of its major components such as Cash, Inventory and Receivables. All these components are dealt with thoroughly in the subsequent chapters.

CHAPTER SUMMARY

Finance is the study of money management, the acquiring of funds (cash) and the directing of these funds to meet particular objectives. Good financial management helps businesses to maximise returns while simultaneously minimising risks. The main concepts in the study of finance function are applicable to the financial problems of all kinds of firms. The discipline can be divided into long-term and short-term decisions and techniques. Capital investment decisions are long-term choices about which projects receive investment, whether to finance that investment with equity or debt, and when or whether to pay dividends to shareholders. On the other hand, short-term decisions deal with the short-term balance of current assets and current liabilities; the focus here is on managing cash, inventories, and short-term borrowing and lending (working capital management). Long-term Investment decisions or Capital budgeting decisions are long-term finance decisions relating to fixed assets and capital structure. Decisions are based on several inter-related criteria. Financial management seeks to maximise the value of the firm by investing in projects which yield a positive net present value when valued using an appropriate discount rate in consideration of risk. These projects must also be financed appropriately.

The sources of financing are, generically, capital as well as debt sourced form outside investors. Since both hurdle rate and cash flows (and hence the riskiness of the firm) will be affected, the financing mix will impact the valuation of the firm as well as long-term financial management decisions. Whether to issue dividends and to what extent, is judged mainly on the basis of the company's unappropriated profits and its earning prospects for the coming years. The amount is also often calculated based on expected free cash flows, i.e., cash remaining after all business expenses and capital investment needs have been met. If there are no positive NPV opportunities, i.e., projects where returns exceed the hurdle rate ($r > k$), then – finance theory suggests – management must return excess cash to investors as dividends.

Decisions relating to working capital and short-term financing are referred to as working capital management. There is a difference of opinion amongst economists and financial managers as to what should be the main objective of financial management in a firm. The economists feel that wealth maximisation should be the main objective while financial managers in general opine that profit maximisation should be the objective. It is believed that the primary goal of financial management is the maximisation of shareholder's wealth. Not only will this goal be in the best interest of the shareholders, but it will also provide the most benefits to society. This will come about as scarce resources are directed to their most productive use by business competing to create wealth. A business firm should also attach importance for its social responsibilities, business ethics etc., which is totally ignored in the profit maximisation goal of the firm. Today, the finance function is no more merely a support function. It has percolated into all aspects of corporate management and a business is made or lost through the finances. Managerial approach to finance evolved with the recognition of Corporate Finance as a distinct field of study at the turn of the 20th century. In the start of 20th century, the corporate finance was based on certain episodic events in the life cycle of the firm - formation, issuance of capital, major expansion, merger, reorganisation and liquidation. The approach, known as the Traditional Approach, was not analytical but descriptive and institutional in nature. In the middle of 1950s, the modern approach came into being. This approach led to an accelerated pace of development with the infusion of ideas from economic theory and application of quantitative techniques. Since the beginning of the modern phase many significant and seminal developments have occurred in the fields of capital budgeting, capital structure theory, efficient market theory, option pricing theory, agency theory, arbitrage pricing theory, valuation models, dividend policy,

Most of the successful companies are treating shareholder value maximisation as their primary goal. It is through effective corporate governance only that today many companies are doing something that was not the rule of thumb in their respective industries. They are restructuring their business operations to enhance shareholder wealth. For example, multinationals like IBM, Unilever etc., are laying off thousands of workers, closing offices and quitting non-core businesses to maximise their investors' wealth. To maximise shareholder value, companies are avoiding over investments, increasing dividend rates, utilizing assets, increasing mergers and acquisitions. These days most of the large business firms are linking a significant portion of executives' pay to the company's market stock price performance.

QUESTIONS

1. Discuss the major decision areas of Financial Management.
2. Is there any correlation between Financing decision and Dividend decision of a joint stock company.
3. What is Working capital? Discuss why it is important to manage.
4. State the objectives of finance function in detail.
5. What is agency problem? What solutions you offer to overcome this problem? Discuss.
6. What are the chief functions of a Finance Manager? Explain.

7. Explain the different approaches to finance function.
8. How financial management in Indian Public Sector is different? Discuss.
9. What are financial reforms in India? Comment on their performance.
10. What is corporate governance? Discuss its relevance for Indian firms.
11. What is Integrated Financial Management System (IFMS)? Why do we need it?
12. Discuss financial management in a small firm.

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Annexure I

CASE STUDY

ARCELORMITTAL'S STEEL PROJECTS IN INDIA

The ambitious plan of ArcelorMittal to invest more than USD 20 billion in two states of India has drawn lot of protest from local tribal communities facing eviction from their traditional lands. The two states, Jharkhand and Odissa, where ArcelorMittal is planning its multibillion dollar projects, are known for their tribal communities and resource rich lands. The minerals under the indigenous lands have been a curse for communities living a traditional life in these states.

ArcelorMittal has selected an area in the Khuti district of Jharkhand for its plant. The project needs around 11,000 acres of land, of which 8,800 acres is required to set up a 12 million tonne steel plant and 2,400 acres for establishing a township. The steel major has also been allocated iron ore mines and coal blocks. Jharkhand means 'forest country' and 27.8 per cent of the total population is indigenous, with 30 tribes and sub tribes in the state. Since its inception, this project has been the subject of local protests, as the huge tracts of land being acquired are the only source of livelihood for many families. A campaign was launched by an organisation opposing the land acquisition called Adivaasi, Moolvaasi, Astitva Raksha Manch (AMARM) in 2008. The campaign started with the distribution of approximately 15,000 pamphlets, which enumerated the details of the project and its future impacts on local people. According to the leader of the campaign, Ms Dayamani Barla, *"Farmers need food grains not steel"*. She also said that *"Pamphlets are being distributed to make people aware of the move of the state government and the state government should immediately stop land acquisition."* The people who have been protesting against the ArcelorMittal project in Jharkhand are resolute about not giving up their farmland and are not afraid to give up their lives to protect it. They have also threatened to intensify their agitation in case Mittal makes any forceful effort to acquire land. Their firm resistance has been met with death threats towards Ms Dayamani Barla, who is a well-known activist as well as a journalist and has been working on various issues concerning tribal communities in India.

The situation at other project site in the state of Orissa is not very different in terms of local opposition. Hundreds of tribals on May 26th 2008 staged a demonstration to protest the proposed steel plant in the Keonjhar district of Orissa. The protestors shouted slogans like "Go back Mittal", and "We will not give an inch of land for the plant", in front of a hall at the district headquarters during a meeting organised by ArcelorMittal. Orissa is predominantly an agricultural state where nearly seventy per cent of the working population depends on agriculture. The state has nearly forty percent of its population belonging to indigenous groups. According to the protestors they would lose more than 800 acres of agricultural land on which they are dependent. They argue that the plant should be set up on barren lands. Mr Muralidhar Sardar, president of the protest group Mittal Pratirodh Manch, said: *"We want better irrigation for our agricultural land, for our better livelihood. We do not want the Mittal steel plant, which would take away our land and thus our livelihood. We are ready to die but would not allow the plan on our land."*

Due to this growing public backlash, ArcelorMittal has started workshops for the first time in the Keonjhar district to convince the people about the benefits of the steel project. This is a tough task as the project would displace nearly 15,000 people in 17 villages in Patna Tehsil, a sub- district of Keonjhar. The approval allows the acquisition of 1,224 acres of land in the first phase. The second phase clearance is for another 1,624 acres, though the actual process is still to begin. ArcelorMittal has already deposited ` 4.03 crore with the industrial development corporation as a processing fee for Phase I land acquisition. The government is waiting for a detailed project report (DPR), which, sources in Mittal said, would be completed by June 2008. Even though ArcelorMittal claims to have "developed an ambitious R&R policy for Jharkhand and Orissa", the details of this have not been made available to even the project affected people. The company has been simultaneously saying that in principle it will not "displace people unless housing for resettlement will be provided". However, none of the settlements or housing has yet been constructed. On the contrary the company is trying to evade the key issue by organising hockey matches etc., as it continues to keep the details of the proposed project in the dark, claim villagers.

On one hand, the company boasts of its stakeholder partnerships, corporate social responsibility and transparency, while ignoring the demands of the local communities to know the reasons for losing their land and livelihoods. The state government, in an attempt to attract businesses, is also aiding companies like ArcelorMittal by allowing reports with unrepresentative data based on just one season and unfair representation of the local communities at the public hearings.

Local activists are feeling intimidated about raising their concerns against the land acquisition and Ms. Dayamani Barla, the tribal leader spearheading the anti-Mittal protests in Jharkhand claims to have received two death threats by phone in 2008, intimidating her with dire consequences if she did not withdraw from organising local people. She lodged a First Information Report (FIR) against the first threat in the Ranchi police station but no action was taken by the local administration, and after lodging the FIR she received a second threat. Local activists also wrote a letter dated July 7, 2008 to the ArcelorMittal headquarters in Luxembourg raising concerns about these threats and asking them to investigate. The protest reflects a larger stand-off between industry and farmers unwilling to surrender land in a country where twothirds of the population depends on agriculture for a living. The poor record of rehabilitation and resettlement in the past and suffering of people due to pollution has left many communities wary of these projects. The promise of jobs and infrastructure does not deter them from opposing these projects, as they have witnessed the plight of many communities who gave away their land in the hope of better lives but were left with neither resources, land, nor livelihood.

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Questions

1. Discuss the major problems faced by ArcelorMittal from the case.
2. List out the major solutions for the problems concerning project launched by ArcelorMittal in India and discuss in detail.
3. Had you been a Project Manager of ArcelorMittal how you would have initiated the projects in India? Discuss.
4. Discuss the major lessons you can learn from the ArcelorMittal case.

Annexure II

CASE STUDY

HINDUSTAN LEVER LIMITED (HLL)'S DIVIDEND STRATEGY

By its decision to issue Bonus Debentures, Hindustan Lever Limited has hit many targets with one master stroke of financial re-engineering. It has rewarded its shareholders for their steadfast support and altered its capital structure in favour of debt, a low cost option. The company's annual outgo on interest would be around ` 135 crore as against the ` 770 crore it paid by way of equity dividend in 2000. To boot, the interest is tax deductible. The debenture option has, thus, larded the company with largesse of every conceivable sort.

It is difficult to say if more companies will follow the HLL route. But the issue it raises is crucial. Lately, more and more Indian companies are becoming conservative in dividend payments. A study conducted by the Centre for Monitoring the Indian Economy — covering a sample of over 4,000 companies in the manufacturing sector — shows that the growth of dividend payment declined steeply from around 45.5 per cent in 1993-94 to 4.2 per cent in 1996-97. Many companies had to pay dividend of at least 13-15 per cent if only to match the interest rate paid on company fixed deposits, a decade or so back. The subsequent tapering off of dividend growth rate dovetails with the soft interest regime. Now, the companies can raise resources at lower interest rates. That explains many of these companies opting for debt.

But the payout ratio — dividend as a percentage of net profit — is inconclusive on this aspect. Again, the CMIE sample shows a mixed trend. The ratio that declined from 24.4 per cent in 1993-94 to 22 per cent in 1995-96 improved to 29.5 per cent in 1999-00. The age profile of the sample companies shows that for the companies incorporated before 1950, the ratio improved from 30.5 per cent in 1993-94 to 39.5 per cent but for those incorporated after 1991, it declined from 20.3 per cent to 19.3 per cent in the same period. Probably the latter set of companies felt the need to conserve resources for future growth and so adopted a conservative payout ratio. Most companies have also faced declining profit margins as borne out by the sample: operating profit margins declined from 12.5 per cent in 1993-94 to 10.8 per cent in 1999-00.

World over, interest rates have been on the decline and the Indian economy is aligning gradually with the trend. The Indian corporates expect the trend to strengthen in future. In that case it is no surprise that most of them would rather inch towards a higher gearing ratio to benefit from low interest outgo rather than carry out corporate slugfest to earn high profit margins to pay more dividend.

(***Source***: Follow the leader?, Editorial by S R Kasbekar, The Financial Express, October 13, 2001)

QUESTIONS

1. "By its decision to issue Bonus Debentures, Hindustan Lever Limited has hit many targets with one master stroke of financial re-engineering". Explain the statement. What targets Hindustan Lever Limited has achieved? And why this can be termed as a master stroke.
2. Discuss the relevance of Hindustan Lever Limited's Dividend Strategy for another Indian firms.
3. In your opinion why more and more Indian companies are becoming conservative in dividend payments? Discuss.