INDIA - FROM LICENSE RAJ TO LIBERALISATION

Dr. Guruprasad Murthy

Shri. Kedar Nijasure

A BRIMS PUBLICATION

DR VN BRIMS

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Dr. V.N. Bedekar Institute of Management Studies, Thane

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CHAIRMAN'S STATEMENT

I am happy to note that Dr. V. N. BRIMS Research Centre has brought out its monograph - ***License Raj to Liberalisation.*** The title speaks for itself. The sea change in our business environment since 1991 is perhaps unprecedented in Indian economic history since independence. There has been a paradigm shift, in approach to economic policies, which has touched the lives of one and all in our country. It has also affected the World at large since 1991. The country faced, in the words of Dr. Manmohan Singh, the then Finance Minister, an 'acute and deep' crisis. India's balance of payments was literally in the doldrums. Serious remedial measures were required. Following devaluation of the Indian rupee, several measures of a radical nature had to be initiated immediately. These measures presented, as mentioned earlier, a paradigm shift from a centrally planned economic system to a market driven environment which has changed mindsets all over the country. It is gratifying to note that Mr. Buddhadeb Bhattacharjee, Chief Minister of West Bengal has gone on record to say that "People of our states do not want bandhs and strikes. Still, the opposition parties are calling bandhs frequently. Bandh culture is bad and will send wrong signals about West Bengal to the World. The people of our state will not tolerate any bandhs and strikes." (Economic Times, 8th Jan, 2007).

This work by Dr. Guruprasad Murthy and Shri. Kedar Nijasure tries to capture several measures of reforms initiated since 1991 into a neat format for analysis. They have identified the economic dimension of business as a convenient point of departure. After presenting a corporate financial model in terms of total management excellence along with its component parts namely operating excellence (management of revenue, costs and capital) and financial excellence (managing interest, taxes and the proportion of different sources of finance), they have addressed several issues at the macro and micro levels. The perspective of this work is global and they have brought out various aspects of liberalisation, globalisation and privatisation and its impact on the economy. The monograph also presents financial statistics based on CMIE data which makes interesting reading and corroborates the happenings in and around business. Further they have provided excellent examples of paradigm shifts, in the Indian economy, which explore the entire gamut of factors that affected the landscape of the Indian economy inter-face all its global partners. Incisive case studies have been presented based on the annual reports of concerned companies like Infosys, Nicholas Piramal and others. In their chapter on Vision 2050 they have attempted a quantification of the nature, extent, direction and pace of change required to achieve the long desired objective of regaining our lost position as a super economic power of the World. History bears evidence that India is the cradle of civilisation. Further India was a major economic power in the past. History bears evidence to this too. According to an economic historian Angus Maddison (*The World Economy : A millennial Perspective)* India had the World's largest economy in the 1st century and 11th century, with a 32.9% share of World GDP in the 1st century and 28.9% in 1000 CE. In 1700, when most of India was ruled by the Mughal Empire, it had a 24.4% share of World GDP, the largest at the time, which fell drastically to 3.8% by 1952. Another estimate of India's pre-colonial economy puts the revenue of Akbar's Mughal empire in Circa 1600 at 17.5 million GBP, in contrast to the entire treasury of Great Britain in 1800, which totalled 16 million GBP.

India is once again awakening and the elephant is learning to dance. If it continues to dance, vision 2050 which is every Indian's dream, will become true. India will be a super economic power!!!

I hope this work receives due attention by all concerned with the Indian economy. Every citizen is concerned with it. I hope society at large will benefit from this publication. I wish the publication every success.

Dr. V. V. Bedekar
Chairman, Vidya Prasarak Mandal, Thane

FOREWORD

"If we command our wealth we will be rich."
"If the wealth command us we are poor indeed"

Edmund Burke

This monograph is an effort to trace the process of economic change that has occurred and continues to take place in India since June 1991. Dr Manmohan Singh the then Finance Minister had said "The crises in the economy is both acute and deep. We have not experienced anything similar in the history of independent India" (Finance Minister, Dr. Manmohan Singh on the floor of the House, presenting the Budget on July 24, 1991.)

In accordance with the rescue package, proposed by IMF/World Bank, a series of reforms were initiated viz monetary, fiscal, trade, exchange rate, licensing regulations, capital issues, entry to new players-local and foreign et.al. The journey since 1991 has had its own impact on every stakeholder all over the World. India Inc has been, particularly, on its tenterhooks ever since 1991. Over the said period of sixteen years there have been great strides and equally great shocks too. However India has emerged to be a World force to reckon with-from a country on the verge of total bankruptcy on the external account (May 1991) to a situation where we need to take account of our foreign currency assets in billions and not meagre millions. Today the issue is how to put our surfeit foreign currency assets to productive use. It is not without reason that in 2005 the Prime Minister **Dr. Manmohan Singh** said "Today, when I look back, I am even more convinced that I was correct to observe in my first Budget speech in 1991 that the idea of the emergence of India as a front-ranking economic power house of the world economy was an idea whose time has indeed come" (Prime Minister **Dr. Manmohan Singh's** speech at the World Economic Forum, November 2005.)

The change in tone and content of the words of Dr. Manmohan Singh and the different roles, (Finance Minister then and Prime Minister now), bear eloquent testimony to the arduous journey of India Inc and the country at large. This monograph is a small effort to track and trace the events, episodes and experiences of the Indian economy and responses of INDIA INC to the challenges of liberalisation, privatisation and globalisation. Never before has economic history of India been as dynamic, turbulent and volatile as it is today. Again, perhaps, never before has the revolution of rising expectations been as poised and provoked for a take off into the process of self sustained growth, to be the World's economic superpower, (2050) only to regain the lost prestige, power and position of India's – past — almost on all fronts including economic. This work is dedicated to all those who have played an important role in India's economic development since 1991

Measures Towards

Globalisation, Liberalisation and Privatisation

INDIAN ECONOMY- SINCE 1991.

TRAVAILS and TURBULENCE

- Devaluation
- Disinvestment
- Dismantling of Licensing Policies and Monopolies and Restrictive Trade Practices Act.
- Direct Investment by Foreigners (FDI)
- Direct Investment by NRIS
- De-reservation of Industries Reserved for Public Sector Undertakings to Private Enterprises
- Divestment of Quantitative Restrictions
- Decrease in Customs Tariffs coupled with liberalised imports
- Decrease in Income Tax Rates.
- Drastic Financial Reforms
- Declining Interest rates.
- Disclosures towards transparency, accountability, ethical practices, objectivity and information security to improve corporate governance.
- De-reservation of items reserved forsmall scale industries

and risen to the occasion and responded proactively and positively, by and large, to the exigencies of the 'acute and deep' situation that emerged in May 1991.

Dr. Guruprasad Murthy

Director Research,
Dr. V. N. BRIMS

Shri. Kedar Nijasure, Chartered Accountant
Lecturer, Dr. V.N. BRIMS

Vidya Prasarak Mandal, Thane

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- Challenges for Indian Multinational
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CONTENTS

"If the rich had spent their new wealth on their own enjoyments, the world would long ago have found such a regime intolerable. But like bees they saved and accumulated, not less to the advantage of the whole community... (they) were allowed to call the best part of the cake theirs and were theoretically free to consume it, on the tacit underlying condition that they consumed very little of it in practice. The duty of 'saving' became nine-tenths of virtue and the growth of the cake the object of true religion."

-JOHN MAYNARD KEYNES,
THE ECONOMIC CONSEQUENCES OF PEACE

SECTION 1 - INTRODUCTION

This Section addresses the following :

- Economic Dimension of Businesses
- Corporate Financial Objectives
- New Measures of Corporate Financial Performance
- Towards a Corporate Financial Model Measuring :
  - ✔ Operating Excellence
  - ✔ Financial Excellence
  - ✔ Total Management Excellence

Introduction

Every business has its first dimension an economic dimension. Enterprise, assesses its performance through a result – resource ratio or ratio of output – input. In economic terms, output refers to profit after interest and tax and input refers to the contribution made by the owners viz equity shareholders (equity share capital plus reserves and surplus also known as net worth) This ratio is known, all over the World, as return on equity (ROE) or return on net worth (RONW) which is a specific version of return on investment (ROI).

ROE is the returns from the owners perspective and is expressed either as a percentage or as a ratio commonly known as earnings per share (eps). The said ratio (ROE) indicates the productivity of every rupee invested by the equity shareholder or the financial worth of every equity share held by a shareholder. ROE or earnings per share is an universally accepted indicator of economic performance of enterprise from the view point of owners welfare. Top management are hired primarily to protect the investments made by shareholders and they (top management) are accountable to the board of directors. Ultimately the board of directors is accountable to the shareholders. Eventually, all actions taken by the business should maximize the owners wealth. In the ultimate analysis, the market value of the business has to be maximized on a continuous basis.

R.O.I in General Motors

Its Bearing on Organization

- It increase the morale of the organization by placing each operation on its own foundation, making it feel that it is a part of the corporation, assuming its own responsibility and contributing its share to the final result.

Its Bearing on Financial Control

- Develop statistics correctly reflecting the relation between the net return and the invested capital of each operating division-the true measure of efficiency-irrespective of the number of other divisions contributing thereto and the capital employed within such divisions.

Its Bearing on Strategic Investment

- It enable the corporation to direct the placing of additional capital where it will result in the greatest benefit to the corporation as a whole.

Source : Alfred P. Sloan, My Years with General Motors P 50.Co. Eds. J Mcdonald and C Stevens Doubleday Publications,2006, USA

Alternative Yardsticks

Over the years, alternative yardsticks of performance have emerged like economic value added, productivity per employee, ecologically sustainable return on investment, unit cost productivity, cash driven returns on investment – may be equity investment or even investment understood as total assets or capital employed. In fact research has shown that cash driven returns are more reliable than returns based on book profits. Hence the future measures of financial performance may hover around cash related measures rather than mere statistics based on accounting or book profits. Further, in future, multiple measures may emerge in lieu of the single measure concept.

Box 1

Objectives of Financial Management

We may define the objective of financial management as :

* continuous improvement in the result-resource ratio;

OR

* continuous maximization of the owners' wealth;

OR

* continuous maximization of the present value of owners' wealth;

OR

* continuous maximization of present value of return on owners' capital.

Box 2

Objectives of Financial Management

"What specific assets should an enterprise acquire ?"

→ "What total volume of funds should an enterprise commit ?" and

→ "How should the funds required be financed"

→ "An alternative way of stating the content of these three related questions is as follows ;

- How large should an enterprise be ?
- How fast should it grow ?
- In what form should it hold its assets ?
- What should be the composition of its liabilities ?"

Source : Ezra Solomon, The Theory of Financial Management,pp 8 – 9
Oxford University Press 1961

Net Present Value

The concept of 'present value of future benefits' will have to take into account the following facts :

*The owner is making a sacrifice of resources (C) today.

*The owner expects a benefit (B), per year, over future years (n years say)

The present value of future benefits can be given by the following expression :

$$\sum_{i=1}^{n} \frac{B i}{(1+k)^n}$$

where Bi = prospective yields expected over the economic life of a proposal at the end of each year ; and

K= discount rate used as the cut off point.

The final value to shareholders is given by the difference between the present value of future benefits and the initial commitment of capital (C). This difference is known, in financial parlance, as Net Present Value (NPV), which is expressed in financial terms as an absolute amount. NPV is a measure of performance used to evaluate the worthiness of investment proposals. Thus the explicit goal towards which financial management must be directed is continuous maximization of the present value of future benefits of shareholders' investment. Through this process the market value of the business can be maximized.

Shareholders Versus Stakeholders

Though the interests of shareholders and other stakeholders have to complement their mutual roles and positions, the interests of stakeholders inter-se tend to be at loggerheads. A reconciliation of the mutual interests of stakeholders is a challenge to management Hence, 'shareholders versus stakeholders'.

Box 3

The Saturn Story

In the mid-eighties, General Motors, the world's largest vehicle manufacturer, faced strong competition from foreign producers of small, efficient, reliable, and inexpensive cars. In response to this challenge, GM set up a separate company to build an entirely new car, the Saturn. The car was designed, produced, and sold according to the best practices available at the time. Workers were highly motivated, car dealers could not keep up with demand, and customers were extremely satisfied with their cars. According to these criteria, Saturn was an undeniable success story.

(Box 3 contd...)

Box 3 (contd.)

However, at the time of this writing, the project had not delivered the rise in value of GM's shares that management had hoped would occur. Why? The Saturn project has not created value because most observers think that it is unlikely ever to become profitable. From the project's inception until the mid-nineties, GM invested more than $6 billion to develop, manufacture and launch the Saturn. According to knowledgeable consultants, this amount is so large that, in order for GM to earn an acceptable return for its shareholders, "it would have to operate existing facilities at full capacity forever, earn more than double standard profit margins, and keep 40 percent of the dealers' sticker price as net cash flow."[1] How long should a firm fund a project that delights its customers, pleases its distributors, and satisfies its employees but fails to deliver value to its shareholders?

[1]*J.M.McTaggert, P.W.Kontes, and M.C.Mankins, The Value Imperative (The Free Press: 1994), 16.*

The important message from the Saturn Story is that projects, which continue to be a toll on shareholders wealth, will have to be examined for their continuation. Such projects will be abandoned sooner or later – preferably sooner to protect further erosion of shareholders wealth.

Depreciation

Depreciation, a non – cash expense, which is deducted from revenue to arrive at book profit is an enigmatic amount influenced by multiple factors viz tax and corporate laws as also other laws, method of depreciation, intentions of corporate financial policy , dividend policies, technological obsolescence et al.

An item which is the result of so many factors and could possibly be changed eventually, many times even post facto, is not a reliable and durable input. Hence the exclusion of depreciation stabilizes the statistic and also provides the cash flow picture of the enterprise. Many annual reports show depreciation adjustments and present slogans like "excess depreciation charged in the earlier years, no longer required and credited to reserves". It is an unwritten policy but known fact that such excess depreciation contributes to the creation of hidden or secret reserves.

Cash is King

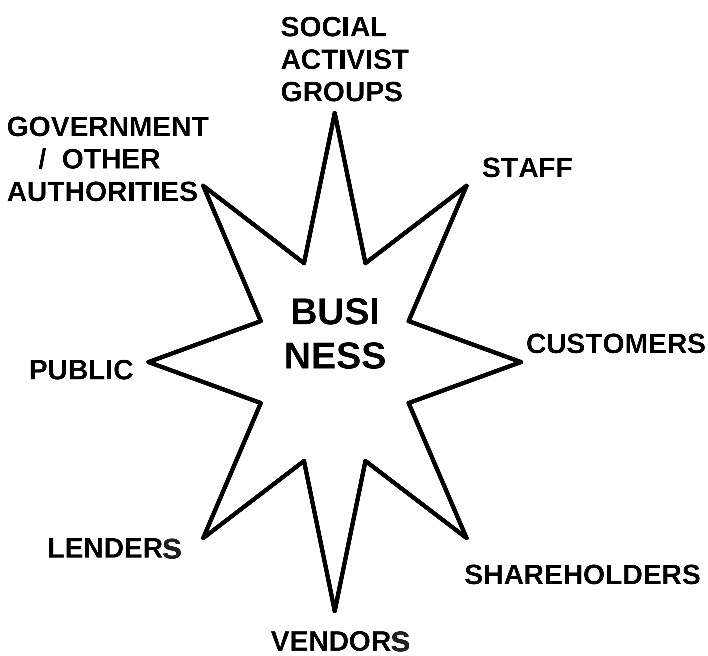
Box 4

There is a paradigm shift in thinking – cash flow measures are relatively more reliable than book profit measures and stock market prices of shares are also better correlated with the former rather than the latter. The view taken is that the firm's shareholders and debt holders have invested cash in the firm and thus their expectations are also in terms of cash returns.

Thus, as a convenient point of departure ROE, book profit basis and cash profit basis, can be a financial goal.

Financial Performance is not the ultimate or the only goal. At the outset is should be clear that while economic performance is a key factor which influences survival and prosperity of business, there are other aspects to the development of any enterprise. An enterprise is a social entity too and has to contribute to the organic growth of society through a variety of methods. Since, 1991, which is a watershed in India's socio-economic history, many paradigm shifts have taken place as shown in Table One. Enterprise has to position itself to capture the new paradigms in its fold and yet show results that satisfy all stakeholders. The interests of many stakeholders may be at loggerheads yet a right, neat and delicate balance has to be struck to achieve the end objective of maximizing the productivity of every rupee invested by the business.

STAKEHOLDERS OF BUSINESS



The corporate financial and other objectives are conditioned and constrained by the ‘ push ‘ and ‘ pull ‘ factors.

Box 5

On October 1, 1974, *The Wall Street Journal* published an editorial lamenting the prevalent focus on earnings per share as an indicator of value :

A lot of executives apparently believe that if they can figure out a way to boost reported earnings, their stock prices will go up even if the higher earnings do not represent any underlying economic change. In other words, the executives think they are smart and the market is dumb....

The market is smart. Apparently the dumb one is the corporate executive caught up in the earnings per share mystique.

Source : T Copeland, T.Koller and J Murrin, Valuation-Measuring and Managing the Value of Companies, John Wiley and Sons, INC, P 69

Box 6

As the Wall Street Journal asserts, the market is not fooled by cosmetic earnings increases; only earnings increases that are associated with improved long-term cash flow will increase share prices. Substantial evidence supports the view that the markets take a sophisticated approach to assessing accounting earnings. This evidence can be grouped into three classes :

- Evidence that accounting earnings are not very well corrected with share prices.
- Evidence that earnings window dressing does not improve share prices.
- Evidence that the market evaluates management decisions based on their expected long-term cash flow impact, not their short-term earnings impact.

Source : T Copeland, T.Koller and J Murrin, Valuation-Measuring and Managing the Value of Companies, John Wiley and Sons, INC, ' P 77 '

Measures of Performance

Post liberalization,the measures of performance, used to define corporate financial objective, have undergone sea changes. The first paradigm shift is from book-profit or accounting profit to cash flow measures. External forces particularly the market accept cash as a much more transparent, reliable and acceptable measure of performance. Similarly, other measures which are impartial, market driven, arbiter of performance have emerged.

Box 7

Maximizing ROE (%) or EPS or Cash Flow per share is a fine proposition. However, the ratios' numerator and denominator are both driven by internal records. While the credibility of these records may not always be doubted, yet measures based on internal records alone may suffer from limitations on account of bias, predetermined intent and natural limitations of computational processes. Hence, the emergence of a new set of measures, amongst others, viz

- Economic Value Added (EVA)
- Market Value added (MVA)

EVA Defined

➢ Excess profits of a firm after charging cost of capital. The quest for value where value is defined as the excess of operating excellence after adjusting for opportunity cost of resources employed to produce those results.

Why EVA ?

EVA is a Quantified Measure and it attends to as many stakeholders as possible viz :Lenders, Government,Share holders and Employees.

Box 8

EVA

"Until a business returns a profit that is greater than its cost of capital, it operates at a loss. Never mind that it pays taxes as if it had a genuine profit. The enterprise still returns less to the economy than it devours in resources.......... Until then it does not create wealth; it destroys it." PETER DRUCKER

As defined by Alfred Marshall : "EVA is a measure of economic profit and represents the wealth created by a firm after accounting for the cost of capital employed in business."

Box 9

Drivers of EVA – 4 M's.

EVA is driven by 4 MS viz Measurement, Management System, Motivation and Mindset

- **Measurement**

  EVA is a measure of total factor productivity

- **Management System**

  EVA is a holistic measure encompassing all segments of business and the drivers of those segments including planning, organizing and control

- **Motivation**

  EVA is an important driver of incentives, rewards, bonuses, compensation et al.

- **Mindset**

  It brings about a change in corporate culture and facilitates a system of internal corporate governance which motivates individuals and groups to develop a proactive mindset.

EVA, a name trademarked by Stern Stewart & Company.

=	The financial benefits accruing to a business out of the capital invested, viz., Net Operating Profit After Tax. (NOPAT)	LESS	The charge on capital i.e. (k_0 x c), where, k_0 = Cost of Capital & c = Capital Invested in Business i.e. Owners Funds plus Long Term Debt.

EVA Formula

EVA =	Net Operating Profit After Tax A		Capital Employed ... B X Weighted Average Cost of Capital... C
EVA = [	(A)	MINUS	(B X C)]

Search for Excellence – Some Inspiration

Peters and Waterman, the management gurus of the 1980s, identified basic practices which were characteristics of the superior performance companies they examined in their book ‘ Search for Excellence; Lesson’s from America’s Best Run Companies (Harper & Raw, 1982). They concluded :

“ We find among the excellent companies a few common attributes that unify them despite their different values. First...... these values are almost always stated in qualitative, rather than quantitative terms. When financial objectives are mentioned, they are almost always ambitious but never precise. Furthermore, financial and strategic objectives are never stated alone. They are always discussed in the context of other things the company expects to do well. The idea that profit is a natural by-product of doing something well, not an end in itself, is also almost universal”. With an even more telling observation Peters and Waterman condemned the obsession that some companies have with detailed financial objectives. In less well – performing companies they were familiar with: “ the only (objectives) that (management) got animated about were the ones that could be quantified – the financial objectives such as earnings per share and growth measures. Ironically, the companies that seemed the most focussed – those with the most quantified statements of mission, with the most financial targets – had done less well financially than those with broader, less precise, more qualitative statements of corporate purpose.”

Box 10

Measurement of profitability – another thought

“It has been argued that profitability is the primary aim and the best measure of efficiency in competitive business. However, profits as such are meaningless unless related to the equity (ordinary) shareholder’s investment in the business. The relationship between the capital invested in a business and the profits earned is the rate of return on capital employed. The ability to earn satisfactory rate of return on equity shareholder’s investment is the most important characteristic of the successful business.”

“Increased sales volume is at best a short term indication of successful growth, and, without additional information, must be viewed as such.”

“In the long run, increased sales volume may prove a deceptive guide post if there is not a proper return on the capital necessary to support these sales. Real growth comes from the ability of management to employ successfully additional capital at a satisfactory rate of return. This is the final criterion of the soundness and strength of a companies growth, for in a competitive economy capital gravitates towards the more profitable enterprises. The company that is merely expanding sales at a declining rate of return on capital employed will eventually be unable to attract expansion capital. Thus any measurement of a company’s effectiveness must be based on the successful employment of capital.”

Source: J.Sizer, An Insight into management accounting, Pelican (1975)

TABLE ONE

Paradigm Shifts Since 1991

Closed economy	To	Open economy
Controls	To	Liberalization
Inward looking	To	Outward looking
Nationalism	To	Internationalism (Globalization)
Socialism	To	Progressive resort to market
Planning by direction	To	Planning by inducement
High interest rate regime	To	Lower and lower interest rates
Labour driven environment	To	Management driven
Labour driven operations	To	Information Technology driven
Self sufficiency within enterprise	To	Net working and outsourcing
Sellers market	To	Buyers market
Controlled prices	To	Market driven prices
Data bases	To	Information and knowledge society
Highest tax nation	To	Moderately taxed nation
Tax avoidance	To	Tax compliance
Profit = Revenue – Cost (Sellers market)	To	Cost = Revenue – Profit (Buyers market)
Small scale concept	To	Size driven by economies of scale
Balance of payments deficit	To	Balance of payments surplus
Middle aged nation	To	Young nation
Mere Kaizen	To	Business Process Re-engineering
Commercial ROI	To	Ecologically sustainable ROI
Male driven society	To	Women empowerment
Quantitative indices for economic development	To	Qualitative indices for economic development
Politics of single party rule	To	Coalition Governments
Poor productivity	To	Improved productivity
Closed skies policy	To	Open skies policy

“ Perfection is the Objective

Excellence will be Tolerated ”

Lufthansa Cargo – Mission Statement

SECTION 2

Operating Excellence - Return on Capital Employed (ROCE)

This section addresses the following :

- Revenue Management – Managing Price, Volume and Mix
- Appreciating INR
- Towards Perfect Competition
- Liberalization and New Players
- Cost Management
- Paradigm Shifts in Cost Management

From amongst the different measures an operational corporate financial objective is return on equity (ROE) also known as return on shareholders equity (ROSE) or return on net worth (RONW). A corporate financial model shown as Exhibit Two, in the glossary, is used throughout this monograph.

ROE Again

Box 11

> ROE – result of overall organizational efforts — operating excellence and excellence with respect to financial management equals total excellence in management

ROE is a result of the efforts put in by all segments and employees of a business. It includes marketing staff for revenue, line management across the global network of a business for inputs (costs) and of course the resources, as well as mix of resources,invested by the business as part of asset formation.

Given that there are three inputs in the ratio of (profits divided by investment), there are then only three ways of improving financial performance viz. improved revenue, reduced costs (input costs and cost of capital) and effective and efficient management of investments. Mathematically, the options can be expressed as reduction in investment or disinvestment .However, while disinvestment (divestment) is an useful management strategy, managing investments profitably helps to sustain ROI. Nevertheless, divestment is part and parcel of business strategy to improve economic performance of any business.

Ways of Improving Enterprise Performance

Sales	→ Volume
	→ Price per unit
	→ Best possible currency mix
Costs	→ Fixed Costs
	→ Variable Costs
	→ Cost per unit or Unit Cost Productivity
	→ Cost of Capital
Investments	→ Manage Investments Effectively and Efficiently

This version of three ways of improving financial performance, truism as it sounds, is universally valid – at macro and micro levels of business. Paradigm shifts in economic management may alter the statistic used to assay performance. However, universally the options to improve financial productivity, to reiterate, hover around the three factors just cited.

Revenue Management

Revenue is an important stream of inflows. It is a product of volume of sales (units) and the selling price per unit. Revenues earned may also come from different countries and hence a currency mix emerges – revenues as a basket of currency. In India, in the past foreign currencies in the revenue mix was a great relief because it supported the external account which was in bad shape – continuous balance of payments problems year on year basis. Table Two alongside showing RBI's foreign currency assets from 1991 to March 2006 speaks for itself about the surfeit of foreign exchange balances of India, in the post 1991 period.

TABLE TWO

RBI's Foreign Currency Assets

Year Ending March	*Foreign Currency Assets (USD Mn)*	*% Increase over previous year*	*Index 1991 = 100*
1991-92	5,631	-	100
1992-93	6,434	14.2	114.2
1993-94	15,068	13.41	267.5
1994-95	20,809	38.1	369.5
1995-96	17,044	18	302.6
1996-97	22,367	31.2	397.2
1997-98	25,975	16.1	461.2
1998-99	29,522	13.6	524.2
1999-00	35,058	18.7	622.5
2000-01	39,554	12.7	702.4
2001-02	51,049	29	906.5
2002-03	71,890	40.8	1276.6
2003-04	107,448	49.4	1908.15
2004-05	135,571	26.1	2407.5
2005-06	145,108	7	2576.82
2006 (Dec.)	**178,000**		
2007 (Feb)	180,000		

N.B. In March 2007, the RBI's foreign currency assets was199.2 billion USD.

Appreciating INR

Today India enjoys an appreciating rupee. Our external account is swelling with reserves and is surging ahead . While a strong currency is a healthy sign, it has its own woes. Corporates which are into exports would be earning revenues in a currency which is not as strong as the INR and hence the adverse economic impact on the bottom line. However, these export oriented businesses spend in rupees which is appreciating. Thus earning in a relatively weak currency (USD) and spending in a relatively strong currency (INR) means that the bottom line of the business is adversely affected.

Box 12

> There is a paradigm shift in the approach to revenue management from a search for avenues to improve the hard currency content to protecting the bottom line against the loss of revenue due to falling value of other currencies – say USD in the immediate context. In June 1991 1 USD = Rs.17.94. Today (2.2.07) ' 1 ' USD = Rs. 44.1 The highest rate in recent times was 1 $ = Rs.48.80 (March 2002)

Companies in the Information Technology (I.T.) Sector and many other sectors having a high export content need to protect their bottom lines through various forex management tools and techniques. They are trying to insulate themselves against the adverse and volatile fluctuations in currency movements – particularly the USD against which the INR is gaining ground continuously. Continuous appreciation of the INR since 2001 has resulted in lower export realisations thus making it necessary for more sales dollars to meet original targets.

While the I.T. Sector is relatively fortunate because of a high profit margin on account of better yield and relatively less outgo on account of imports (expense), the manufacturing sector is not so fortunate. The manufacturing sector's import content is relatively higher. Hence, and otherwise, profit margins are once again, relatively low. The appreciating INR is helpful because less payment need to be made for imports. The distortion to the bottom line is relatively less. India Inc. is enjoying the virtuous circle of an appreciating INR, because IT sector is export prone and manufacturing sector is import prone (raw materials).

Earlier the exporters delayed the remittance of USD earnings. This was motivated on account of a depreciating INR and a potential gain on account of exchange rate. Thus, dollars delayed created short supply which enhanced the value of the USD till March 2002. Subsequently and even today since INR is appreciating enterprise is hastening dollar inflows, which has increased the supply of USD and pushed up, this time, the value of INR. It was then a vicious circle (prior to 2002).

Box 13

This is a paradigm shift, again in revenue management driven by a progressive movement from balance of payments deficit to a robust swelling external account, since 1991.In fact continuous appreciation of a country's currency creates complications concerning corporate's revenue targets.

Box 14

IMPACT OF THE APPRECIATION IN INR

The continuous appreciation of the Indian rupee vis-a-vis the U.S. Dollar has put substantial strains on the revenue budget of export oriented companies. Information Technology (IT) Companies and companies like TCS encounter this problem. Thus, even excellent performance in sales does not dazzle. It just looks good. For instance, though the total sales of Infosys for the quarter ended 31 st December 2006 looked very good,the final impact was not as good. For the full year, Infosys has also revised, marginally upwards, its projected topline growth to over 46% (about Rs. 13,919 crore). EPS growth for the full year is expected to be 48 % at Rs. 66.63. According to Company's CFO "Despite the rupee appreciation by 200 basis points, we maintain our margins. For the outlook, we have taken the value of the rupee at 1 USD = Rs. 44.11 and we continue to hedge proactively."

Most IT companies are affected by the falling U.S. Dollar vis-a-vis INR. To offset the same they look for better revenue productivity, increased license revenues and reduced overheads. Export oriented companies in the services sector like ***Satyam, Wipro, TCS*** all suffer on account of the appreciating INR. A substantial amount of revenue of TCS comes from export earnings and quite a bit of the same comes from U.S.A. and Canada. The thumb rule here is that a 1 per cent increase in the value of the rupee against the dollar has a 50 basis point impact on the operating margins of software companies.

" Exporters generally want the rupee to remain above 45. The problem will be if the rupee keeps on appreciating". Federation of Indian Export Organisations Director General Ajay Sahai.

" Unlike India, China has controlled its currency and is not allowing it to go up. As an exporter it is always difficult if the value of the domestic currency appreciates. If it is not checked it will impact economic growth". Vardhman Group, Chairman SP Oswal.

Source : Economic Times, 22nd March, 2007, New Item : "Rupee Surge to hurt more in the future"

Revenue Management – Pricing and Volume

India is a country with a huge population – a mass middle-class market. However, these markets have to be nurtured and cultivated. Markets can emerge only when there is an effective demand i.e. want backed up by purchasing power . Prior to 1991, the Indian economy was essentially a controlled market with the license raj in action. Enterprise enjoyed a local market, which was fully sheltered from outside through tariffs and quotas and controlled from inside through regulations which monitored the selling price, sales volume and production mixes. Controls existed in all markets – factor, output as well as financial – capital and money, markets. Entrepreneurs got used to profit levels and quantums under inefficient conditions of business operations. There was one and only one theme : given the farrago of laws and controls and all other rules of the game how to maximize profits. People developed a special skill to manage and even manipulate their moves to be within the four walls of law and yet make the most by flouting as many laws as possible. The Industrial Development and Regulation Act laid down restrictions on the maximum units to be produced through licensed capacities. Yet companies sold more than the production capacities Corporates used their legal acumen to identify that the law only restricted production volumes – not sales volumes. This was a fine distinction between being within the law (produce only what is permitted) and selling beyond production — outside the law if home production exceed limits and within the law if, through outsourcing, sales exceeded production. Yet the spirit of controls was to prevent a monopoly, duopoly or oligopoly in factor market as well as output market. In fact, controls were distorted by violating the letter of the law and truncating the spirit of the law. The license raj encouraged development of talent in a perverted direction and professionals developed skills in avoiding the rigours of law that is to say the art of dodging the spirit and letter of law without breaking the law.

The theme of managing revenue was therefore driven by revenue maximization objective in a controlled, regimented, regulated, license driven environment. There has been a traumatic change now – decontrols, dismantling of the monopolies and restrictive trade practices, industrial development and regulation act, foreign exchange regulation act, and many other business related legislations.

The field was suddenly open to local players, who had to compete with each other, and also open to foreign players. Suddenly the rules of business underwent a radical change to the chagrin of local entrepreneurs at that stage (1991). Enterprise literally were taken by surprise and also grouped themselves to seek level playing fields as mentioned in Box 15.

Box 15

Removing the regulatory fetters wasn't easy. The government's liberalization policies faced stiff resistance from the domestic industry, which got used to the license permit-raj. The famed ' Bombay Club' which represented the old guard, was led by none less than the fiercely vocal Rahul Bajaj, whose two-wheeler company sold scooters that had a 10-year waiting period. While Bajaj vehemently refutes any dealings with the Bombay Club, he does not shy away from his argument. "What were the liberalizers doing till 1991? Although the Prime Minister is at heart a liberalizer, surely, there was no sign of this till 1991".

Source : Business Today, 15th Anniversary Issue, January, 2007 , p:64

Towards Perfect Competition - Survive or Perish

The year 1991 saw the launch of change in nature, content and direction of approaches to economic management. The list of reforms, by no means exhaustive, is presented in Box 16. The reforms covered, as can be seen, changes in fiscal, monetary, trade policies and also exchange rate management.

The theme was compete successfully or perish in the course of business because of the invasive nature of market forces and the muscle power of new alien entrants. From small number of producers suddenly the el dorado of competition , nay perfect competition, became a potential reality. The grouse that assymetry of information creates market discrimination does not hold water any more. The electronic media revolution has made perfect competition a reality. Thus, an almost equilitarian culture emerged in the market place which is no longer spread at different locations. On the contrary there is a paradigm shift because the virtual market place has emerged for the buyer and seller with virtual banking acting as the modern day funding intermediary.

There was a paradigm shift from a sheltered protected market to a market driven by competition and market forces allowing only the fittest to survive. The theory of continuous entry and exodus of firms – inefficient firms withdrawing and efficient firms entering and surviving became a way of life.Several examples can be cited as shown in Box 20.

Thus, revenue management was suddenly a function of costs , competitiveness, effective product differentiation, appropriate choice and use of technology and timely moves — preferably pre-emptive moves. From managing laws and licensing limits governing business, enterprise had to shift abruptly, and rather sharply, to business management in the real sense.

Box 16

List of Reforms - 1991

- Capital Licensing of Industries was discontinued.
- Legislative restrictions on expansion were removed.
- Reservation of Industries for public sector was discontinued.
- Import restrictions on import of foreign technology was withdrawn.
- Industries reserved for small scale sector were opened up.
- The numbers of reserve industries scale down from 836 to 326 in 1991.

  SEBI was formed as the regulator of activities in the capital market.
- The financial sector opened up the Insurance sector to limited foreign ownership. The monopoly of the public sector was dismantled in favour of oligopoly. This was to give way to competition.
- The Telecom and Insurance regulatory authority of India were formed.
- Custom duties were brought down an average of more than 100% in 91 too substantially lower levels.
- State level taxes were replaced or transformed to VAT-Value Added Tax. This has facilitated the collection process in the state tax system and also contributed to simplification, rationalization and reasonable uniformity.
- Tariff rates have been reduced from peaks of 400% to 12.5%
- Since 1991 the personal income tax and corporate tax rates have gradually been brought down to 30 per cent, along with considerable simplification. A great change since the times when India was labelled as the highest taxed nation with maximum marginal tax rates being abnormally and atrociously high.
- Fiscal Responsibility and Budget Management Act (FRBM) of 2004, enjoined the government to eliminate its revenue deficit. Fiscal deficit is to be contained to 3% of GDP.
- Introduction of service tax in 1993-1994.

Box 17

- As a result of the reforms initiated in 1991 erstwhile legislation suddenly assumed a historical status viz. *Industrial Development and Regulation Act* and *Foreign Exchange Regulation Act.* While FERA became *Foreign Exchange Management Act. The Monopolies and Restrictive Trade Practices Act* was re-christened as *Restrictive* and *Unfair Trade Practices Act.* Further the capital issue control order was rendered defunct.

Box 18

"The obsolete system of capacity licensing of industries was discontinued; the existing legislative restrictions on the expansion of large companies were removed; phased manufacturing programmes were terminated; and the reservation of many basic industries for investment only by the public sector was removed. Restrictions that existed on the import of foreign technology were withdrawn and a new regime welcoming foreign direct investment, hitherto discouraged with limits on foreign ownership, was introduced."

Source : Address by Dr. Rakesh Mohan, Deputy Governor, Reserve Bank of India at a Public Seminar by Institute of South Asia Studies in Singapore on November 10, 2006.

Box 19

New Legislations Since 1991

- The Public Liability Insurance Act, 1991
- The Securitisation and Reconstruction of financial assets and Financial Assets and Enforcement of Security Interest Act, 2002.
- Special Economic Zones Act, 2005
- The Right to Information Act, 2005
- National Rural Employment Guarantee Act, 2006

Liberalisation and New Players

Box 20

⇨ **1991 and LATER**

Branded Shirts market was dominated by Kapitan of Bombay Dyeing, Stanrose of Mafatlals, Double Bull and Christian Dior. Thereafter foreign brands like Indigo Nation, Louis Phillip, Peter England, Scullers(T-Shirts), Benetton and others have captured the market especially amongst the affluent class.

⇨ Shaving Blades market was divided between Topaz , 7 O'clock, Gillette, Wilkinson, Erasmic and others. After liberalisation improved products like Twin-Blades of Gillette and Electric shaver of Phillips replaced ordinary shaving blades market. Erasmic and Wilkinson have become almost extinct.

Box 20 cont....

Box 20 (contd.)

- Two wheelers market was confined to Vespa of Bajaj and Lambretta of Automobile Products of India. Motor bike market was restricted to Bullet of Royal Enfield and Rajdoot of Escorts. Bajaj Auto lost its top position to Hero-Honda in Scooters and Bikes market(in 2005) and products are now available off the shelf. Number of models made available every year has also increased due to competition.
- In 1993, the refrigerator market belonged to three brands-Godrej, Kelvinator, and Voltas-which among them held more than 90 percent of the market share. By the end of 1994 and early 1995 their combined market share had eroded to less than 70 per cent with the advent of the newcomers- Videocon, Whirpool and BPL.
- In the 1980's the colour TV market was dominated by brands such as Weston, Nelco, (Blue Diamond), Uptron, and Bush. By 1994 and 1995, most of these had been replaced by new brands like Videocon, BPL, Onida, and Philips. Other global brands like Sony, Akai, and Goldstar had already started making inroads.
- In the civil aviation sector the open-sky policy announced in 1991 created routes for eroding the monopoly of Indian Airlines and Vayudoot. By March 1994, the big five private air-taxi operators (East West, Jet, Damania, Modiluft and Sahara) had captured 27 per cent of the market. On trunk routes, their share accounted for 44 per cent of the traffic. Today there are newer airlines like Kingfisher, Go Air, Spice Jet, Deccan Air. Some of the airlines mentioned earlier like East-West, Damania and Modiluft are out of the airline business.

Enterprise had to evolve new ways and means to manage the top line (revenue)and bottom line (profits after tax) with the middle line (costs) acting as the key link.

Box 21

There was a paradigm shift in the equations governing business from **profit equals revenue minus cost to cost equals revenue minus profit.** Role of management accounting underwent a major shift in providing inputs that helped and guided timely and prudent management decision making, in the context of the new equation in which cost became the key factor.

Box 22

Target Costing : HLL Paradigm

SALES = COST + EXPECTED PROFIT

PROFIT = SALES – COST

COST = SALES – PROFIT

Consumer Led **Our Ambition**

Source: Dr.Guruprasad Murthy and S.R.Kale, Role of Management Accounting, pp 30, Himalaya Publishers, 2002 (Presentation made by Shri.D.Sundaram in 2001 p 30)

Cost Management

COST management acquired utmost importance to sustain the new wave of competition . Indian producers were used to high cost production, sellers market margins and resultant super normal profits. Now, there were new signposts viz buyers market, variety of products , number of producers and sellers, cost conscious new entrants and market as the arbiter of economic activity. The electronic global village became the rendez vous for one and all. Again and again enterprise efforts to seek level playing fields and crutches from the Government failed and Indian business had to accept the new order of the day i.e. a paradigm shift from conditions of closed market to an open market with free flow of trade and commerce through competition. Thus revenue management depended upon a competitive price and profit per unit was driven by unit cost productivity. Hence, a paradigm shift took place in the algebraic relations with the three factors amongst themselves viz revenue, cost and profit, as shown in Box 22.And quantum of profits was dependent on mass volume of sales. All the three parameters had to be built in afresh into Indian business, And business itself was moving in a totally new direction with changes from all quarters being announced and initiated by players from different parts of the World at an unprecedented pace, perhaps unprecedented in the business history of our country.

The options open to business in the normal course are ‘ high margin – low volume’ or ‘ low margin – high volume. Competition literally destroyed the sellers market syndrome and the protected margins as well as amount of profits. Consumer goods, consumer durables and other products experienced the heat of competition. Of course, within the competitive market there are exclusive products positioned to skim the cream i.e. high margin and rather restricted volume.

Box 23

Louis Vuitton (LV) which is in the business of making expensive watches priced at Rs. 1 crore per piece and other products like travel accessories and ready-to-wear line has a policy regarding pricing. According to the authorities of the company "Our prices remain constant as we want our customers to feel they've paid the right price for the product. To put the same product on sale would be shortchanging them." When there are unsold products (travel accessories and ready-to-wear line)the company prefers to burn them rather than offering them at a discounted price. However, in niche market for watches which cost Rs. 1 crore a piece the company is very careful about quality. Taking about eight months to manufacture, it comes with a five-year guarantee. But the more astonishing aspect is – whether you want it in gold or platinum, studded with diamond or rubies, with your initials engraved or your family crest – the price remains the same!. Since 2004 the company has sold only 40 watches.

Source : The Bombay Times, 23rd Feb. News Item **' We burn our unsold products!'** *pp 01*

Box 24

The new rules of business, display a great learning experience to operate with strange multi-cultural and multi-racial bedfellows with symbiotic alliances in the factor market, bitter business battles in the output market and hectic competition in financial markets. The rules of the game have changed so much and so fast that there is turbulence and chaos arising out of the actions and interactions of friends and foes who are all the same. It's as if that in a football match while the game is on, the size of ground could change, players could exchange sides, umpires could change rules, goal posts could be shifted, duration of the match can be altered after the game has started and the ground itself could be in motion while the game is being played.

SOURCE :Dr.Guruprasad Murthy Dr . V.N.Bedekar Memorial Research Volume p 70, 2006.

The new rules of business was resisted by many. However, there were enterprises which did adapt, adjust and adopt learning and venturing as a key management tool. Mahindra and Mahindra (M & M) once known for tractors and jeeps had to venture into businesses functionally unrelated to their core competence. Today M & M are in hotels and real estate too. Similarly, Reliance a textile giant, once upon a time, diversified into telecom and oil exploration. Many other players like MESCO, Atul Products, Kedia Group, Shakti Group not to say about Tatas, Birlas, RPG, ITC, WIPRO and Larsen and Toubro, ventured into new vistas heralded by the post 1991 liberalization measures.

Box 25

Zero Based Budgeting — Modus operandi

Budget Requesting Unit with Relevant
Responsibility and Commensurate Authority.

TO MAKE

- Budget Requests
- Status Quo Requests
- Status quo plus Higher, New Budget Request
- De Novo Budget Requests

TO SCREEN

Budget Requests' Screening and Processing
(Cost- Benefit Analysis and related tech- niques to evolve
yardsticks for assessing economic worthiness of budget requests)

TO RANK

Budget Requests ranking Process

N.B. : ZBB had to be applied vehemently to accommodate and absorb the impact of paradigm shifts. Every event – new rules, products, ideas, meant a shift to a zero base. Business had to begin ab initio.

COST AS A KEY FACTOR

Cost became the key factor to influence the survival, growth and prosperity of business. Unit cost productivity acquired great importance and all the hitherto neglected cost management approaches had to be brought to the fore. Yet, our history on cost management is unique, perhaps unparalled in the World. India was the first country in the World to make cost audit compulsory through the provisions inserted in the Companies Act, in 1965.

Box 26

COST AUDIT – COMPULSORY SINCE 1965, A supporting, instrument was necessary "to strengthen the provisions relating to investigation into affairs of companies and to provide for more effective audit in dealing with cases of dishonesty and fraud in the corporate sector". (Daftry Shastry Committee)

Box 27

<u>As per Companies Act Section 233B</u> : "where in the opinion of the Central Government it is necessary so to do in relation to any company required under clause (d) of sub-section (1) of section 209 to include in its books of account the particulars referred to therein, the Central Government may, by order, direct that an audit of cost accounts of the company shall be conducted in such manner as may be specified in the order by an auditor".

Thus, cost audit was very much available as a mandatory tool. However, its presence was rather perfunctory to be used only to meet prescribed regulations. The spirit underlying legislation governing cost audit was grossly obliterated. However, some companies did practice cost control and cost reduction. Even the Government of Maharashtra initiated, under the stewardship of late Dr.S.Jichkar, the concept of zero base budgeting.(ZBB) The idea was to bring about a change in mindset – greater and better mindsets for greater and better productivity and therefore greater economic performance. ZBB was used by corporates too.

However, the efforts were sporadic in a few islands of excellence which were dedicated to the cause of professional management. By and large the customer had no choice but to bear the brunt of cost escalations of business There was no motivation to either employ professional management methods or seek specific gains through improved cost productivity or pass on value added features to the customer either through product or price. It was seller is king in lieu of the current thought that customer is king.

`The paradigm shift from seller to customer as the focal point is a powerful change transmitting many compulsory lessons to business – India in particular and the World at large in general

The implications of the shift in this regard is presented in Chart 1.

Chart 1

Over the past 25 years or so, management accounting has undergone substantial changes in concepts, application methodologies and various other paradigms. With market boundaries no more existing business going global, management. The latter part of the 20th century witnessed the emergence of number of cost management techniques that enabled cost management to be perceived from a totally different perspective i.e. how to manage costs strategically to sustain competition. The chart below tries to look into some major shifts in this vital management function.

Paradigm shift in cost management

Areas	Old paradigm	New paradigm
Foucs	Seller's market driven cost	Buyer's market driven cost
Sphere	Local	Global
Cost shift	Cost + profit = price	Cost = price - profit
Approach	Cost control	Cost management
Perspective	Internal cost control	Strategic cost management
Orientation	Industry specific	Multipurpose
Functioning	Manual	IT driven

COURTESY : Shri. R.S. Verma, Lecturer, Dr. V. N. BRIMS

Box 29

- Chaparral Steel company (USA), founded in 1973, has become a global productivity leader in the intensely competitive steel industry. Employing over thousand people, company manufactures steel products for, among others, the construction, automobile and defense industry.

  As an example of the benchmark position, Chaparral uses 1.3 hours of labour to make one tonne of rolled steel whilst best comparable plants in the US, Europe and Japan average well over five hours. And, according to a case study in the Work in America, the company is an integrated learning organisation, one of the world's lowest cost steel producers and a best practice benchmark for employee participation in Human Resource sub-systems viz employee involvement and team-based activities, labour management partnership, integration of technology and social systems, communication and information sharing.

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Cost Specifics – Variable and FixedCosts

Costs encountered by business are of two types - variable and fixed. The former are driven by volume unlike the latter which are independent of volume for a given time period. In the sellers market environment, huge levels of fixed costs could be justified because, as mentioned earlier, customer bore the brunt of internal inefficiencies of the firm. Further because, of labor legislation and judicial decisions being pro-labour, wages became sticky in the download direction. The philosophy of socialism and egalitarianism supported the revolution of rising expectations, which included improved conditions of work and monetary quid pro quo sans productivity improvements. Today, courts are of the view that any kind of misconduct or indiscipline is to be viewed seriously. This was preposterous but true. The result was a high cost private sector which looked efficient only vis-a-vis the white elephants in the public sector. 'UNIT COST' was high both in the public and private sectors. The efficiency (rather inefficiency) was only a question of degree. Production volumes of Indian companies were and are rather pygmy by global standards. In the late eighties the so called giants at home were grossly incomparable to foreign production volume scenario.

The post 1991 scenario has seen changes. Box 30 shows global capacities of a few Indian Companies.

Box 30

Global Capacities of some Indian Companies

- ✔ KEC International, an RPG Group company, is the world's second largest producer of transmission towers.
- ✔ The Aditya Birla Group is the world's largest producer of rayon fibre, and the second largest producer of palm oil
- ✔ Bajaj auto is the third largest two-wheeler producer in the world
- ✔ Arvind Mills is the fifth largest producer of denim in the world
- ✔ Lupin Laboratories is the world leader in the anti-TB drug, ethambutol, with 70 percent share in the world market
- ✔ Hero Cycles is the world's largest producer of bicycle
- ✔ Raymond Mills is the fifth largest manufacturer of worsted suiting
- ✔ Nirma is the world's largest producer of detergents
- ✔ Nicholas Piramal is the World's largest producer of bottles used to store finished pharmaceuticol.

Source : Madhukar Shukla Competing through Knowledge-Building a Learning Organisation, 1997, pp 43

Mahindra and Mahindra increased its production levels by 50 % to 60,000 tractors per annum. Mukand Iron and Steel increased its production from 450 to 2500 tonnes per annum that is to say by a whopping five and half times. Now, with Laxmi Mittal's Arcelor and Tata's Corus deal the situation in the steel industry is different.

However such increases in production are required across the entire network of business and that too on a continuous basis. Box 31 presents the profile of automobile production on a global basis. The unit cost productivity of General Motors vis-a-vis Suzuki Maruti is a question of imagination. Even if we concede that in mega enterprises of the US like Walmart, General Motors, IBM and General Electric dis-economies of scale creep in. Suzuki Maruti at 21 Lakhs units per annum (world producation) is rather low to reap economics of scale that can provide a competitive edge in global markets. Indian businesses have to improve the 'size factor' to approach optimal levels and gain the edge on account of unit cost productivity, as soon as possible.

➢ Country wise Global Car Production Report Volume-2005

Box 31

Country	2005 (Figures in Lakhs)
US	115
Japan	100
Germany	55
China	51
South Korea	37
France	35
Spain	27
Canada	26
Brazil	24
UK	18
Mexico	16
India	14
Russia	13
Thailand	11
Italy	10

➢ Company wise Car Production : Top 15 in the World

Box 32

Cars	2005 (Figures in Lakhs)
GM	90
Toyota	71
Ford	64
Volkswagen	52
Daimler Crysler	43
PSA Peugeot Citroen	34
Honda	34
Nissan	34
Hyundai Kia	29
Renault-Dacia-Samsung	26
Suzuki-Maruti	21
Fiat	19
Mitsubishi	13
BMW	13
Mazda	13

PROJECT MANAGEMENT - Pre 1991

The asset base of the country increased in size but not in terms of utilization towards improved output. Liberal banking facilities both commercial and development added fuel to the fire. Cheap loans from the 'parallel purse' of the exchequer viz. the IDBI, IFCI and State Financial Corporations resulted in acquisition of assets. However, monies were sunk in projects with long gestation period, whose importance was neutralized as the immediacy of the project was nullified and end results which fructified came in rather late and lost their value addition potential. Technological advancements also created hurdles for projects completed after a long gestation period. Obsolescence invaded the projects which were commissioned after several years of gestation. Time was and is of essence in the developmental process – macro as well as micro levels.

Box 33

> The time and cost overruns of projects in the public and private sectors, stemming from managerial inefficiencies and administrative delays,was a big toll on the Indian economy and acted as a drag on the country's then exiguous resources.

Our inefficiencies within the system due to sellers market conditions affected our propensity to make a dent into export markets – notwithstanding several export incentives including those specified in the provisions of the Income Tax Act 1961, from time to time.

In the post 1991 scenario the motivation to manage costs effectively and efficiently has emerged out of literal helplessness – compete and survive or perish. Thus, today Indian industry, as mentioned earlier is walking the talk on budgets, benchmarking, standards, standard costs, productivity measures particularly unit cost productivity, quality, kaizen, business process re-engineering, E commerce, technology driven systems and procedures, cost- benefit analysis, appropriate cost classification schemes, human resources productivity and a variety of other tools, techniques and tested methods limited only by the genius of business.

The paradigm shift in approaches to cost management (pre 1991 versus post 1991) bear eloquent testimony to the pull and push effects of competition as well as market driven and imposed compulsions. The appropriate levels of manpower became an important matter and painful experiences of downsizing went into action. However, public sector units have, by and large, refrained from downsizing as a policy measure to contain costs. Yet, the writing is on the wall. For the first time recruitment drives were geared to meet productivity norms and human resource levels were flexible in either direction. A great achievement indeed. Similarly, through value analysis in different segments of business, productivity was monitored to yield the best possible result-resource ration. The top line was driven by ambitions of market share. However, competition dictated the ultimate volume accruing to enterprise. The bottom line represents the ambition of management manifest in the form of periodic targets. Hence, it was the middle line, that is to say the costs, which had to be closely watched and managed to deliver results. India Inc experienced, perhaps for the first time, that costs can be reduced to levels which can contribute to profits substantially and yet leave customers happy through competitive pricing and value additions – goods or services.

Box 34

Electronic media has made possible the transmission of messages to educate the customer on an on line basis. The average citizen is taking informed decisions regarding pricing, now that people are aware that the maximum retail price is a ceiling which cannot be exceeded and further that the maximum retail price (MRP) can be flexible, unlike in the past, in the downward direction.

Cost management also had to do with proportioning of fixed costs and variable costs. While in most cases the ratio of fixed costs to variable costs is 1:1 fixed costs usually tend to be a little higher – say 55 % of the total costs. However, enterprises in different industries adopt different approaches. Organizations which want to be lean and mean do have a cost policy which keeps fixed costs as low as possible just 20 percent. Outsourcing is the key factor which permits a low fixed costs. The risk of business is substantially reduced. Many companies, especially multinationals, have adopted the practise of mass outsourcing, liquidated real estates and used the cash inflows for repatriation and reduced cash outflows, on account of limited outlay on fixed assest as well as loan amortisation, to improve return on investment . Since the assets were diluted, through real estate divestment, suddenly these multinationals became lean and mean and ROI was really catapult.

The general theme is that higher the fixed costs greater the self sufficiency of resource requirements. However, viewed from another perspective higher the fixed costs greater are the risks. Hence managing the proportioning between the fixed and variable costs became an important issue in risk management with respect to costs. Appropriate management strategies had to be evolved- to choose between a ‘low variable and high fixed cost level’ vis-a-vis the reverse scenario of high variable and rather low level of fixed costs.

The former scenario meant a lot of facilities within the system yet a high risk. High fixed costs means a high break even sales. The gap between actual sales and break even sales is rather narrow. Further the operating leverages will bring about violent fluctuations in bottom lines for small changes in the top line (sales) of business. The risk also meant that if for some reasons business is not forthcoming in adequate volumes, either enterprise has to resign itself to losses, may be continuously, or quit. Both options are painful, making choice difficult – devil versus the deep-sea. With high fixed costs, risk is high and bail out is difficult and comes only with painful decisions and damage to the financial health of business. The extent of non-performing assets bears ample testimony to the damages caused to India INC on this score.

The alternate strategy of high variable costs and relatively low level of fixed costs meant a lean and mean organization. Many organizations adopt this approach to keep themselves fit to match different volumes of business without increasing their permanent commitments with respect to inputs (costs). If volume materializes the organizing machinery to cater to the needs of customers through the outsourcing outlets is actioned. If not, the organization continues in business with limited commitments.

Box 35

- In the middle nineties, El Air, the flag carrier of Israel had a variable : fixed cost ratio of 80: 20.. As soon as the customers emerged at the airport, an aircraft could be hired from the tarmac,. Similarly other inputs required could also be hired. This used to be known in airline lingo as ' Power by the Hour'.
- The Toyota Car production environment is characterized by a similar approach. Through, the just-in-time approach inventories get delivered twice a day straight into the assembly line. Working capital is managed through a lean and mean current assets portfolio.
- Hero Honda vis-a-vis Bajaj Auto is another case in point. Hero Honda is relatively speaking lean and mean, and hence the economic performance of Hero Honda stands out. Hero Honda has only 30 percent of the total assets of Bajaj Auto(Rs.12804 crores for 2006). However, Hero Honda enjoys a 107 per cent of sales of Bajaj Auto of Rs. 8162 crores for 2006) and 90% of Bajaj Auto's profit after tax of Rs.1082 crores

Again in business the knowhow as to how manufacturing products are built accounts for 60-70 percent of their development costs,. In service industries and consulting firms knowledge component of development costs account for 90 percent. For example, in airlines business knowledge regarding air craft maintenance or reservation systems represent massive investments. Such investments are recouped through massive cost savings, on account of internal operations and revenue generated through services offered to third party work. Nike and Reebok are global leaders in the sportswear business. Nike, owns only one production outlet. Reebok does not own a plant. The key assets are the knowledge of designing and marketing high technology driven state of the art products viz footware and sports goods. The production centres are in Asia. Thus, what is to be managed in the assets portfolio is not physical assets but knowledge manifest in the form of patents, copyrights and technical knowhow.

A choice is made between make or buy decision in favour of buying from the outside and networking with outlets capable of catering to business needs as and when necessary. It is not without reason that business process outsourcing has emerged as a powerful network of activities and is handling large scale volume of activities on behalf of principals across the global network. Developed countries like US, UK and other European countries have constantly used the cheap labour and intellectual capital of countries like India, China and also few others in the Afro - Asian continents. India has a competitive edge over the rest of the World as on date because of the reservoir of trained intellectual capital and communications skill in English. China is making big strides in improving its competitiveness in English. When the dragon awakens and unleashes its potential in English, China may be the rendez vous for global business and emerge as a World Trade Centre, unless India can offer cost effective, competitive, value added goods or services. India may be a choice at best second to China. Thus, there are many paradigm shifts that have taken place and are worthy of listing separately as shown in Box 36.

Box 36

Paradigm Shifts in Cost Management

- a movement from cost as a fait accompli to cost as a key factor to be managed to influence survival, growth and prosperity of business;
- a shift from high fixed costs, high risk business to low fixed costs, low risk, lean and mean portfolios, as far as possible;
- a shift from on loading everything within a business to offloading to outside business process outsourcing agencies; and
- a shift from seeking rendezvous outside to establish Indian business to offering India as the best rendezvous for business with the caveat that India's competitiveness can last only so long as English language is a handicap for Chinese; unless Indian productivity improves by leaps and bound and surpasses global benchmarks.

Asset Utilization

Asset utilization provides signals regarding the wisdom of investment decisions of the past. If enterprise has to protect the overall productivity of assets, the options are clear - increased revenues, reduced costs and effective and efficient management of investments. So long as revenues and costs are moving in proper alignment vis-a-vis assets, business is safe with respect to asset utilization. Otherwise, investment management will also include prudent and timely divestments to release cash, reduce asset obesity and allow capacities installed to relate themselves to effective demand. Continuous poor performance on asset utilization means faulty choice of projects and capacity installation.

Enterprise World over face this problem – lean business activity resulting in underutilization of capacity and under trading. On the other hand brisk business activity results in over utilization of assets and over trading.

Sellers market conditions providing for protected profit margins under license raj resulted in underutilization of assets, under trading, limited volume of select goods, high prices (depending on the discretion towards price fixation) and also a parallel market for goods in short supply either through internal leakages or smuggling and may be occasionally legitimate imports (since foreign exchange was a constraint) There is a paradigm shift again - opportunities for mass markets under conditions of stiff competition and also competitive cost-price structure. Mass markets refer to global markets and the size to be captured is left to the desire, dare and ambition of the entrepreneur. To reiterate, the Indian middle class market itself is a big mass market - 350 million plus.

The analysis so far has tackled revenue (sales volume x sales price), costs (fixed and variable) and capital employed i.e. assets. The indicators used to measure performance leading to productive use of capital employed is Return on Capital Employed (ROCE)

Factors Influencing Operating Excellence

Box 37

Return on Capital Employed	= PV Ratio	X Margin of Safety	X Turnover of Capital Employed
(%)	(%)	(%)	(times)

Thus, the risks of the firm with respect to proportion of revenues between different revenue patterns - currency, markets, product lines, customer networks, price bands and proportions of costs between those driven by volume and those that are fixed along with the aggregate capital employed decides the operating performance or excellence of enterprise viz ROCE.

Return on Capital Employed (ROCE)

ROCE accounts for operating excellence of business – managing sales, variable and fixed costs and capital employed. Before exploring the other dimension of business – management of interest and taxes, an exposure to the financials of India INC is in order.

"A Picture is Worth a Thousand Word"
- *Anonymous*

SECTION 3

India inc. - Manufacturing Sector -Financials

List of Tables

List of Graphs

Table A

	India Inc – Manufacturing Sector								
	Profitability Ratios (Book Profit Basis)								
	Return on Total Assets			Return on Capital Employed			Return on Net Worth		
Year	PAT/SALES (%)	Sales/Total Assets (Times)	PAT/Total Assets (%)	PAT/SALES (%)	Sales/CE (Times)	PAT/CE (%)	PAT/SALES (%)	Sales/ Networth (Times)	PAT/Networt h (%)
Mar 1989	1.95%	1.02	1.99%	1.95%	1.67	3.25%	1.95%	3.81	7.44%
Mar 1990	2.58%	1	2.58%	2.58%	1.73	4.45%	2.58%	3.89	10.03%
Mar 1991	2.52%	0.98	2.47%	2.52%	1.74	4.40%	2.52%	3.99	10.07%
Mar 1992	2.26%	0.95	2.16%	2.26%	1.71	3.88%	2.26%	4.19	9.49%
Mar 1993	1.67%	0.91	1.52%	1.67%	1.67	2.79%	1.67%	3.89	6.49%
Mar 1994	2.65%	0.86	2.28%	2.65%	1.51	3.99%	2.65%	3.19	8.45%
Mar 1995	4.34%	0.88	3.83%	4.34%	1.48	6.42%	4.34%	2.82	12.24%
Mar 1996	4.57%	0.88	4.04%	4.57%	1.5	6.86%	4.57%	2.75	12.57%
Mar 1997	2.80%	0.87	2.45%	2.80%	1.48	4.14%	2.80%	2.88	8.07%
Mar 1998	2.00%	0.82	1.64%	2.00%	1.37	2.73%	2.00%	2.82	5.63%
Mar 1999	0.88%	0.82	0.72%	0.88%	1.39	1.22%	0.88%	2.98	2.61%
Mar 2000	0.81%	0.9	0.72%	0.81%	1.59	1.28%	0.81%	3.24	2.61%
Mar 2001	0.72%	1.02	0.73%	0.72%	1.8	1.29%	0.72%	3.81	2.73%
Mar 2002	0.20%	0.98	0.19%	0.20%	1.91	0.38%	0.20%	4.03	0.80%
Mar 2003	1.91%	1.02	1.95%	1.91%	2.08	3.98%	1.91%	4.36	8.34%
Mar 2004	3.48%	1.08	3.76%	3.48%	2.2	7.66%	3.48%	4.23	14.73%
Mar 2005	4.46%	1.13	5.06%	4.46%	2.23	9.94%	4.46%	4	17.85%

Source Data: CMIE Prowess – Financial Statements

Table B

India Inc – Manufacturing Sector Profitability ratios (Cash Basis)									
	Return on Total Assets			Return On Capital Employed			Return on Net Worth		
Year	Cash Profit/ Sales(%)	Sales/Total Assets (Times)	Cash Profit/ Total Assets(%)	Cash Profit / Sales(%)	Sales/CE (Times)	Cash Profit/ CE(%)	Cash Profit/ Sales(%)	Sales/Net Worth (Times)	Cash Profits/Net Worth (%)
Mar 1989	5.67%	1.02	5.78%	5.67%	1.67	9.45%	5.67%	3.81	21.62%
Mar 1990	6.61%	1	6.63%	6.61%	1.73	11.42%	6.61%	3.89	25.71%
Mar 1991	6.32%	0.98	6.19%	6.32%	1.74	11.03%	6.32%	3.99	25.22%
Mar 1992	6.06%	0.95	5.77%	6.06%	1.71	10.37%	6.06%	4.19	25.39%
Mar 1993	5.92%	0.91	5.40%	5.92%	1.67	9.88%	5.92%	3.89	23.03%
Mar 1994	6.46%	0.86	5.56%	6.46%	1.51	9.74%	6.46%	3.19	20.61%
Mar 1995	8.07%	0.88	7.14%	8.07%	1.48	11.95%	8.07%	2.82	22.79%
Mar 1996	8.05%	0.88	7.11%	8.05%	1.5	12.09%	8.05%	2.75	22.15%
Mar 1997	6.36%	0.87	5.56%	6.36%	1.48	9.40%	6.36%	2.88	18.33%
Mar 1998	6.00%	0.82	4.92%	6.00%	1.37	8.19%	6.00%	2.82	16.89%
Mar 1999	5.07%	0.82	4.18%	5.07%	1.39	7.05%	5.07%	2.98	15.10%
Mar 2000	4.91%	0.9	4.42%	4.91%	1.59	7.81%	4.91%	3.24	15.91%
Mar 2001	4.51%	1.02	4.58%	4.51%	1.8	8.13%	4.51%	3.81	17.17%
Mar 2002	4.63%	0.98	4.53%	4.63%	1.91	8.83%	4.63%	4.03	18.69%
Mar 2003	6.02%	1.02	6.13%	6.02%	2.08	12.54%	6.02%	4.36	26.25%
Mar 2004	7.69%	1.08	8.31%	7.69%	2.2	16.92%	7.69%	4.23	32.52%
Mar 2005	8.40%	1.13	9.52%	8.40%	2.23	18.70%	8.40%	4	33.58%

Table C

India Inc – Manufacturing Sector					
Revenue-Cost-Profit					(Rs. Crores)
Year	**Sales**	**Variable Cost**	**Contribution**	**Fixed Cost**	**Profit**
Mar 1989	129394	57091	72303	31400	40902
Mar 1990	154219	67610	86609	37186	49423
Mar 1991	182031	79848	102184	43916	58268
Mar 1992	216040	95017	121023	52259	68764
Mar 1993	249015	110187	138827	60603	78224
Mar 1994	287902	126127	161775	69370	92405
Mar 1995	372890	160524	212366	88288	124078
Mar 1996	452680	194396	258283	106918	151365
Mar 1997	509045	222649	286396	122457	163938
Mar 1998	544275	240027	304247	132015	172232
Mar 1999	600632	267914	332717	147353	185365
Mar 2000	713432	318459	394973	175152	219821
Mar 2001	845405	377704	467701	207737	259964
Mar 2002	840283	377381	462902	207560	255342
Mar 2003	958063	422882	535182	232585	302597
Mar 2004	1101558	478444	623114	263144	359970
Mar 2005	1240379	533254	707126	293289	413836

N.B: 1) Fixed costs are assumed at 55% of Cost of Sales
2) Variable costs are a balancing figure placed at 45% of Cost of Sales

Table C1

India Inc – Manufacturing Sector						
Profit Indicators (Break Even Analysis)						
Year	**P/V Ratio**	**Margin of Safety**	**Operating Profit Margin**	**Sales/TA (Times)**	**ROTA**	**Break Even Sales (%)**
Mar 1989	55.88%	8.61%	4.81%	1.02	4.90%	91.39%
Mar 1990	56.16%	8.55%	4.80%	1	4.81%	91.45%
Mar 1991	56.14%	8.02%	4.50%	0.98	4.41%	91.98%
Mar 1992	56.02%	7.84%	4.39%	0.95	4.19%	92.16%
Mar 1993	55.75%	7.20%	4.02%	0.91	3.67%	92.80%
Mar 1994	56.19%	8.73%	4.91%	0.86	4.22%	91.27%
Mar 1995	56.95%	10.69%	6.09%	0.88	5.38%	89.31%
Mar 1996	57.06%	10.91%	6.22%	0.88	5.50%	89.09%
Mar 1997	56.26%	8.35%	4.70%	0.87	4.11%	91.65%
Mar 1998	55.90%	7.17%	4.01%	0.82	3.29%	92.83%
Mar 1999	55.39%	5.88%	3.26%	0.82	2.69%	94.12%
Mar 2000	55.36%	5.92%	3.28%	0.9	2.95%	94.08%
Mar 2001	55.32%	5.31%	2.94%	1.02	2.99%	94.69%
Mar 2002	55.09%	5.72%	3.15%	0.98	3.08%	94.28%
Mar 2003	55.86%	8.45%	4.72%	1.02	4.81%	91.55%
Mar 2004	56.57%	10.48%	5.93%	1.08	6.40%	89.52%
Mar 2005	57.01%	12.23%	6.97%	1.13	7.90%	87.77%

Comment on Table C 1

The P/V Ratio which shows the rate at which surplus is generated to recoup fixed costs and then earn profit is in the range of 55% to 57% for the study period of 1989-2005. The Margin of safety which is indicative of the cushion which business enjoys vis-a-vis breakeven sales is in the range of 7% to 12%. Apparently this is not very high. In fact less than 10% means that break even sales (BES) is 90% of sales. This is a high risk scenario. However in recent times (2003 to 2005) the Margin of safety has improved from 5.7% to 12.2%. The risk levels have been well managed causing reduction in fixed costs - thanks to outsourcing, divestments (hiving off), planned reductions in levels of investments (lean and mean asset portfolios), downsizing and overall productivity improvement in India Inc Manufacturing Sector. The corresponding complementary impact is visible in the higher total assets turnover ratio which has increased from 0.82 times in 1998-99 to 1.13 in 2005. Hence, the return on total assets has shown improvement of nearly three times that is to say from 2.95 per cent in 2001 to 7.9 per cent in 2005. Thus, entrepreneurs have launched a multi pronged attack on various inefficiencies that plagued India Inc. during the license raj. Liberalisatioin has enabled and empowered enterprise to enact themselves by taking bold, daring and imaginative steps to improve the result-resource ratio.

Table D

India Inc. - Manufacturing Sector			
Debt – Equity Ratio			
Year	Nos. of Companies	2:1 Nos. of Companies (%)	3:1 Nos. of Companies (%)
Mar 1989	938	63.97%	83.26%
Mar 1990	1005	65.17%	82.79%
Mar 1991	1236	63.27%	82.77%
Mar 1992	1391	65.78%	83.11%
Mar 1993	1644	70.32%	85.10%
Mar 1994	2111	78.40%	89.48%
Mar 1995	2502	83.37%	92.45%
Mar 1996	2623	83.87%	92.95%
Mar 1997	2605	82.46%	91.40%
Mar 1998	2570	80.66%	90.82%
Mar 1999	2669	78.01%	88.46%
Mar 2000	2675	78.13%	87.93%
Mar 2001	2583	78.16%	87.80%
Mar 2002	2520	77.70%	87.30%
Mar 2003	2589	77.17%	86.87%
Mar 2004	2522	78.71%	88.22%
Mar 2005	2106	79.68%	89.03%

Comment on Table D

Debt-Equity Ratio-After 1993 number of companies showed substantial increase upto 2004. In 1993, 85% of the companies were having a maximum debt-equity ratio of 3:1. Till 2004, the said per cent (85) increased to 88% indicating that more and more companies preferred reasonable and manageable debt-equity ratios not exceeding 3:1. In fact after 2005 better managed companies have shown preference for equity rather than debt inspite of tax advantage in debt finance.

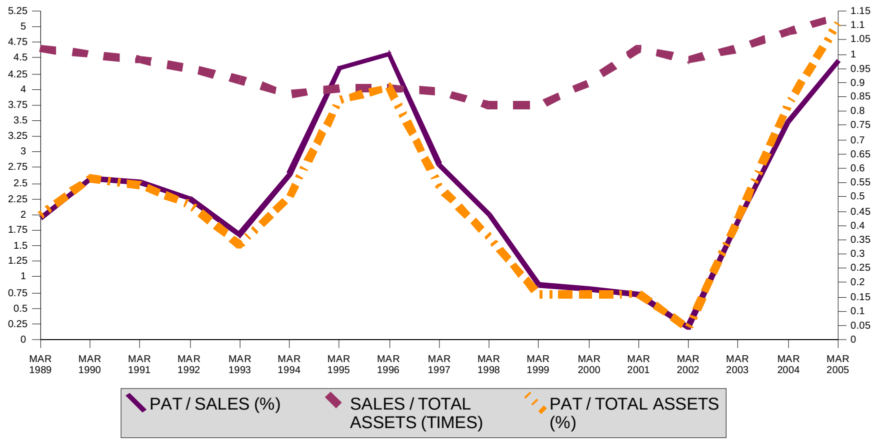
Comment on Table E

Table E

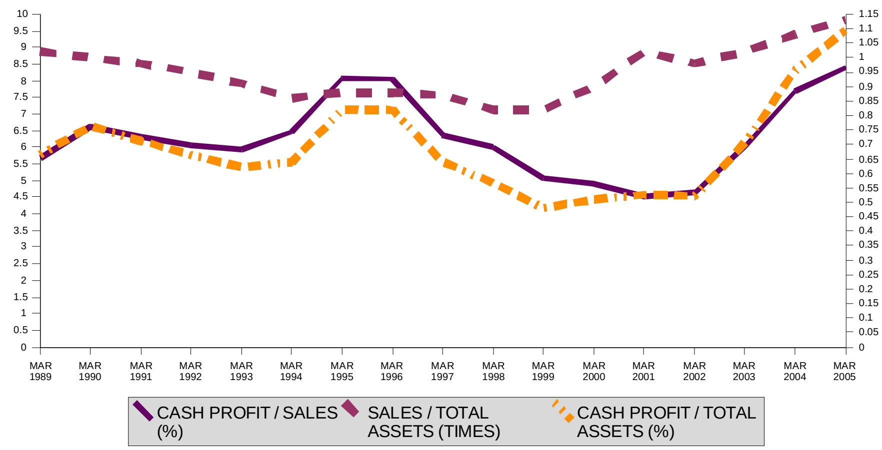
India Inc. - Manufacturing Sector					
Aggregates					Rs. Crores
Years	**Sales**	**PAT (NNRT)**	**Net worth**	**Total assets**	**Capital employed**
Mar 1989	129388	2525	33949	126941	77663
Mar 1990	154219	3974	39637	153831	89275
Mar 1991	182031	4592	45621	185792	104341
Mar 1992	216040	4891	51529	226709	126174
Mar 1993	249015	4154	63963	272701	149026
Mar 1994	287902	7620	90219	334508	190859
Mar 1995	372890	16171	132099	421857	251974
Mar 1996	452680	20688	164576	512570	301697
Mar 1997	509045	14269	176762	582235	344683
Mar 1998	544275	10880	193172	663212	398511
Mar 1999	600632	5267	201465	728160	431405
Mar 2000	713432	5746	220142	792565	448094
Mar 2001	845405	6063	221931	831385	468700
Mar 2002	840283	1658	208330	859383	441088
Mar 2003	958063	18327	219793	940575	460129
Mar 2004	1101558	38349	260431	1019401	500510
Mar 2005	1240379	55371	310158	1094106	557000

Till 2000 India Inc.'s Total Assets were more than India Inc.'s Sales. But after the year 2000 India Inc reduced fixed assets as well as current assets by hiving off divisions or by sale of business or of landed property. Outsourcing has facilitated this change. Again, interest rates and taxes both were reduced from 1999 onwards. Thus there is a jump of almost 3 times in profit after tax (PAT) in 2005 compared to 2003 and 9 times in profit after tax compared to 2001. The number of companies reduced by 18% from 2001 to 2005.Obviously, sales of India Inc grew by 29% only while total assets grew by 16%. Whereas PAT increased by 300% during 2003-05, India Inc.'s networth increased by 45% only for the same period. Apparently, the PAT was distributed rather liberally through unreasonably high dividend payouts. The PAT increased, to reiterate, due to reduction in interest and taxes. Thus, though top line did not show much of an increase, the bottom line responded very positively. Excellence in financial management of India Inc came to the fore to contribute to its bottom line.

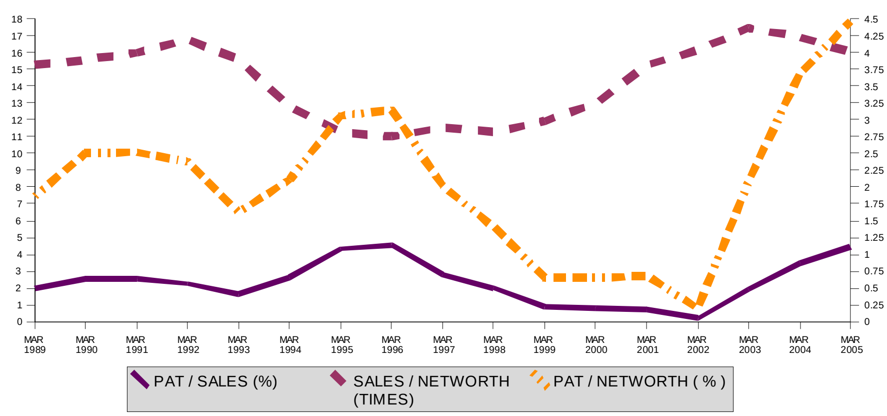
Graph 1: Return on Total Assets - Book Profit Basis



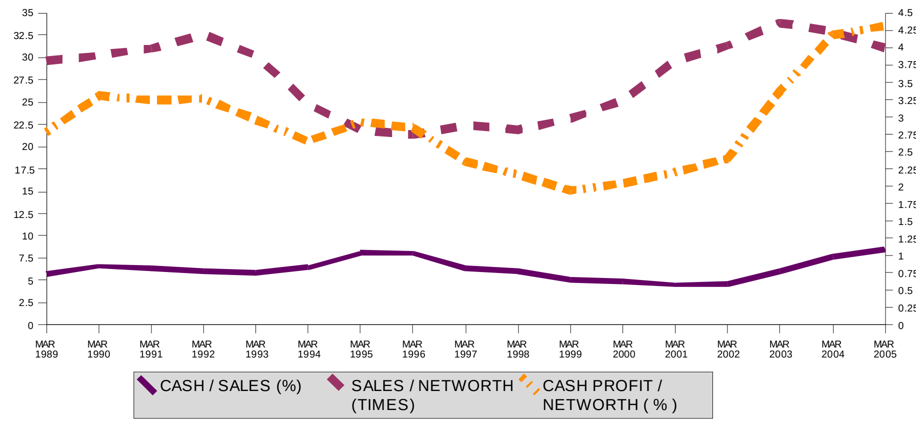
Graph 2: Return on Total Assets - Cash Profit Basis



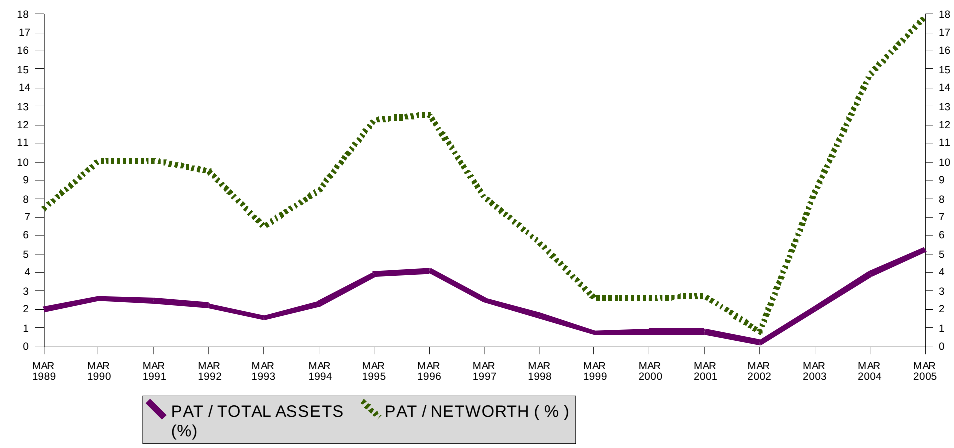
Graph 3: Return on Net Worth - Book Profit Basis



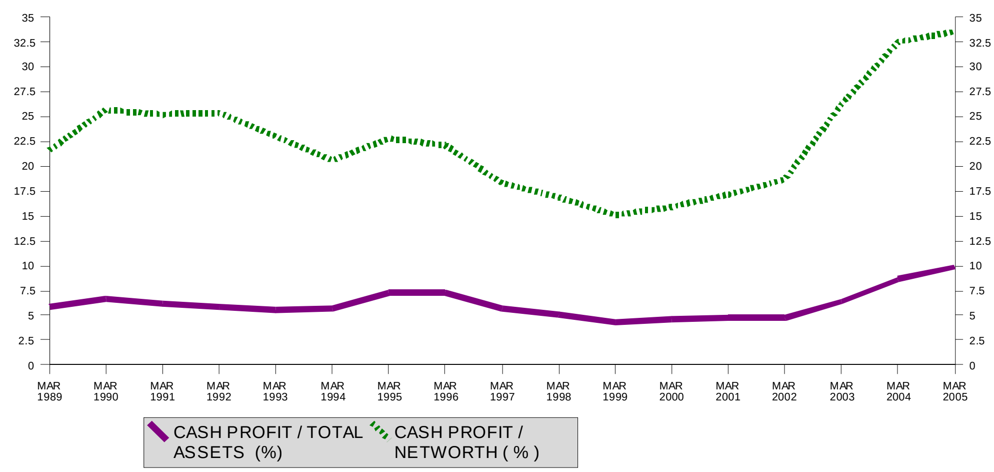
Graph 4: Return on Net Worth - Cash Profit Basis



Graph 5: 2 ROI's - Book Profit Basis



Graph 6: 2 ROI's - Cash Profit Basis



Comment on Graphs – Based on Tables A & B

Based on the Graphs the following inferences can be made :

Graphs 1 & 2

1. Return on Total Asset (ROTA)-Book Profit vis-a-vis Cash Profit Basis

ROTA (book profit basis) is a physical product of Profit Margin (%) and Total Asset turnover ratio (times). The turnover ratio is more or less stable and is within a narrow range of .82 to 1.13. Thus, ROTA is a direct function of the profit margin (%) . Hence as per Graph 1 the profit margin graph is almost in total alignment with the ROTA which ranges between .19% to 5.06%. Thus,the financial productivity of INDIA Inc (ROTA – book profit basis) is linked with the profit margin (%) ratio. The ratios of Graph 2, which are computed on cash basis, are pitched at levels higher than those depicted in Graph 1.

Graphs 3 & 4

Return on Networth (RONW) : Book Profit vis-a-vis Cash Profit Basis

RONW (%) (book profit basis) is a function of Profit Margin (%) and Turnover of Net Worth(Times). RONW (%) (book profit basis) ranges from .80% (2002) to 17.85% (2005). The relatively high RONW (%) in certain years is due to improved ratio of Sales / Net worth, profit margin (%) ratio being the same as compared to Graph 1. RONW (%) cash profit basis (Graph 4) is pitched at levels higher than their counterpart in Graph 3 as well as Graph 2.

Graphs 5-6

shows the profitability ratios comparison for ROTA and RONW on book and cash profit basis respectively. Since depreciation is added back to profit after tax all cash based profitability ratios are placed at much higher level than their counter parts expressed as book profit profitability ratios.

India Inc's financials presented in tables, graphs and prose reveal certain changes in the structure of corporate finance. These changes are well corroborated by the episodes, events and experiences of India Inc in particular and the Indian economy in general. The said changes are well discussed in the course of the foregoing and following Sections.

“ To speak of the abolishing of usury is idle. All states have ever had it, in one kind, or rate or other. So as that opinion must be sent to Utopia.”

(Francis Bacon, Essay ‘of Usury’ 1618, England)

SECTION 4

Financial Excellence: Managing interest

- **Interest as an Input Cost**
- **Negative Interest Rates**
- **Nominal and Real Interest Rates**
- **Short Term and Long Term Interest Rates**
- **Cheap Money Policy and Funding Strategies**
- **Four Case Studies**
- **DEBT and EQUITY**

Operating Excellence Link to Total Management Excellence

ROCE is only one side of the story. Operating excellence captures within its fold revenues and costs and that too only operating costs. Operating excellence is almost a pre - condition for overall excellence though there may be exceptions to the rule. And there are many. Given certain assets employed to operate a business it is necessary that those assets are gainfully employed in business. If not, the portfolio of non-performing assets emerge and this is a toll on business and a bane on society at large. Hence the theme that operating excellence is a necessary condition for overall excellence is recommended with the caveat that there are exceptions to the rule.

Box no.37

> There are many situations in business when operating losses emerge. However, the final bottom line (profit after tax) may be positive. Thanks, to income other than sales which emerges by design or default. Planned sale of fixed assets or hiving off of Strategic business units are Strategic decisions. These events emerge out of design. Bonanza gains arising out of favourable developments in markets – say foreign exchange can bring about improvements in bottomline by default – unplanned and unthought of, yet tangible and real.

Financial Excellence – Managing Capital, Structure, Interest Costs and Taxes.

ROCE as seen earlier, is a measure of operating excellence. However, the end objective is to measure performance of shareholders investment i.e. Return on Equity (ROE). The link between ROCE and ROE is the obligations towards creditors and the exchequer. Interest payments and income taxes intercept the 'operating profit' and net profit (profit after interest and tax)

Box 38

Operating Excellence x Financial Leverage x Tax Impact

$$\text{ROE (\%)} = \text{ROCE} \times \left\{ \underset{(\%)}{\frac{\text{Profit before tax}}{\text{Operating Profit}}} \times \underset{(\text{times})}{\frac{\text{Capital Employe}}{\text{Owners fund}}} \right\} \times \left\{ \underset{(\%)}{\frac{\text{Profit after interest and tax}}{\text{Profit before tax}}} \right\}$$

Financial Operations Ratio

The ratios relating to interest and tax management and the mix of debt and equity are known as financial operations ratios. The ratio of profit before tax to operating profit indicates the extent to which operating excellence is depressed on account of obligations to the creditors . A high ratio indicates that treasury has been able to shield operating excellence in favor of equity shareholders, pro tanto, and vice-versa Thus, treasury skills and motivation come to the fore – interest costs and also management of debt and equity.

Interest as an Input Cost

Interest depends on the borrowing policy of the business. The amount of debt depends on the policy governing leverage and its role in business. It also depends on the need for borrowings. There may be an intent to lever but no need to lever. There may be a need alright but availability and affordability are considerations which cannot be overlooked. Since leverage helps to boost ROE and an aggressive leverage helps to catapult ROE, enterprise should be interested in using their equity base to raise as much debt as possible. It is like speeding a car at a high or highest gear. In fact leverage alternatively expressed is known as gearing of capital. Yet, borrowings do not take place as a routine perfunctory exercise. There are extra – commercial considerations influencing capital structure decisions like, the attitude of borrowers, creditworthiness in the market, nature of industry, tax considerations, cash flow needs and ability, nature of industry, reinvestment plans as well as opportunities and government regulations (if any) and last but not the least autonomy desired by the enterpreneur.

A high ratio of capital employed divided by funds is indicative of high gearing of capital, and vice versa. Increasing role of debt helps to lever the capital structure to improve ROE. A low leverage restricts opportunities to boost ROE. The presence of debt also means creditors are always observing and the autonomy of the business could be limited to the mind-set of the lenders. Leverage per se helps to boost ROE and so long as the marginal efficiency of capital is greater than the marginal cost of capital the benefits of leverage can continue rather indefinitely- ad infinitum. However, the non-quantitative factors like controls exercised by lenders, covenants imposed by lending financial institutions and the fear of exposure to banks punitive action are factors which inhibit unfettered use of leverage. In addition to these qualitative considerations, business environment may see changes in fiscal, monetary and trade policies which require enterprise to revisit, periodically, the choice between debt and equity. Hence, the choice between debt and equity is one of evaluating, like all other decision choices, the quantitative and qualitative dimensions and assessing the combined impact of the same on corporate financial objectives in particular and corporate objectives in general. The choice finally boils down to risk-return matching and evaluation of the best option available and arrive at a possible solution given a set of circumstances in today's dynamic ever dis-equilibrated business situation. Financial leverage requires decision making with respect to interest management nature, form, source, cost , currency, country from where debt is sourced, tax rates and the proportions between debt and equity subject to constraints (if any) imposed by laws of the land in which business is transacted. Yet, borrowings need not necessarily happen.

Companies which are not interested in expansion or diversification may not need funds and hence the question of borrowings does not arise. Companies which are not interested in using debt for expansion or diversification tend to restrict expansion and diversification plans to funds available from within through internal generations.

Companies do tend to be conservative with respect to borrowings as a policy and also because they would not like to loose control – the presence of creditors, individuals or institutions, means loss of control to the extent of the restrictive covenants agreed upon. Invariably bankers impose covenants that tend to be harsh on borrowers. Moreover, bankers have a notorious reputation - <u>“ offering an umbrella when there is sunshine and withdrawing it when it starts raining”.</u>

Hence the urge of enterprise, for this and other valid reasons, to be out of the clutches of the banking system.

Underutilization/ over utilization, under trading/ over trading and under capitalization and over capitalization of enterprise were all driven by the motivation of entrepreneurs which was influenced in the main by licensing laws and controls prevailing during the permit raj.

Corporates, as a policy, do not wish to entertain a fair weather cock. While conservative policies may result in low leverage, cash rich companies also need not borrow. Hence the leverage is rather low or may be nil. On the contrary cash rich situations demand cash deployment policies to identify re-investment opportunities which can absorb surplus funds. A fundamental financial tenet is in operation – cash rich companies suffer from surfeit cash – high liquidity. However, liquidity and profitability are at loggerheads. Cash rich businesses have to find ways and means of literally disposing off cash, into productive ventures, as soon as possible. Otherwise, cash surpluses can posit a severe problem to enterprise. Several examples can be cited. What is true at the corporate level is true, with greater force, at the country level. For instance Switzerland enjoys or suffers the inflow of cash of all stripes, black, white and grey, from different parts of the World.

The cash excess reaches a point where the country can no longer afford to allow further inflows. If further cash comes in bankers have problems of identifying reinvestment opportunities to invest the surplus funds. The returns on these investments have to meet the modicum expectations, which is just not possible.

NAGATIVE INTEREST RATES

Box 39

In Switzerland :

Keep the money in the bank pay interest,
Withdraw money from the bank earn interest.

Though negative interest rate is a theoretical concept, it occurs in the real World. It takes place in Switzerland and Japan from time to time due to the strong currencies viz the Swiss franc and the Japanese yen respectively.The moral of the story – excess of anything is an unmitigated nuisance.

Box 40

The interest rates in Switzerland have been very low over the last several years. Between 1975-2005, the highest rate per cent per annum, of short term interest rates, has been 10.47 % and that too only once (1974).

The concept of negative interest rates works in commodities markets too. Excess agricultural or dairy production tends to create serious problems for Governments and farmers. Farm prices become unremunerative and Governments have to bear the burden. To overcome this problem, World over, farmers behaviour is uniform and this emerges from the fundamental tenets governing capitalism – mass production, mass consumption and mass destruction if necessary. Thus, agricultural produce – wheat in USA, potatoes in Canada, apples in Australia, coffee in Brazil, sugar in Cuba, onions in Maharashtra (India) dairy products in Scandinavian Countries and excess production of cars in Europe all get dumped literally as scrap because cost of holding the production is greater than the benefits of the same. Production that is just not of any use, on the contrary an obstruction to profit motivation, is dumped in the sea, or just left on the roads.

TABLE THREE

Switzerland : Profile of Short TermInterest Rates-1974-2006

Interest Rate	*Frequency*
0%	1
less than 1%	4
1% but less than 2%	6
2% but less than 3%	4
3% but less than 4%	4
4% but less than 5%	7
5% but less than 6%	1
6% but less than 7%	-
7% but less than 8%	2
8% but less than 9%	2
9% but less than 10%	1
10% but less than 11%	1
TOTAL	33

Table Three is self-explanatory and shows the levels of interest rates in Switzerland.

Box 41

Switzerland had a variety of capital controls in effect since 1971. The controls which were strengthened between 1973 and 1975, included negative interest rates on Swiss Franc Deposits of non-residents (1970's). Again, Japan had introduced various controls because of the strength of the Japanese yen. Interest rates in Japan tend to be negative from time to time since1998. Recently, on January 24, 2003 domestic interest rates went negative in Japan.

Table Four

World Interest Rates

Major Central Banks – An Overview

Central Bank	Date of Change	Interest Rate(%)
Bank of Canada	24.05.06	4.25
Bank of England	11.01.07	5.25
Bank of Japan	14.07.06	0.25
European Central Bank	7.12.06	3.5
Federal Reserve	29.01.06	5.25
Swiss National Bank	14.12.06	2.00
Reserve Bank of Australia	8.11.06	6.25

✔ **Relationship between nominal and real rates is as follows :**

Box 42

(1 + Nominal) = (1 + Real) x (1 + Inflation)

OR

$(1 + N) = (1 + R) \times (1 + I)$

where N, R and I represents rates

A zero nominal interest rate occurs when the interest rate is the same as the inflation rate. If inflation rate is 4 per cent and interest rates are also 4 per cent, investing for a year at a zero real interest would result in a status quo position at the end of the year vis-a-vis the starting point. A loan of Rs. 100, at 4 per cent per annum would fetch Rs 104 at the end of the year. However, Rs 104 is required to command a purchasing power of Rs.100. Hence the status quo prevails. Thus:

- If the nominal rate is greater than the inflation rate, the investor's real payoff is diluted but positively;
- If the nominal rate equals the inflation rate the investor is indifferent; and
- If the nominal rate is lower than the inflation rate the investor is adversely affected ab initio.

Box 43

✔ According to some economists a zero nominal interest rate can be caused by a liquidity trap:

The Liquidity trap is a Keynesian idea. When expected returns from investments in securities or real plant and equipment are low, investment falls, a recession begins, and cash holdings in banks rise. People and businesses then continue to hold cash because they expect spending and investment to be low. This is a self created trap.

Box 44

Wikipedia explains the relationship between the liquidity trap and zero nominal interest rates:

In monetary economics, a liquidity trap occurs when the economy is stagnant, the nominal interest rate is close or equal to zero and the monetary authority is unable to stimulate the economy with traditional monetary policy tools. In this kind of situation, people do not expect high returns on physical or financial investments, so they keep assets in short-term cash bank accounts or hoards rather than making long-term investments. This makes recession even more severe.

New Dimensions of Interest Management - Inverted Interest Rate in India

At one stage, prior to 1991, India was practising a dear money policy with high interest . Inflation used to be rather high, usually, near about, double digit. Interest rates were kept high to prevent profligacy and encourage parsimony, with respect to the end use of loanable funds. Further, short term interest rates were higher than long term interest rates. In other words " interest rates were inverted." The IMF World Bank rescue package of 1991 made special mention of inverted interest rates and its inconsistency with normalcy. The need to correct the inversion in interest rates, and that too quickly, was emphasized. Post 1991 India had to fall in line with the rest of the World. The RBI did initiate policy measures to drive interest rates southwards. Between 1991 and 2004 short term interest rates moved from 16.5 % to 10.25 %.

Box 45

Short Term and Long Term Interest Rates - THE INDIAN SCENE

The relationship between short and long term interest rates has also undergone a change, albeit the structure of interest rates has not been corrected, in toto, from inverted to a regular relationship where interest rates are driven by tenure of lending. However the following points emerge:

- Between 1970 and 1990 the short term interest rates continued to be higher than long term rates.
- Between 1991 and 1996 the respective interest rates were either at par or driven by the tenure of lending except in 1993 when short term rates were again higher than long term rates.
- The years 1997 and 1998 again encountered inverted interest rates with a correction in the years 1999 and 2000 and a reversion to the old order in 2002 and 2003.
- For a long time in India, the long term interest rates were lower, in fact much lower, than short term interest rates. This runs contrary to the interest rate theory that the level of interest rates should be functionally related to the tenure of the loan.

Table Five

Profile of Iinterest Rates in India- 1970 to 2004

Years	*Rates(%)*	*Rates(%)*
	(SBI)	*(IDBI)*
1970-1972	8.5	8.5
1973	9	9
1974	13.5	10.25
1975-76	14	11
1977-78	13	11
1979	16.5	11
1980-89	16.5	14
1990	16.5	15
1991	16.5	20
1992	19	19
1993	19	17.5
1994	15	15
1995	16.5	19
1996	14.5	16.2
1997	14	13.3
1998	14	13.5
1999	12	17.1
2000	11.5	14
2001	11.5	11.5
2002	10.75	10.2
2003	10.25	8.9
2004	10.25	-

NB : SBI rates refer to benchmark rates for short term.

IDBI rates refer to benchmark rates for long term.

Borrowings Again

Companies do not borrow because they do not want to or they need not. What about companies which use leverage ?

Reliance is a very good example of successful leveraging year on year basis. Perhaps this is the only example of its kind where leverage has been proactively employed to raise funds, pre-empt outflows on account of repayment and boost returns on equity through a series of conversions of debt into equity.

Similarly, certain types of businesses which are capital intensive tend towards borrowings as a necessity. Aviation, shipping, cement, machinery manufacturing are good examples. No entrepreneur would like to risk his own money into such ventures. Hence, borrowing is an inevitable complement.

Box 46

In airline business it is said that to enter the aviation industry one has to be a billionaire. He should be lucky to get out as a millionaire."

However, venture capitalists and now private equity volunteer to offer risk capital as a policy with the intent of encashing their role at a later date through divestment of controlling interest and that too at a bonanza price. Such a divestment follows only after the initial contribution of the venture capitalist is converted into equity. e.g: Citigroup, Progeon, and Infosys. (case study 1, pp 69-70)

Box 47

Cheap Money Policy and Funding Strategies of Enterprise

- In India inflation control is a predominant desiderata of monetary policy. Hence, short term interest rates were and may continue to be used as a lever to balance the demand for and supply of loanable funds. Infact, in monetary parlance, high powered money was a critical parameter to be watched and controlled. Therefore, even between 1991 to date interest rates have been inverted from time to time. In fact, unfettered expansion of credit through overdraft, cash credit and pledge resulted in flow of funds into hoarding of stocks giving vent to the profit motive, nay profiteering. By default or otherwise this fanned the fumes of inflation. Hence from time to time interest rates were raised to make hoarding less attractive. High interest rates increased the cost of hoarding and therefore hoarding became expensive making it uneconomical to practice profit motivation via hoarding. This was the Singapore experience too. As a strategy, interest rates were placed at levels twice the inflation rate to make hoarding an unattractive proposition. Hence inverted interest rates emerged and had to be accommodated and sometimes inducted as a part of planned policy. This seemed to be a 'fait accompli' at least till 1998.

  However, since 1999 the inversion of interest rates stands corrected due to fall in inflation rates to levels below even the floor rate of four percent. Though, generally short term interest rates have to be lower than long term interest rates, this relationship is deliberately distorted from time to time, because in India inflation management is the key consideration.

Box 47 contd.

Box 47 (contd.)

Between 1991-1998, this was the main reason for which distortions between short term and long term interest rates were tolerated even though it defied the financial fundamentals. After 1998, the Government started using interest rate as an instrument relevant for enterprise investment decisions and cost of capital. Hence, short term interest rates continuously lowered themselves from 1997 to 2004 as part of the new paradigm shift from dear money policy to cheap money policy and from inflation management to investment decisions. Now, the main objective was to encourage investment with a view to offer attractive returns to enterprise. The side-effects of this effort was that short term debt became cheaper than before. However, low tax rates and low interest rates made post- tax debt cost not very attractive. Thus, the impact of tax breaks demotivated use of debt. Further, low interest rates improved the bottom line and increased the dividend. The equity investors were happy because profit levels improved and dividends were tax free. They responded positively to new issues of equity through Initial Public Offers (IPO's). Hence equity became attractive and cheaper than debt. However, cheap money policy did not really interest many enterprises. Since banks were keeping industry on their tenterhooks,industry wanted to be as unfettered as possible by being outside the scope, ambit and purview of the stranglehold of banks. Enterprise wanted total freedom from the control of banks. Banks were putting a condition that the end purpose of term loans given should be strictly complied with. Moreover, using cash credit facilities from a particular bank was made compulsory, if the borrower had availed of term loans facility from that particular bank.

Box 48

Entrepreneurs – Changing Mindset

Industry wanted autonomy with respect to investment decisions because daring entrepreneurial decision like acquisitions, mergers and demergers were in the offing. Hence, as a strategy many enterprises hived off certain strategic business units to augment cash flows and enjoy unfettered use of the same. Simultaneously they were outside the banking system. This upset the apple cart of the banking sector. In the anxiety of the banking system to retain their customers, the banks wanted to ensure that customers completed their tenure as borrowers. Hence the concept of penalty clause for premature amortisation of loan was introduced. Companies like Imperial Chemical Industries (India) Ltd.(ICI), Nestle, Glaxo, Nicholas Piramal hived off their basic strategic businesses from 2001 onwards,

Box 48 contd.

Box 48 (contd.)

generated a lot of cash and freed themselves from the yoke of the banks. This was a paradigm shift in the mindset of enterprise notwithstanding the cheap money policy.

There was one more paradigm shift and that was relating to the mix of finance used to run business. Companies preferred equity to debt. This served their purpose inasmuchas falling interest rates, falling tax rates, improved dividends and a buoyant capital market, rendered equity cheaper than debt after 2002. As if this was not enough, entrepreneurs started giving vent to their ambition by seeking loans at cheaper rate from foreign countries in terms of external commercial borrowings, global depository receipts, american depository receipts and foreign currency convertible bonds, after 2002. Since the INR was continuously appreciating, it became cheaper for entrepreneurs to borrow in foreign currencies now and repay at a later date taking full advantage of an appreciating local currency viz. INR. The paradigm shift that has taken place is the change in mindset towards the currency mix in the financial structure. In the past, there was a fear of foreign currency because of a falling INR and the adverse impact of devaluation on loan amortisation. Now, enterprise wanted to ride at the crest of the wave of a rising INR.

The appreciating INR had its own problems. Sales targets of export sector, as mentioned in Box was continuously disfigured. The loss in earnings due to receipt of relatively weak currency particularly the USD was feared by many. However, this loss was more than offset by the incremental volumes mopped up by a booming IT export sales in particular and other products too viz gems and jewellery. Incidentally the payments for imports were reduced because of an appreciating INR and the favourable effects were reduced imports, improved balance of trade and a favourable current account balance. The model examples cited above namely Infosys, ICI, Nicholas and Bharat Forge follow.

Four Case Studies: A Synoptic View

Box 49

- ✔ Infosys, Progeon and Citigroup : Win Win Business Strategy
- ✔ I***mperial Chemical Industries*** Divestment with a view to be in the core business and attain and maintain lean and mean operations free of most, long term encumbrances.
- ✔ ***Bharat Forge*** Funding Strategy to minimise cost of capital and maximise investment opportunities leading to maximising present value of future benefits for the business.

Box 50

Nicholas Piramal

- Visioned to develop a hub for state of the art manufacturing and research and development facilities for end to end servicing.
- Established a supply chain management with a trained sales force.
- Entered into collaborations to manufacture their products which were total value addition to the total enterprise. Emerged as "World Class Manufacturer". The benefits were: quality production, larger volume, economies of scale, unit cost productivity, range of therapeutic products under one umbrella.
- Market share improved by leaps and bounds.
- Funding strategy used the following instruments :

→ redeemable preference shares Rs 53.37 Cr @ 5% - 6% Dividend rate;

→ equity share capital for acquisitions;

→ external commercial borrowings (to replace costly debt) – Rs. 67 crores;

→ rights equity issue at substantial premium Rs. 173-for Rs. 2 – face value (Issue size Rs.332.7 crores); and

→ sale of real estate and other fixed assets over a period of time.

Case Study -1

Financial Implications of Infosys-Progeon- Citigroup Deal

In April 2002 Infosys formed a 100% subsidiary called Progeon. The main purpose was to capture non-voice business. This was a novel proposition at that point of time in the BPO market. The initial capital of ***USD 5 million*** was put in by Infosys. Infosys selected Citigroup International Fund as a venture capital investor. There was an agreement that Citigroup will invest ***USD20 million*** in the form of non-voting shares i.e. ***0.005%*** Cummulative Convertible Preference shares. ***25%*** of Infosys business came from Citigroup and its associate companies. In June 2005, Citigroup had already exercised its conversion right at Rs. ***75.83*** per share as conversion price per share (face value of share being Rs. ***10/-***). Infosys wanted to retain 100% control over its BPO unit Progeon, which was to be merged with Infosys later on. This required buying post conversion equity portion held by Citigroup (approx. 23%) in Progeon's equity capital. This deal was concluded finally in April 2006 at a price of ***USD 115 million*** (This deal was denied by Infosys in March 2006).

The important messages are as follows :

- Infosys did not want to go the debt route because it was flushed with cash. Question of borrowing was done away from the view point of the goodwill of the company.
- Infosys paid more than 5 times the amount initially taken by way of issuing preference shares.These, preference shares were convertible. It may be noted that in the normal course enterprise would have avoided this approach for fear of loss of control. However, in view of the business partnership Infosys adopted the said route.
- While Infosys paid an astronomically high amount (USD 115 million) for acquisition for Citigroup it was a bonanza.
- Ultimately it was still a win-win situation because in the said 4 years (2002-2005) Citigroup was Infosys' most valued customer. Infosys benefited through the business that it got from Citigroup of the order which exceeded the role of the above conversion. In ultimate the value of the business from Citigroup exceeded USD 300 million or Rs.1300 crores in the said 4 years. The deal paid for itself.
- Infosys could manage the said deal financially because of healthy financial situation in terms of profit, profitability and extra-ordinary liquidity. Wherever these aspects of economic performance do not coincide, by default capital intensive deals have to be funded through debt.

It is interesting to know that the cash received by Citigroup was, strategically and quickly so, deployed into another business where the entrepreneur was on exit route.Citigroup acquired the holding of Standard Life plc; U.K., in HDFC. When Standard Life Ins.co.Ltd. decided to get out of non-core housing finance business to raise money to overcome the financial crises it faced in the UK., Citigroup captured that opportunity by investing into housing finance business with the eventual intention of getting footage in mortgage backed financing business in Indian Financial Markets.

Case Study -2

TABLE SIX

Imperial Chemical Industries (India) Ltd.(ICI)

→ A look into the Annual Report of ICI gives insights into the business strategies and their financial implications, as reflected through financial statements shown in Table six.

TABLE SIX

6yrs. ending 2004	(Rs Crores)
Profit before Tax	301
Exceptional Items Profit	298
Provision for Tax	107
Post Tax Profit	492
Dividend	200
Loan Amortisation	109
Cash Surplus even after Loan Amortisation (since 2000)	229
Debt (since 1999)	NIL
Debt/Equity (since 2000)	Negative
Working Capital (since 2003)	Negative

The picture is very clear. The company enjoyed a debt free situation since 1999. The debt-equity was reported negative. Further the working capital defined as current assets minus current liabilities was also negative and placed at Rs.48 crores for the year 2003. The negative working capital continued to be negative for the years 2004-2006. As a result of the above the assets profile of the company underwent change in 2006 as against 2003 as shown below:

TABLE SEVEN

	2003 *(Rs. Crores)*	*%* *In Total Assets*	*2006* *(Rs. Crores)*	*%* *In Total Assets*
Net Fixed Assets	187	30	145	21
Investments	200	33	253	36
Current Asset	228	37	296	43
Total Assets	615	100	694	100

It can be seen that investment as a % of Total Assets has gone up to 36% , while that of Net Fixed Assets reduced to 21%. The rate of increase in investment is 27% for a company which had reasonably high Net Fixed Assets in 1999. The business strategy was to increase investment outside the company per se but within the umbrella of ICI group. This strategy helped the company to become lean and mean. VRS was the key to this and the substantial reduction in staff due to the hiving off of divisions bear testimony to the same. Inspite of the hiving off of divisions, the sales of ICI have shown a 20% increase while reaching to Rs. 993 crores over the 8 years ending 2006. The long term liabilities on account of obligations towards employees were funded through long term one time cash flows made possible through sale of divisions. The extinction of obligations was Rs. 294 crores and the funding of the same order came, to reiterate, from sale of divisions. In the same period though increase in sales was meagre 20%, the extent of increase in profit was mindboggling 95% over the said 8 years ending 2006. The surplus which emerged on account of sale of divisions was used to extinguish obligations to employees and repayment of debt. Further cash surpluses were used to pay 325% dividend for the 3 years ending 2004. This amounted to Rs. 41 crores in 2002 and 2003 each year and Rs. 51 crores in 2004. The total dividend paid is of the order Rs.133 crores.

ICI situation is interesting - today it has no debt to be paid, minimal staff, initial capital of Rs. 41 crores more than fully recouped- 3 times; infact recouped umpteen times. The company is totally free of any responsibility whatsoever. The company is mean and lean in the true sense of the term. Thus ICI as a foreign investor can walk away with their realizations at market prices as soon as possible. (See Tables Eighteen and Ninteen for hefty dividend payouts of select companies.)

Box 51

The ICI experience indicates that the company eventually wants to delist itself and go into the background so that disclosures, transparency and accountability pro tanto gets diluted. Governance gets restricted to the four walls, of a neat closely held group, which has its own advantage along with opportunities for quick decision making with respect to a wide variety of issues. Today corporate management is guided by the compliances requirement of SEBI, Company law, et al. Hence decision making is circuitous.

It is interesting to note that “Tatas have decided to keep Corus as an unlisted company to be held by one of Tata Steel’s subsidiaries”. *(Times of India dated 5/3/2007)*

Case Study- 3

Bharat Forge Ltd.

Annual Report 2005-06 shows following changes in financial structure of the company.

TABLE EIGHT

Loans Repaid ***(Long Term)***	***Rs. Millions***
9.25 % Redeemable secured Non-Convertible Debentures	100
Foreign Currency Term Loan (secured loan)	112
Rupee Term Loan (secured loan) from Banks	53
Public Deposits (unsecured loans)	77
Foreign Currency/Rupee Demand Loans from Banks	628
Total	970
Unsecured Loans Raised	
0.5% Convertible Foreign Currency bonds (FCCB)	4752
Short term finance for import of goods by buyers line of credit	111
Pre shipment Packing Credit from Banks	68
Total	4931

This obviously reduced the cost of finance for the company but more than that it released charge on assets of the company because it repaid "secured loans" whereas Foreign Currency Convertible Bonds was an unsecured loan. Taking a step further, it repaid 0% Interest Sales Tax Package Loan of Rs. 43.86 millions and obtained a discount on early repayment of loan which was a "capital profit" !

Even on the share capital side company used three different instruments to generate huge funds (though not immediately required for business operations, but certainly keeping in mind future business acquisitions) by taking advantage of a booming capital market.

1. Global Depository Receipts (GDR)
2. Right issue at substantial Premium in October 2004
3. Conversion of Detachable Warrants which were issued alongwith right shares at hefty premium i.e. Rs. 266/- per share of Rs. 2/-

In this manner company generated Rs. 6946 million extra money by way of share premium for increase in share capital of Rs. 49 million only! No wonder at first it repaid 9.5% Redeemable Cumulative Non- Convertible Preference shares of Rs. 100 million.

To top it up the company converted Foreign Currency Convertible Bonds (FCCB) at a premium of Rs. 334/- per share of Rs. 2/- face value into equity capital with almost negligible cost of finance for ever. This modus operandi of the company clearly indicates strategic approach to funding decisions with least constraints.

Case Study - 4

Nicholas Piramal India Limited **(NPIL) –** consolidation for all round competitive edge-THE PIRAMAL WAY

Mr. Ajay Piramal charted a different route by acquiring Nicholas Labs. from Sara Lee in 1988 and went on taking over more pharmaceutical companies one by one since then. Today Piramal Enterprises is Rs. 2500 crores group, with a research centre in Scotland, U.K. He achieved inorganic growth of pharma business by acquiring following well-known pharma companies or their established brands :

Roche Products Ltd.; Boehringer Mannheim India Ltd.; Hoechst Marrion Russel Ltd.'s research centre; Rhone Poulenc Ltd.; ICI's pharma division;

Aventis's Research Facility; (in Dec.05) Avecia Pharmaceuticals plc., U.K., Rhodia Organique Fine Chemical Ltd.(w.e.f. 11.1.05)

NPIL has entered into 2 strategic agreements with AstraZeneca AB, of Sweden and Pfizer International Inc., USA.

Initially financial strength was created by disposing off landed property of some of the acquired pharma companies and that money was pumped into the flagship Company Nicholas Piramal India Ltd. But many of the subsequent acquisitions were carried out by issuance of equity shares, without losing control over the business. NPIL has sizable Redeemable Preference Share capital of Rs. 53.37 crores (even more than equity share capital of the company) at just 5%-6% rate of dividend.

NPIL used convertible share warrants as well as right shares that it alloted in Sept.'05 at hefty premium of Rs. 173/- for Rs. 2/-face value equity share. NPIL also raised USD 15 million (Rupee equivalent 67 crores) as External Commercial Borrowing (ECB) from two foreign banks at cheap rate and repaid unsecured loans, totalling Rs.115 crores, which were costly domestic loans.

Right issue resulted in Rs. 3.8 crores increase in equity share capital and added Rs. 328.9 crores to Reserves. Right shares issued in F.Y. 05-06 at high premium brought down Weighted Average Cost of capital (both Debt as well as Equity taken together) substantially. At the same time the company invested a fresh Rs. 460 crore in Fixed Assets that gave an advantage to the company in tax saving through depreciation on assets. Company also part financed additional requirement of working capital of Rs. 88 crore necessitated by growth in business.

NPIL has Joint Venture 49:51 with Boots plc. U.K., since April '02 in the name of Boots Piramal Healthcare Private Limited for OTC segment with products like Polycrol, Lacto-Calamine, Saridon, Strepsil and Clearsil to make it a leader in OTC Pharma business.

NPIL has business partnership with Allergan India Limited for Medical Optics business (e.g treatment of blindness)

Box 52

Theme : The company adopted inorganic growth route for faster development through acquisitions and strategic alliances with foreign pharma majors and converted its production and research and development facilities into world class manufacturing and research facility centre for large numbers of pharma products of other companies. It concentrated on end chain production processes rather than full chain production of pharmaceuticals. At the same time it strengthened its All-India distribution network to provide end to end solutions in marketing pharma products with wide range of over the counter products in its fold. All this was financed in steps by re-investing profits and relying on risk-capital rather than costly borrowings.

Corporate growth through Mergers and Acquisitions (M and A)

Ajay Piramal Style

The differences between the stereotypical predator and somebody like Piramal who is akin to an artist in terms of M and A activities is as follows:

Stereotype	***Artist***
Canny negotiator	Compelling persuador
Focused on details	Big picture man
Hands-on deal-maker	Strategy-maker
Post-takeover integrator	Total delegator

Source: Prof. S Shiva Ramu, Corporate Growth through Mergers and Acquisitions pp 246, Sage Publications 1998

Box 53

Piramal's Tactics in Acquisitions

- Take decisions alone: Consultations can obscure the objectives.
- Never pay more than you want to: The benefits may not be worth it.
- Act as quickly as you think: delays can sour deals and attract competitors.
- Be patient if the timing is not right: A good acquisition is worth waiting for.
- Accede to unreasonable demands: It allows you to draw on your credit later.
- Do not get snarled in details: The nitty-gritty never needs top-down attention.

Source: Prof. S Shiva Ramu, Corporate Growth through Mergers and Acquisitions pp 246, Sage Publications 1998

Box 54

Piramal's tactics may not be successful in other industries such as cars, computers and process industries. Piramal started to diversify from his family's Morarjee Mills textile business. He first moved from non-patented medicines and antibiotics to nutritional and biotechnology products. In the pharmaceutical industry, Piramal first acquired the Indian associate of the French multinational Nicholas group in July 1988. This was followed in 1993 by the acquisition of German multinational Roche's Indian subsidiary.

Source: S Shiva Ramu, Corporate Growth through Mergers and Acquisitions pp 246, Sage Publications 1998

Low Interest Rates – A New Paradigm – Leading to Newer Paradigms

High Interest rates and high tax rates were complimentary and worked on many occasions to the advantage of enterprise. High tax rates mean an opportunity for leveraging the benefits of tax deductibility.

Thus, 'if e = expense and t = tax rate, tax shelter = ' **t x e** ' and tax adjusted expenses = '(1- t) e. In the context of this formula, higher the tax rate, higher was the tax shelter. In the seventies, when the intensity of marginal tax rate was as high 95 percent plus, (more than 100 % including wealth tax) an incremental amount of Rs.100 tax deductible expense meant that the Exchequer bore the burden to that extent namely at least 95 % of the expense. Only the residual 5 % or less was borne by the business. Enterprise was also motivated to boost the amount of expenses claimed for tax purposes..

Over the years things have changed and there has been a paradigm shift from the idea and concept of a " highest tax nation" to a moderately taxed nation. With falling tax rates the impact of tax shield is reduced. This has further reduced the motivation to use debt as a component in the capital structure. The role of leverage is moderated and with a booming stock market which facilitates raising equity capital at a premium, debt becomes a relatively expensive proposition. There is a paradigm shift indeed from the theme that debt is cheaper than equity to a reverse situation viz equity is cheaper than debt.

DEBT and EQUITY

- When income tax rates were high and interest rates were also high the tax adjusted interest cost was reduced substantially. In 93-94 Reliance Capital and IDBI could price their shares at Rs.130 per share (Rs.10 face value). The post issue price ruled around Rs.55-60. The substantial premium of Rs. 120 per share(1200 %) depressed the effective cost of equity to such an extent that equity was cheaper than debt even with the combination of double digit interest rate and tax rates placed above 50%.The post issue price gave shock waves to many entrepreneurs who wanted to follow the Reliance Capital route. While Reliance Capital managed the show and so did Larsen and Toubro finance, Mahindra & Mahindra financial services and the Kotak group, a few others failed miserably viz. Lloyd Finance, Suman Motels and Mafatlal's finance.

  In 2006 the corporates raised a lot of money through IPO equity issues along with hefty premium. Sun TV raised Rs. 500 crores with equity shares of face value of Rs. 10 at a price of Rs. 730 to Rs. 875 per equity share giving a premium of at least 630%. Similarly D.S.Kulkarni builders raised Rs. 100 crores with an equity share face value of Rs. 10 and a premium of 230%. Plethico Pharmaceutical raised Rs. 110 crores with a face value of Rs. 10 and a premium of at least 240%. In the case of Sun TV the premium itself was substantial and would have helped the company to service the capital almost into perpetuity. In all such situations there is no such thing as a choice between debt and equity. Equity is bound to be prefered. Till recently since tax rates were low and interest rates were also falling, companies which managed to go to the primary market by issuing shares, at a premium prefered equity to debt. Thus the theme that debt is cheaper than equity is not a dictum applicable universally in vacuo. The cost of debt and equity is driven by interest rates, tax rates and the ability of the companies to mop up surpluses by way of share premium at the time of issue of shares.

After tracking and tracing different dimensions of interest management – macro as well as micro, it is necessary to understand various aspects of India Inc's issues concerning managing taxes – pre and post 1991.

In the World nothing is certain but Death and Taxes

Letter to J.B. Levoy (13.11.1789)

SECTION - 5

FINANCIAL EXCELLENCE

MANAGING TAXES

- ✔ Tax Planning
- ✔ India – The Highest Tax nation
- ✔ Reliance Industries Ltd.
- ✔ Minimum Alternative Tax
- ✔ Depreciation as Source of Funds
- ✔ Tax Avoidance and Tax Evasion
- ✔ Mc Dowells Case

TAX PLANNING

The Exchequer's role in garnering taxes and mobilizing resources may be at loggerheads with the entrepreneur's objective of maximizing post tax profits. If the incidence of tax is high, profit after tax is low to that extent . Tax management is therefore a very important function in business all over the World. Newspaper advertisements inviting applications for positions like tax accountants, tax managers, tax executives bear ample testimony to the special status for the tax function all over the World. The role of the tax manager is to minimize tax liability of enterprise and yet make sure that no law is flouted – neither the letter nor the spirit of law should be invoked to meet perverted, short run, mala - fide objectives. The concept of tax management has had a chequered history . In the earlier years, efforts were made to minimize tax liability by arranging incomes and expense in a manner that profits always tend to zero or negative levels. There are cases where corporates had not paid taxes since inception – hence the expression ' zero tax companies' evolved in India. A look at the financial statements, of Reliance Industries, shows that provision for tax appears at 'nil ' value year on year basis. This is true for several business houses. In fact at one time in the late sixties and during the seventies, it was accepted that ' tax evasion is illegal but tax avoidance is legal '. The subtle difference between the two expressions provided breathing space to enterprise to use the intellectual capital of the accounting world to make perversions stemming from intent to evade look as if the idea is to avoid tax liability. To pre-empt the possibilities of zero tax situations, the 1996-97 Union Budget introduced the concept of Minimum Alternative Tax (MAT) on companies. Today, MAT stands, even today, as part of the Income Tax Act through S115J. (Box 61)

The modus operandi of tax planning and its impact on tax liability on corporates is represented in Table Nine regarding Reliance Industries Ltd. What was true of Reliance was true of other companies too. The introduction of S115J in 1996-97, to reiterate, was to bring zero tax companies within the fold of tax paying assessees.

India-The Highest Tax Nation-Once Upon a Time

Box 55

- In India, income taxes on individuals, even prior to the Union Budget-1970, was the highest in the world. The gap between the intensity of tax rates in India and other countries was substantial. At one point of time, if wealth tax was included along with the tax on urban properties, tax would exceed 100% of income in certain cases. This is preposterous but true ! Though such progressive taxation helped mopping of resources from the affluent,it had its own adverse impact. Even the managerial, professional and intellectual classes had to bear with the incidence of a marginal tax rate of 66% to 77%, depending upon the position in the incomes ranging between Rs. 40,00/- to

Box 55 cont...

Box 55 (cont.)

Rs. 80,000/- per month. This substantially destroyed the incentive to work and acted as a disincentive towards intellectual capital formation.. Even the moral fibre of the country was adversely affected because high tax rates put a premium on dishonesty. It led to the creation of black money and the emergence of a flourishing parallel economy. In those days tax rates were unfair and rather expropriatory and adversely affected the economic and technical development of the country. Thus the top 10 nations based on high taxation and the countries with relatively low tax rates are shown below in Table Eight.

TABLE EIGHT

Top 10 Nations (High Incidence of Taxation)	***Top 10 Nations (Low Incidence of Taxation)***
Congo- 55.7%avg. tax rate	Mexico-13.8%
China-46.9%	Singapore-11.5%
Argentina-44.3%	Ghana-9.9%
Brazil-38.8%	Ecuador-8.2%
Germany-38.1%	Ukraine-7.7%
United States- 38.0%	Hong kong-6.1%
Russia-37.6%	
Canada-36.6%	
Japan-32.2%	
France-32.1%	

Box 56

Impact of Tax Planning

Over the last thirty years ending 2006, tax record of **Reliance Industries** shows that

1. On 15 occasions between 1975-1995 i.e. over 21 years, the provision for tax is NIL;
2. From 1996-97 to 2005-06 the provision for tax is positive. The said provision ranges from a minimum of 1.73% to a maximum of 8.41% of profit before tax.
3. Over the thirty years ending 2005-06, the total profit before tax is Rs. **2744.15** crores and the provision for tax is a mere **5.53 %** of profit before tax. Even after the introduction of MAT the tax record of **Reliance Industries** shows that the provision for tax as a percentage of profit before tax is rather low, a maximum of **8.41%** in the year 2005-06.

Box 56 cont...

Box 56 (cont.)

4. There were several companies like Reliance which have enjoyed the benefits of the bonanza of tax planning using the several benefits and incentives provided in the Income Tax Act.

TABLE NINE

Reliance Industries Ltd.			
Column 1	**Column 2**	**Column 3**	**Column 4**
		(Rs. In Crores)	
Year	**Provision for Tax**	**Profit before Tax**	**Col.2 as% of Col.3**
1975-1976	NIL	0.6	-
1976-1977	0.05	2.98	1.67%
1977-1978	0.2	6.75	2.96%
1978-1979	NIL	8.21	-
1979-1980	NIL	11.2	-
1980-1981	NIL	19.69	-
1981-1982	NIL	29.16	-
1982-1983	NIL	38.52	-
1983-1984	NIL	61.09	-
1984-1985	10	71.33	14.02%
1985-1986	NIL	14.17	-
1987-1988	2	80.77	2.47%
1988-1989	NIL	79.37	-
1989-1990	10	90.5	11.05%
1990-1991	NIL	125.55	-
1991-1992	NIL	163.32	-
1992-1993	NIL	321.75	-
1993-1994	NIL	575.49	-
1994-1995	NIL	1064.85	-
1995-1996	NIL	1305.27	-
1996-1997	45	1367.7	3.29%
1997-1998	63	1715.67	3.67%
1998-1999	30	1733.69	1.73%
1999-2000	57	2460.25	2.32%
2000-2001	135	2780.62	4.86%
2001-2002	190	4428.7	4.30%
2002-2003	245.9	4974.21	4.94%
2003-2004	351	6301.14	5.57%
2004-2005	705	9068.68	7.77%
2005-2006	900	10704.06	8.41%
TOTAL	2744.15	49605.29	5.53%

India Incs —— Incidence of Tax

Box 57

1. On the eve of liberalisation, that is to say in the assessment year 1990-91 the Income Tax rates were as high as 54% including surcharge. For closely held companies it was higher by at least 10%. The highest incidence of taxation was on foreign companies. However from assessment year 1991-92, as part of liberalization process, these rates were scaled down. Today for assessment year 2006-07 the rates for domestic companies are as low as 36.59% (including surcharge and education cess). For foreign companies the income tax rates are 40.80%.

Box 58

INDIA INC'S EFFECTIVE TAX RATE IS ONLY 17%

2. According to a recent news item the effective tax rate for corporates is a mere 17%. A panoply of tax breaks have contributed to the low incidence of taxation and the actual tax rate of 33.66% is only a theoretical rate. The range is 11.7% (IT sector) to 32.5% (paint industry). The effective tax rates according to the study made by the finance ministry is Oil and gas **22.8%** ; Banks **22.0%** ; Metals **25.6%** ; Capital Goods **28.4%** ; Paints **32.5%** ; IT **11.7%** ; Telecom **14.0%** ; Cement **12.0%** ; Textiles **15.8%** and Power generation **13.9%**.

Source : The Economics Times February 2007.

Box 59

3. According to the Finance Minister Mr.P.Chidambaram, corporate tax rate is already low and at par with ASEAN levels. To quote Mr.Chidambaram, " Effective tax rate is not only moderate...... The effective tax rate in India is 19.2 per cent. Show me one ASEAN country which has an effective tax of less than 19 percent." he said at a post-budget interaction at FICCI.

(Mumbai Mirror, 6.03.07, p 22)

Box 60

4. A recent study showed that of the fifty companies paid less than 33 per cent tax on their profit. A few companies paid more than the applicable corporate tax rate. However, this was attributable to arrears and appeal decisions dividend distribution tax, interest tax and other taxes. (Business World, 26.02.2007, P.54)

Box 61

➜Minimum Alternative Tax on Companies – 1996-97 Union Budget

- In recent times, the number of zero-tax companies and companies paying marginal tax has grown. Studies have shown that inspite of the fact that companies have earned substantial book profits and have paid handsome dividends, no tax has been paid by them to the exchequer.

  The new proposal provides for those companies to pay tax on 30% of the book profits, whose total income as computed under the Income tax Act is less than 30% of the book profits as per the books of account prepared in accordance with Parts II and III of Schedule VI to the Companies Act, 1956. "Book Profit" is defined and certain adjustments are also provided in the proposed section.4

  The proposed amendment will take effect from 1st April, 1997 and will, accordingly, apply in relation to assessment year 1997-98 and subsequent years.

(Clause 37)

TAX PLANNING – How Depreciation became a tangible source of funds?

Box 62

- During the license raj, licenses were obtained. However, capacities were not installed. This process of preempting production capacities, through procurement of licenses for holding, resulted in the legislation then called as MRTP-Monopolies and Restrictive Trade Practices Act. MRTP Act came into the scene following the Hazari Committee Report in the late sixties. Preemption of capacities was the key malaise which then plagued the mindset of enterprise. Thus even with under utilisation of capacity new licenses were obtained, once again to retain the monopoly, prevent new entrants and initiate new activities only at the will of the entrepreneur. In some cases machinery was obtained from abroad, installed,duly licensed but not put to production. Thus, capacity was created and the depreciation on the same was claimed for 365 days though the machinery was owned only for a few days- in some cases owned only for a day because the tax statutes then allowed claiming of depreciation for 365 days though the asset was owned and installed only for a day. The high marginal tax rate only added fuel to the fire by encouraging such motives which were not transaction driven but driven only by tax benefits accruing to the business. In this sense depreciation became a tangible active source of cash (funds).

Box 63

Tax Planning-Tax Avoidance Versus Tax Evasion -Then and Now

In the past there was a subtle but real difference between avoidance of tax and evasion of tax. Over the years this distinction was accepted. Infact this distinction evolved in 70's through the Wanchoo Committee Report on black money. The wide variety of incentives provided under the Income Tax Act (1961) section 32 (depreciation), section 32 (A) (investment allowance earlier known as development rebate), section 80 J (tax holiday at a prescribed percentage of capital employed), section 35 (a series of incentives by way of amortisation of preliminary expenses, patents and copy rights as well as export promotion incentives) et al. These incentives were taken full advantage of. It was accepted as legitimate to take advantage of these incentives and minimise tax liability, maybe, year on year basis. Hence, the concept of zero- tax companies evolved. However in a decision in 1985, the Supreme Court in the case of McDowell and Company Ltd. (1985) came out with a new version of judicial view on the issue of tax planning, tax avoidance and tax evasion. According to the court tax avoidance is "the art of dodging tax without breaking the law".

In the English case this principle of Westminster was buried. Said the judge "No one can now get away with a tax avoidance project with the mere statement that there is nothing illegal about it". The court observed that while tax planning is perfectly legitimate the presence of the following in planning of tax could be termed as "tax avoidance":

a) fraudulent motives ; or b) *mala fide* intentions or ; c) colourable devices ; or d) form of transaction in accordance with the letter of law but absence of substance of transaction defeating the legislative intent.

Tax planning is a perfectly legitimate exercise if it complies with under-mentioned ingredients :

→ Tax planning should reflect the basic intention of legislature behind the statute.

→ Tax incentives availed of by the assessee is within the ambit of legitimate tax planning.

→ Planning of financial affairs by a series of transactions (doctrine of form) each having individual legitimacy and composite effect produced as a whole (doctrine of substance) following the true spirit of law is perfectly legitimate.

Tax planning should not involve use of colourable devices for reducing tax liability.

The Government had also a complicated network of sections, which provided for a variety of incentives announced by State Governments through State Financial institutions. All incentives taken together it appeared, at least prima facie, that enterprise could be started with little or no capital, physical incentives made life easy to do business and finally tax planning could keep the Exchequer at a distance for years together. The spirit underlying business management was not to pay taxes at all through appropriate tax avoidance policies. Added to all this was the high marginal tax rates which were unduly high – tax rates were rather preposterous. Hence, the motivation of enterprise to aviod taxes.

Managing a business during the license raj and a highly taxed and controlled regime was like developing a mathematical model which would capture all constraints and conditions imposed by law and yet all businesses to survive happily. The skill and attitudes that developed were perverted in nature and talent was hired mainly to meet objectives which could easily be defended as bona fide yet had a hidden agenda of achieving ulterior may be mala fide, goals. The environment of high taxes also encouraged conspicuous consumption, ostentation and prodigal dispensation of wealth.

Post 1991 things underwent a radical change. For the first time in several decades fiscal policy was designed to facilitate active participation of assesees in favour of compliance rather than avoidance or evasion for that matter.

Following Mc.dowell’s case the subtle difference between evasion and avoidance was erased in favour of compliance and adoption of ethical coupled with bonafide attitudes towards payment of income taxes, given the relatively low tax rates.

The Income Tax Authorities also started looking at assessees not with suspicion and distrust but with pro-active support for compliance. Over the years the approach to tax management has undergone a reasonable change – from the corporate perspective as well as from assessee’s perspective. Yet if corporate financial objective, of maximizing returns on shareholders equity, has to be met on a continuous basis, tax planning and management is inevitable and imperative. Minimizing tax liability in accordance with the laws governing taxes is a bonafide objective for any category of assessees. Any a priori assumption that tax planning designed to minimizing tax liability is unethical and intended to deprive and defraud the Treasury of revenue is unacceptable. Hence the importance of tax management in corporate financial management.

Thus, financial management performance is functionally related to management of at least three aspects – interest liability, debt-equity policy and tax management. All these three factors, representing financial leverage and tax impact, viewed together will decide the extent to which operating excellence can be or is transmitted to shareholders. Should financial management carve out a separate proactive, niche in business, treasury management can not only complement operating excellence but actually, actively, contribute to boosting the bottomline as well as return on equity. To start with treasury management is essentially a cost or expense centre. As activities increase and treasury contributes proactively, it assumes the status of a profit centre at par with such centres like marketing, production (a synthetic profit centre) and other segments of business. Ultimately, treasury operations may become so large, important and profitable that it assumes the status of an independent investment centre and is floated as a full fledged corporate organisation. L&T Finance, Reliance Capital, Mahindra and Mahindra Financial Services and many other groups have pursued this route. Among other advantages one which stands out is the high leverage permitted to finance companies. The sister companies are legitimate beneficiaries of this bonanza leverage facilities without resort to bankers. Thus, the autonomy of enterprise vis-a-vis the clutches of the banker is fully protected.

Of course the autonomy of the finance company and other sister companies, inter-se, is retained and yet all actions taken by all the inter-related companies will have to converge towards the overall organisational objective of maximising the wealth of shareholders.

Finally the measure of performance is Return-on-Equity that is to say total management performance which is a product of operating excellence and excellence with respect to interest and tax management, as shown in Box 38.

The issues presented and discussed so far have given the components of total management performance viz operating and financial excellence. It is now necessary to capture the impact of the changes that have take place since 1991. Section Six addresses various issues that seem to be pointers towards the changes that have occurred.

Commerce defies every wind, outrides every tempest and invades every zone.

George Bancraft

SECTION - 6

FROM HERE TO WHERE? - VISION 2050 ! ! !

- ✔ **From License Raj to Liberalization**
- ✔ **Indian Farmers – From Farming to E Chaupal**
- ✔ **India - From Downgraded to Up graded Sovereign Rating**
- ✔ **Indian Financial Markets to Foreign Financial Markets**

From License Raj to Liberalization

In India, during the license raj capacities were restricted by law. Limited production resulted in monopolies with demand exceeding supply. Prices were high and profit margins were also high. The quantum of profits was driven by the extent of freedom with respect to price fixation. However, high tax rates and interest rates reduced the post tax profit. Capital mobilization was adversely affected partly due to poor profits and mainly due to controls imposed by the office of the Controller of Capital Issues with respect to quantum of funds, mix of funds, cost of funds, frequency of funds raised through rights issue and or public issue and pricing of securities raised in the market. This situation continued until the dawn of liberalisation (1991). As part of the liberalisation process there was a series of reforms since 1991 as shown in Box 16.

As a result discretion for decision making emerged on all the three fronts viz. capacity creation (production capacity), imports of raw materials as well as capital goods and interest rates fixation by banks.

Thus, industry went in for an almost unfettered expansion during the said period 1991-1996. However, demand continued to exceed supply.

Expansion programmes for medium and large-scale unit got a fillip. Further, production activity hitherto the preserve of the reserved sector were opened. This created new opportunities for industry to expand in all directions- main production as well as auxiliary production. Perhaps this kind of expansion was unprecedented in recent business history. Simultaneous to the above liberalization the opening of the economy to imports added to the volume of goods and services available in the markets. There was a sudden glut in the market and supply exceeded demand. Between 1998-2000 there was a slow down in industrial activity and the stock markets responded sharply- creating a divide known as old economy shares and new economy shares. Monetary policy had to address a mood of pessimism and revive business activity. This motivated the dawn of cheap money policy. Moreover, interest rates had to be aligned with the rest of the World. The idea was to give a boost to industry and improve the returns on investment. Wholesale banking and development banking became a thing of the past and retail banking emerged from 2001 onwards. There were other effects supply increases, low interest rates, inflation control and activity revival which was restricted primarily to India. Other countries, particularly the USA, were experiencing a stagflation. FDI's and FII's increased and the banking and insurance sector got a new fillip. Mutual funds became an important outlet for investment because of high savings rate, which were driven by the overall per capita income increase. Thanks to the lead taken by the software sector, this favourable phase continued upto 2003. Downward interest rates continued till July 2004. After the change of Government in May 2004 the actual inflation rate in the economy, which was more than 6%, was addressed by Government. It became imperative for interest rates to rise in order to control inflation. Since stock market had revived, companies including banks encashed on the equity boom from October. 2004 onwards. Changes in taxation of dividend and exemption of long term capital gain from investment in shares quoted on the stock exchange assured attractive returns on stock market investment which never looked back since October 2004 . Industry was also comfortable because of cheap foreign currency loans through Global Depository Receipts, American Depository Receipts, Foreign Currency Convertible Bonds and Euro Bonds route. Without fear of rupee depreciation this was coupled with heavy inflow of foreign funds in the nature of FII investment, FDI and private equity.

The paradigm shifts in interest rate, taxation and other policies related to permitting freer flow of funds from foreign countries as well as abolition of the office of Controller of Capital Issues followed by a regulated, market driven, stock exchange transactions including demat and screen trading showed that Indian markets moved from its erstwhile narrow and shallow profile to a new avatar with the required breadth and depth. Above all it portrayed the spirit of entrepreneurship, the dare and ambition to rise to the occasion by unleashing the hidden potential of entrepreneurship, and exhibiting the true spirit of India to the World and ourselves.

Indian Farmer: Farming to Bourses

- A new development in the field of ‘development of markets’ is the emergence of commodity markets. Till recently commodity markets were rather inactive except in case of oil seeds, grams, dal and tamarind. Of late commodity markets are emerging in different regions in Maharashtra and other places. Thus, we have a very active and busy commodity market for grains (dal, gram) and sugar, gur, tamarind (Sangli District) in Maharashtra. Similarly there is a wheat commodity market in Harayana and the Punjab. Andra Pradesh boasts of strong commodity markets for tobacco, cotton, chillies and tamarind. These markets are slowly getting integrated. Through connectivity there can be consolidation finally leading to unification with agricultural produce market committee. Such an independent market for commodities for future trading, on the basis of spot market, has enabled farmers to take advantage of business motives without necessarily playing on the stock markets. This is an important development in the overall context of development of markets since 1991and helped farmers to feel markets and externalise, to reitrate, their business motives without going to the equity market. Moreover the farmers have knowhow of commodity markets and feel very comfortable using their native skills, acumen and confidence in taking decisions on the commodity bourse. This comfort zone of familiarity, confidence and concomitant motivation does not exist when they look towards the stock exchanges.
- E Chaupal is a place where the farmers got a first feel of commodity markets without going to the ‘mandi’. Communication links were established through mobile and the process got into action. Bullion markets developed, in their initial stages, through

this process where traders could get the prices of gold everyday in the morning. This was happening with a small group of traders, though. now, it is happening to farmers on a reasonably large scale.

India's Sovereign Rating Upgraded

- Standard and Poor (S & P) an international rating agency has recently upgraded India's rating as an investment destination. India's sovereign rating has moved up from a prevailing speculative grade to an investment grade. According to the agency "The upgrade reflects the country's strong economic prospects, external balance sheet and its deep capital market, which supports a weak, but improving fiscal position."

  Moody's another global rating agency had upgraded India to investment grade in 2004. Fitch also did the same in August 2006.

  India's rating was downgraded in May 1991 when the external account was under severe stress. We had enough foreign exchange only to meet two weeks import bills. This grading did not change till recently because of fiscal imbalances. The combined fiscal deficit of the state and central governments was still hovering around 7.5% GDP. This is much below comfort zones. Infact India's total debt equals 85% of annual output and interest on loan absorbs 35% of revenues. The current situation is bullish because of a buoyant buying spree from the growing affluent middle class-854billion dollars. India is rated as the fourth fastest growing economy in Asia-Pacific this year. According to Goldman Sachs the country will become the second largest economy ahead of the United States and next only to China by 2050. S and P say "Further rating improvements will depend on sustained prudent fiscal policy that leads to a decline in government debt and interest burden, and further reforms that lift the growth prospects and income levels,"

TABLE TEN

India Ahoy 10 Years of Change

	Feb-97	*Feb-07*
GDP Growth Avg for 3 yrs (%)	7	8.6
Forex Reserves ($ bn)	26	190
FII inflows ($ bn)	7	8
Tax Revenues (Rs cr)	153,347	442,153
Tax Payers (million)	12	35
Service Tax Collections (Rs. Cr)	1,059	34,500
Peak Customs Duty (%)	50	12.5
Total Expenditure (Rs cr)	232,481	563,991
Prime Lending Rate (%)	14.5-16.0	11.0-11.5
Credit to agriculture (Rs cr)	28,000	1,75,000

Source : TOI, 26, Feb. 2007, pp 01. News Item "10 years on, will the FM dream again?"

From Indian Financial Markets to Foreign Financial Markets

Over a period of time India INC has managed various options, to improve return on investment, such as increase in revenue, reduction in cost, effective and efficient management of capital and last but not the least management of cost of capital . The corporate financial objective of maximisation of present value of future benefits gets fulfilled automatically as and when cost of capital moves downward .This is because projects which are rejected with a tough, rigorous, target or hurdle rate would get accepted if the rigour of the said rate is diluted through shrewd and timely management of cost of capital.

Now,

$$\sum_{i=1}^{n} \frac{B i}{(1+k)^{n}}$$

is the present value of future benefits where, as mentioned earlier,

Bi = prospective yields expected over the economic life of a proposal at the end of each year, in rupees and K = discount rate (%) used as the cut off point.

The final value to shareholders is given by the difference between the present value of future benefits and the initial commitment of capital (say Rs. 'C'). This difference is known, in financial parlance, as Net Present Value (NPV), which is expressed in financial terms as an absolute amount. NPV is a measure of performance used to evaluate worthiness of investment proposals. Thus the explicit goal towards which financial management must be directed is continuous maximization of the present value of future benefits of shareholders' investment. Through this process the market value of the business can be maximized.

As the denominator 'k' becomes lower and lower the value of the above algebraic expression is automatically increased. The degree of change in the amount of wealth and value created depends upon the extent to which the cost of capital is lowered, all other things being equal.

Box 65

MANAGING COST OF CAPITAL

Managing cost of capital usually denoted by an algebraic expression (k_o) is key to wealth maximising strategies of enterprise. In fact,k_o is an input to establish the minimum acceptable rate of return (R). Thus:

$$\mathbf{R \geq k_o}$$

R refers to the expectations of management on account of a variety of factors. These expectations tend to push R as away from k_o , in the upward direction, as possible. The factors influencing the shift of R away from k_o

Box 65 cont...

include a variety of risks – currency, exchange, sovereign, business and financial risks to list a few. Various metrics are used to quantify (R). However some judgmental input is also required and the final imputation of value to R may not always originate from pure quantification. R thus represents a fundamental standard of financial performance against which investment proposals are assayed. R may be defined as a target rate or hurdle rate which must be surpassed in order to justify the use of capital. The computation 'k_o' is quite involved particularly in the context of capital asset pricing model (CAPM) and is presented in the glossary.

In the post liberalisation era, managing cost of capital has been a key challenge and opportunity to improve the competitive edge. There has been a progressive shift from one method of funding to alternative methods of funding and from one kind of instrument to another and further, again, from one country and type of currency to another. Thus in the early years 1991-1997, debt was cheaper than equity, thanks to high marginal tax rates and interest rates. However as interest rates moved downwards from-double digit to single digit and tax rates also moved from the rigours of a highest tax nation to a moderately taxed nation, the benefits of leverage on account of high tax rates got diluted. With a buoyant capital market and high, positive, bullish, optimistic expectations coupled with improved book profits, increased payout ratios were the order of the day. The entrepreneur found equity to be better and cheaper than debt for more reasons than one—hefty premiums and simultaneously out of the clutches and fetters of the banker. Enterprise autonomy was also ensured. In the same way the effort of enterprise to allow cost of capital to move further down resulted in adventures of Indian enterprise into foreign financial markets which historically have enjoyed or suffered from cheap money policy. Thus, corporates ventured to raise, to start with, debt or debt related instruments like external commercial borrowings(ECBs) and euro bonds. Further India INC also raised funds through foreign currency convertible bonds, global depository receipts (GDR) and american depository receipts (ADR) . These instruments were convertible into equity at a premium on the basis of the covenants established at the time of issuance in foreign markets. Thus corporates ventured to raise finance through cheaper instruments in foreign financial markets . To start with two new instruments namely GDR and ADR were launched in 1993. It may be noted that GDR/ADR holders were entitled to dividends (subject to tax) as well as bonus and rights issue during the tenure of the said receipts. This eliminated the exchange risk, when rupee was depreciating in 2002. The investor had an option to either accept the conversion into equity or claim redemption of the instrument. Migration to new instruments took place at a time when interest rates at home were around 21% per annum. India Inc. also raised funds through ECBs or Euro bonds and interest rates were very low. The interest rate payable for the said borrowings were as low as 1% (2001) in the

US market. The rates of interest were a little higher in European markets. However in Japan the interest rates were rather low, perhaps the lowest. It is believed that the issuance cost amounted to 1.25% on an average. Of course, the interest cost excludes the issuance cost. It is interesting to know that as late as 2006 Bharat Forge raised funds through foreign currency convertible bonds at half per cent interest rate as indicated in the 'Annual Report' of the company for 2005-06. However these were debt capital raised in foreign currency and in foreign land. In any case debt had to be repaid. In the event of default the difficulties that emerged were rather awkward. The sovereign rating could be damaged too. The reputation of entrepreneurs and the country may be adversely affected. Hence convertible bonds were issued to forestall the repayment of principal as and when necessary, provided all other covenants are met. Thus this was the final act of entrepreneurial adventure of India Inc to issue equity capital in foreign markets, through Foreign Currency Convertible Bonds keeping cost of capital as low as possible and also enabling them to maximise the value creation for the shareholders. Needless to add that shifting from one level of cost of capital to another, lower level, is a continuous process and will undergo several proactive iterations to push the cost of capital to its lowest possible so as to maximise the present value of future benefits of shareholders.

Box 66

HDFC INITIATIVES

Upto 92-93 there was a lot of conservatism regarding the sources of foreign finances for Indian enterprises. Two new instruments were permitted for launch in 1993. Only very highly rated companies with a lot of credibility and excellent fundamentals were allowed to launch such instruments. Further, companies which desired to go ahead with these types of instruments which had to be listed on New York Stock Exchange and Luxemberg exchange.

Incidentally HDFC to date has tapped several innovative instruments of raising finance in foreign countries like external commercial borrowings, foreign development institutions (Asian Development Bank) and also development banks like International Financial Corporation and banks from Germany. They have also issued floating rate notes and foreign currency convertible bonds. The interest rates, for the said instruments were much lower than the rate prevailing in India at the time of the issuance. Similarly HDFC has raised huge amounts by way of local instruments like commercial paper for funding operational requirements of a short term nature.

Source : Annual Report of HDFC-2005-06

Box 67

Bharat Forge : Global Depository Receipts (GDR) :

The company has issued 3, 636, 500 Equity shares of Rs. 10/- each (later sub-divided into 18, 182, 500 Equity shares of Rs. 2/-each) in April and May 2005 represented by 3, 636, 500 Global Depository Receipts (GDR) (on sub division 18 182 500 GDRs) evidencing "Master GDR Certificates" at a price of USD 27.50 per GDR (including premium). GDR's outstanding at the close of the year are 9,75, 950. The said money, after incurring issue expenses, aggregated Rs. 4, 235 million, have been temporarily deployed by Investments in Debt oriented Mutual Funds to the extent of Rs. 2, 271 million and the balance amounting to Rs. 1 964 million is held in Fixed Deposits with banks.

Source : Annual Report of Bharat Forge-p-60

Box 68

FCCB (Foreign Currency Convertible Bonds):

On March 17, 2006 1,753,246 Equity Shares of Rs. 2/- each were issued and alloted at a premium of Rs. 334. 105 per share on Conversion of USD 13,500,000, 0.50% Foreign Currency Convertible Bonds (FCCB) Tranche-1 in terms of Offering Circular dated 15th April, 2005.

Source : Annual Report of Bharat Forge-p- 60

Box 69

TATA Chemicals

During the previous year the Company has issued Foreign Currency Convertible Bonds (FCCB) of a face value of US $ 1000 aggregating to US $ 150 million. As per the terms of the issue, the holders have an option to convert the FCCB's into Ordinary Shares at a conversion rate of Rs. 231, 375 per Ordinary Share at a fixed exchange rate conversion of Rs. 43.65 = US $ 1, from 13th March, 2005 to 22nd January, 2010. The conversion price is subject to certain adjustments of corporate actions and consequently the conversion price has changed to Rs. 230.78 per Ordinary Share. Further under certain conditions the company has an option of early redemption in whole but not in part. Unless previously converted, redeemed or purchased and cancelled, the Company will redeem these bonds at 120.89 per cent of the principal amount on 1st February, 2010.

Source : Annual Report of TATA Chemicals-p- 68

Cheap, Cheaper and Cheapest Cost of Capital

In the post liberalisation period (Nov. 1992) the government wanted Indian enterprise to tap funds in foreign markets, with a view to encourage inflows of foreign currency into India. To start with government permitted tapping Foreign Currency Convertible Bonds(FCCB), Global Depository Receipts (GDR) and American Depository Receipts (ADR). The GDR's and ADR's represent ordinary shares. The rupee was then not as strong as it is today. In fact it was depreciating. A fall in the value of INR would make foreign borrowings relatively costly. The repayment amount increases. GDR and ADR became very handy. This was a route preferred to External Commercial Borrowings (ECB). However in 2001, interest rates were low all over the World. The rupee started appreciating from-2002 onwards. In the circumstances borrowings became a viable proposition because payment of interest and repayment of loan were in favour of India Inc.The exchange risks were low and the rupee, to reiterate, was appreciating. Thus corporates launched fresh initiatives to improve companies' debt repayment plan. With a view to reduce cost of capital India Inc. went in for another instrument viz. FCCB which had many advantages viz. very low interest rates (half per cent), no exchange risk because of the conversion facility and hefty premium available on conversions. As a result the post tax cost of capital became very negligible. Thus India Inc. has moved from cheap source of finance (GDR and ADR) to cheaper source of finance viz. ECB and finally to the cheapest source of finance viz. Foreign Currency Convertible Bonds(FCCB). The important message is continuous financial restructuring and innovation, alongwith pre-emptive moves to take full advantage of market conditions, is key to maximisation of shareholders wealth.

TABLE ELEVEN

Transition To Foreign Financial Markets

1993-2001	***2001-2003***	***2003-2006***
GDR/ADR	***ECB***	***FCCB***
● GDR/ADR are referred to as tradeable receipts issued overseas in foreign currency and are exchangeable at pre-determined ratio with ordinary shares issued and held in India.	● Low interest rates in Overseas Markets.	● Very low interest rate. Due to conversion, no exchange rate risk.
● GDR/ADR proceeds were to be used mainly for acquisition of assets and /or partly for working capital or for acquisitions abroad.	● Share market was at low ebb, due to slowdown World- over after 9/11 event in US.	● Low cost of capital due to hefty premium on conversion.
	● Hence debt was preferred despite exchange risk involved.	
	● ECB reduced cost of borrowed funds.	
● Dividends paid were moderate and tax rates were high and interest rates were also high till 1998.	● Rupee became stable, in fact appreciated during 2003-05	● Interest rates increased for ECB and exchange risk also increased
	● Lower crude prices	
	● Inflation was low and exports were on rise.	
● Infotech shares were in demand during June 1999 to April 2001(thanks to Y2K-hype).	● Profit after tax increased.	● But high dividend % resulted in high price /equity ratio enabling companies to encash high premium.
	● Dividend payout % increased.	● Dividend and long term capital gains from shares both were tax free.
	● Economic growth started	

> ***"Whoever can make two blades of grass grow where only one grew before deserves better of mankind than any speculative philosopher or metaphysical system builder"***
>
> ***- JONATHAN SWIFT***

CONCLUSION

The Year 2006-2007 has been an excellent year on all counts- booming economy, bullish stock markets, buoyant tax collections (coffers full), burgeoning forex reserves and better and better management of the fiscal deficit-from 3.8% to 3.0% of GDP. The assumption made is that the Indian economy will continue to grow at, at least, 8.5-9.0 per cent per annum. As the Finance Minister puts it :

"There are many pluses and a few minuses, and I shall deal with both candidly. The biggest plus is that the growth rate of GDP has improved from 7.5 per cent in 2004-05 to 9 per cent (Quick Estimate) in 2005-06 and, according to Advance Estimate, to 9.2 per cent in 2006-07. The average growth rate in the three years of the UPA Government is, therefore, 8.6 per cent." *(Speech of the Finance Minister Mr. P. Chidambaram as on Feb. 28, 2007).*

The Finance Minister is ambitious and is entertaining an optimistic expectation that the Indian economy will, grow at a double digit rate-10% per annum. Considering that the Chinese economy grew at 10.7% per annum in recent times, India has to keep up and improve to come up to expectations. It is rather heartening to note that the economy has gathered greater and greater momentum. The industrial growth has gone up to 11% during Jan. 2007. During April 2005-2006 industrial growth was placed at 8%. This augurs well for every one including the optimistic expectations of the Finance Minister Mr. P. Chidambaram (TOI, 13th March 2007, pp-21). In particular, our foreign exchange reserves are surging ahead almost every day- placed at 195 billion USD as on 04.03.2007. It is believed that in March 2007, 1 billion USD was added within just 7 days. A mind boggling situation compared with the rather pathetic figure of 1.1 bn USD in August 1991.

The issue today is slightly different. In 1997 the Finance Minister proudly announced that foreign institutional investor's investment had accumulated to a total of 7 billion USD since 1993 when they were first allowed. Today, this is a rather meagre amount because in 2006 alone 8 billion USD came through Foreign Institutional Investors (FII's). In 2005, a 10 bn USD entered the country through the FII route. India is now talking of its forex reserves in billions of USD and the issue is how to use the surging, surfeit, foreign exchange reserves which are standing at more than 190 billion USD (March 07). The future seems to be very bright as per all indicators and from all quarters.

It is said that "India's per capita GDP will grow four times by 2020." *(TOI, 24th Jan 07, pp-01).*

Per Capita Income, GDP Growth and Indian Middle Class

The per capita income has moved up progressively from Rs. 9,913 in 1990-91 to 10,711 in 1995-96. Further the per capita income moved up from Rs.12,916 in 2000-01 to Rs. 15,357 in 2005-06. The GDP growth at factor cost also revived from 5.57% in 1990-91 to 7.34% in 1995-96. Again after a slump in 2000-2001 at 4.37 %, the GDP growth looked northwards at 8.43 % in 2005-06.

India's middle class market of more than 300 million is one of the largest markets of the World. Further they represent a global movement. Again the high net worth individuals in India are also growing at nearly 15 per cent per annum. The averages spend per head per year is nearly USD 10,000.

The Indian economy will be a leading economy in the World. A Goldman Sachs report says that there has been a structural increase in India's growth potential from the historic Hindu growth rate of 2 per cent or 3 per cent to 5% and now new levels of 8% and above. To quote the report "Productivity growth has been the key driver behind the jump in GDP growth, contributing to nearly half of overall growth since 2003 compared with a contribution of roughly one-quarter in the 1980's and 1990's," *(TOI, 24th Jan, 07, pp-01)*.

Productivity growth will help India sustain over 8% growth until 2020 and make it the second largest economy in the World, even ahead of the US,(next only to China) by 2050.(TOI, 24th Jan. 07). In fact, it is gratifying to note that, today productivity is slowly gaining grounds. It seems that the key factor to high growth is going to be productivity improvement and that too quickly through quantum jumps.

Productivity Again

It may be noted that 1984-85 onwards the role of the services sector has improved. In terms of contribution to GDP the services sector is playing a very crucial role as shown below :

TABLE TWELVE

Sector wise Contribution to GDP (%)

	1984-85	***2002-2003***	***2003-2004***	***2004-2005***
Agriculture (%)	35.2	26.5	21.7	20.5
Industry (%)	26.1	22.1	21.6	21.9
Services (%)	38.7	51.4	56.7	57.6

Source : Economic Surveys (GOI, Publications)

The contribution of agriculture leaves much to be desired. With a large labour force still in agriculture (60 per cent plus), a meagre contribution to GDP, from the primary sector, could act as a drag on the Indian economy now and even later. This is at a time when India is poised to hoist itself as a World economic superpower. Hence productivity improvements, in agriculture, are a top priority for policy makers and every citizen of India. As Mr. M.S. Swaminathan says "We must remember that if agriculture goes wrong, nothing else can go right" And as Jawahralal Nehru had said in 1947 "everything else can wait, but not agriculture"

Box 70

Indian Economy Vital Statistics.

- ✔ Productivity in Industry and services is more than four times that in agriculture, which employs nearly **60%** of the labour force.
- ✔ Since 2003, there has been a structural increase in potential growth to nearly **8%** from **5%-6%** in the previous two decades
- ✔ From 2007 to 2020, India's GDP per capita in US$ terms will **quadruple** (a third higher than the original BRIC's projections).
- ✔ Indians will also buy about five times more cars and consume three times more crude oil
- ✔ According to demographic trends, more than **100m** people will enter labour force by 2020
- ✔ India has **10** of the world's 30 fastest-growing cities and is witnessing rapid urbanisation. **140 m** rural dwellers will move to urban areas by 2020, while **700 m** will urbanise by 2050

Source : TOI, 24th Jan, pp-01

Human Assets Productivity

As part of improved productivity of the country as a whole, human assets management has to assume a new role to take full advantage of, and contribute to, the knowledge society. The key input for wealth maximisation is knowledge stemming from newer and newer ideas that is to say, from creativity and innovation. It is expected that careers which develop the right hemisphere of the brain will be pursued. So far there have been rat-racers for safe careers in engineering, management and civil services. These rat-racers are mainly the left brained group. If we have to appropriate fully the benefits of knowledge society, risk taking is inevitable and imminent. Hence parents should start encouraging their children to pursue new professions which provide for proper nursing and nourishment of the right hemisphere of the brain. Innovation and creativity stems from people with the right kind of risk taking ability. Developed countries like US and Japan had focused a lot on developing these qualities of creativity and innovation of individuals. If this can happen successfully, the growth rates would assume a geometric progression providing opportunities for exponential growth rates in lieu of historic rates in terms of an arithmetic progression. According to an article *The Times of India* by *M.S.Ghogre-Take a right turn* "India cannot afford to rest on its laurels, which are largely earned in left-brained professions. We need to correct this imbalance in order to really take India to the big league. It is here that parents need to encourage children to create their own professional career, depending on where their natural strengths lie. The time to take the risk is now." The younger generation must develop a 'spirit of inquiry' to create a 'scientific temper' in our environment.

Expectations of Society

Of course there are a few expectations of one and all in terms of more reforms, further simplification of tax laws and administration, and opportunities for entrepreneurship of foreigners in India (global expectations) and Indians in foreign lands. The country looks forward for further investments in the tertiary sector like education, health, infrastructural facilities and development of younger generation considering that youth is the key factor in the demographic profile of India.

Will India make it – Super Economic Power -(2050)

There are many 'ifs' and 'buts' in India reaching its destination as a World economic super power- third largest, second highest or the top as the case may be. After all 2050 is not far off. Fifty years (43 to be precise) is a small span in the life of a country that has been the cradle of civilisation itself. It is not the first time in its life time that India would be a super economic power. Indians and foreigners should know and be informed on this score. If vision 2050 materialises it is only a regain of its lost position. The panorama of India's past lends support to its historic, leading, global competitive edge. Similarly periods of 'mental stupor' and 350 years of Imperialism and social, economic and political brigandage of the British had brought things to a nought. Things were aggravated further by an unparalled holocaust on the eve of 15.08.1947.

Now the 'ifs' and 'buts', enumerated below can still act as inhibitors, constraints and obstructing factors. It is believed, and the belief is not untrue, that the foundation of the present boom is rather shaky. A few thoughts in this behalf :

- → 350 million middle class consumers slowly moving up the ladder of purchasing power ; however more than one out of every 5 Indians is officially poor , - 35 per cent of our population gets by with under Rs 45 a day and another 45 per cent lives on Rs 45 – Rs. 90 a day.
- → India is ranked 126th out of 177 countries in the UNDP Human Development Index.

- In Maharashtra power failure is a serious problem. Major cities lose power one day a week to reduce the pressure on the grid. Intel Corporation chose Vietnam over India as the site for a new chip assembly plant. Lack of reliable power is believed to be an important factor.
- India's export, even as it is increasing, accounts for less than 1 per cent of global trade compared with 7 per cent of China.
- Industry is losing millions of USD on account of weak and woefully inadequate infrastructure viz. inefficient roads and rail services, erratic power supply, poor air and ship ports facilities, inadequate health facilities and low levels of literacy and education amongst masses.
- Public debt stands at 82% of GDP, the eleventh worst ranking in the World. Hence much of infrastructure financing has to come through private financing from home and abroad. However India captured only 3 billion USD as foreign direct investment in 2006 compared to a whopping 65 billion USD mobilised by China through the same route for infrastructure projects.
- Inadequate size of Indian enterprises, by global standards, which may inhibit enterprise from taking full advantage of the economic prowess of size ;
- Inadequate investments in research and development to set into motion the engine of economic growth in full momentum.
- Corruption index of India is amongst the highest in the world. A polished lingo used to describe corruption is 'leakage'. Corruption has emerged to stay. Unfortunately, it has been accepted as a way of life. Perhaps the rest of the World has also accepted the same. It is not without reason that Swaminomics says "So, perhaps democracy explains why India, despite being as corrupt as many African failures can nevertheless register 7.5% GDP growth. Democracy is probably good enough reason for the World Bank to keep lending to corrupt India". *(TOI, 15th April 2006).*

India unpoised could pose many problems to vision 2050.

Box 71

India is not Poised !

India is poised. Yes. But which India? Millions of Indian do not know who their President is, or for that matter, who their MP or MLA is! Our GDP is zooming, but mainly due to the redoubtable services sector. Agriculture, on which 65% of Indians are still directly dependent, does not appear to be "poised" at all. Sensex has scaled peaks of 14,000 plus. But less than 1% Indians invest in stocks. 70% Indians do not have even a bank saving account. India is poised indeed, but for what? Wither India?

Source : Dr. Tapan K Pradhan, My Times, My Voice

Mr. N.R. Narayana Murthy has gone on record to say "If our infrastructure gets delayed, our economic development, job creation and foreign investment get delayed. Our economic agenda gets delayed – if not derailed."

Further Prof Jadgish Bhagwati has rightly pointed out that "domestic product growth would run two percentage points higher if the country had decent roads, railways and power".

If India is to be a super economic power by 2050 certain efforts are required in a given direction and required pace, as shown in Box- 66. If we are able to meet the said bench marks then Indians will hold the global fort and India will rule the World waves.

Box 72

If India has to emerge as a World Economic Power 2050

✔ India Inc has to improve its size by 8-20 times in terms of revenues, 10-33 times with respect to assets and 10-20 times in terms of size of profitsvis-a-vis US Inc (based on Fortune 500 data for 2005-06). (See Boxes 73 and 74)

✔ India has to grow at an average rate of 10.52 % p.a. China may grow at7.97% p.a. US may grow at 5.43% p.a., and Japan may grow at 1.51 % p.a. However, as far as India is concerned, the growth rate of 10.52% is necessary to achieve a projected GDP size of $69,630.07bn. Compared tothe projected US GDP of $ 136,006.38 bn. by the year 2050, ceteris paribus. Even, with a 10.52 %p.a. there is a gap between the two countries India & USA. US GDP continues to be ahead.

✔ Indian demographic pattern shows the highest percentage, (57% and more)

Box 72 contd...

of working population in the age group of 15-59 years, in the World. Unlike their forefathers who were predominantly risk averters, this percentage of workingpopulation have to be risk takers to take advantage of the benefits of entrepreneurship.

- ✔ Mergers and Acquisition seems to be the only choice for quick growth. Tata- Corus was worth about $ 12.01 bn. We require 14 such Tata- Corus deals to simply come upto the level of the largest acquisition in the US by America Online – Time Warner (January, 2000; $166 bn.), not considering the time value of money and fluctuations in exchange rates. However, well begun is half done. (See Tables 13 to 17)

- ✔ Research and Development (R and D)efforts have to improve by leaps and bounds. Ranbaxy laboratories have a R & D expenditure of about $ 4.05 million, which is about 17.88 % of its revenues for 2005-2006. The efforts of Ranbaxy have to be replicated across the network of India Inc.

Source : Raj Singh and Amit Pal Singh Ossan, Vision 2050, India as Super ' Economic Power, March 2007 (Working Paper).

Table – 13				
US Largest Acquisition in 2000-2006				
Acquirer	Target	Location	Price ($ bn.)	Year
America Online	Time Warner	US	166.00	Jan-00
AT&T	BellSouth	US	86.00	Dec-06
Sprint	Nextel	US	36.00	Aug-05
SBC	AT&T	US	16.00	Oct-05
Verizon	MCI	US	8.50	Jan-06

Source: Wikipedia (URL: http://en.wikipedia.org/wiki/Merger_and_acquis

Table – 14				
Europe Largest Acquisition in 2000-2006				
Acquirer	Target	Location	Price ($ bn.)	Year
Royal Dutch Petroleum	Shell Transport and Trading	Europe	75.00	Oct-04
Glaxo	SmithKline	Europe	76.00	--
Mittal Steel	Arcelor	Luxembourg	33.10	Jun-06
Vivendi SA	Seagram	Europe	32.00	Jun-00

Source: Wikipedia (URL: http://en.wikipedia.org/wiki/Merger_and_acq

Table – 15			
Top 10 India Acquisition till February 2007			
Acquirer	Target	Price ($ bn.)	Stake (%)
Tata Steel	Corus	12.009	100
Hindalco	Novelis	5.659	NA
Rain Commodities	Carbon Canada	0.369	100
Alembic	Dabur Pharma	0.036	100
Gujarat Heavy Chemicals	Best Manufacturing	0.035	NA
Investor Group	Spicejet	0.032	10.01
Koon holdings	Valecha Engineering	0.027	NA
Triveni Group	Sadhna TV	0.011	60
Champagne Indage	Monash Winery	0.008	100
Investor Group	Jyoti	0.007	NA

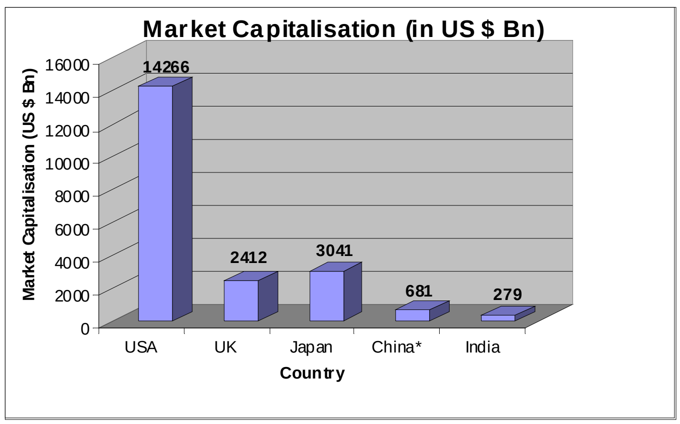
Source: BusinessWorld, 26th February, 2007

N.B: The top two acquisitions shown above are also the top two Asian Acquisition.

Table – 16			
Top China Acquisition in 2006			
Acquirer	Target	Price ($ bn.)	Stake (%)
Consortium led by Citigroup Inc	China's Guangdong Development Bank	3.114	85.6

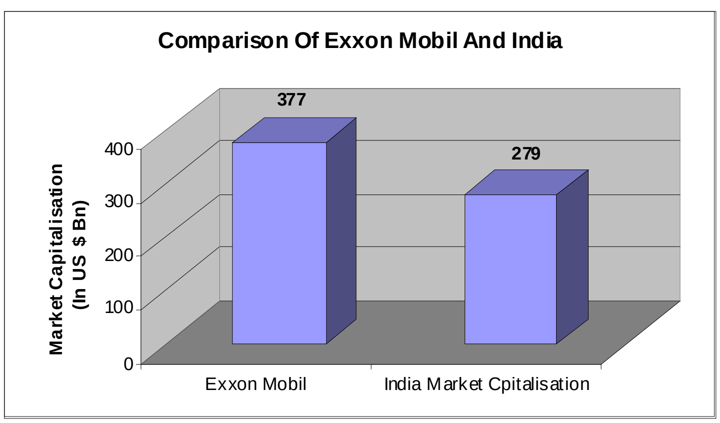
Source:*All-China Federation of Industry and Commerce (ACFIC)(China.org.cn), Jan 07*

Box 73



Source – S&P Emerging Stock Market Fact book 2004

Box 74



Source- Fortune 500

N.B: While the stock market is bullish for a long period now (since Oct. 05) and had scaled a new peak of 14,500 (January 07) Exxon Mobil alone accounts for more than the market capitalisation of entire India INC quoted on the Bombay Stock Exchange .

TABLE SEVENTEEN

PROFILE OF CERTAIN PARAMETERS
INDIA VIS-A-VIS SUPER POWERS

	India	*Japan*	*US*	*UK*	*China*
Steel Production (Million Tonnes)	44	116.2	98.5	1.1	418.8
Cement Production (MillionTonnes)	110	72	92.6	11.35	750
Health Expenditure (% of GDP)	1.2	6.4	6.8	6.9	2
Electricity Production (Billion kwh)	630.6	996	3,717	363.2	2,500
% age of Roads Paved	47.4	78.19	64.77	100	81.03
Overall Productivity per person in $	7279	50594	74625	50825	--
Agricultural Productivity (Value added per worker-USD)	382	26557	36863	26897	373

TABLE EIGHTEEN

INDIA INC : PROFILE OF DIVIDEND PAYOUTS OF SELECT COMPANIES

Wyeth	*Equity Capital*	*Dividend*
2006	22.72	56.8
2005	22.72	45.44
2004	22.72	22.72
2003	22.72	13.63

HLL	*Equity Capital*	*Dividend*
2005	220.12	1100.6
2004	220.12	1100.6
2003	220.12	1210.66

Hero Honda	Equity Capital	Dividend
2006	39.94	399.4
2005	39.94	399.4
2004	39.94	399.4
2003	39.94	399.4

Legend: Equity Capital and Dividend (Rs. Crores).

TABLE NINETEEN

INDIA INC : PROFILE OF DIVIDEND PAYOUTS OF SELECT COMPANIES

Company	*Dividend Yield (%)*	*Average Payouts (%)*
Colgate Palmolive	1.9	74.36
Essel Propack	3.67	65.85
HLL	2.07	69.03
Lakshmi Machine Works	1.6	75.52
Apollo Tyres	1.6	67.82
Titan Industries	0.04	50.44
Glaxo SmithKline Pharma	2.1	52.13

Legend : Dividend yield = (dividend per share divided by market price per share) * 100

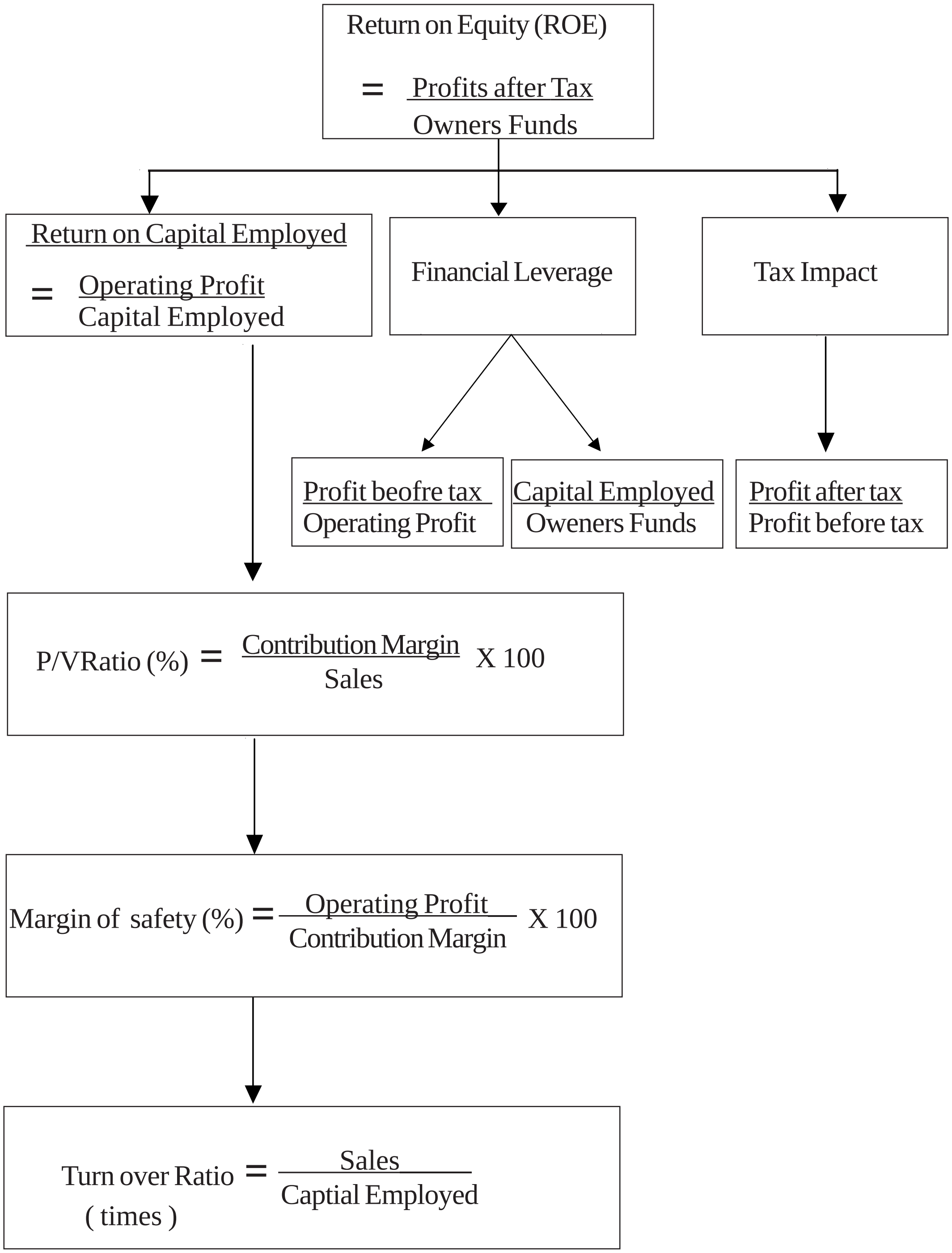
$$\text{Average Payout} = \frac{\text{Dividends Paid}}{\text{Profit After Tax}} * 100$$

GLOSSARY

EXPLANATION OF KEY EXPRESSIONS

- ✔ **EXHIBIT 2 : CORPORATE FINANCIAl MODEL PERFORMANCE**
- ✔ Box 66 ——— What is ROI ?
- ✔ Box 67 ——— What is P/V Ratio ?
- ✔ Box 68 ——— What is Margin of Safety ?
- ✔ Box 69 ——— What is Turnover Ratio ?
- ✔ Box 70 ——— What is Profit Margin ?
- ✔ What is Financial Operations Ratio ?
- ✔ What is Tax Management ?
- ✔ Computation of WACC (Ko) and Capital Assest Pricing Model (CAPM)
- ✔ Responsibility Centres

CORPORATE FINANCIAL PERFORMANCE MODEL



Box-75

What is R.O.I ?

- → is a ratio expressed as a percentage.
- → has a numerator which captures **'Profits'** i.e. Results,

  and
- → a denominator which shows **'Total Assets' or 'capital employed' or 'net worth' i.e. resources committed in business.**
- → is an indicator of financial productivity or profitability and is expressed as a percentage.
- → is an indicator of the financial returns generated on every rupee invested in business.
- → is a grand overall measure of business performance that guides management in various business decisions.
- → is expressed in different ways for different purposes – different ROI for different purposes.
- → can be expressed as Return on Capital Employed (ROCE) to indicate the financial productivity of every rupee invested in business, or as Return on Equity (ROE) to indicate the financial productivity of every rupee invested by the owner (equity share capital plus reserves).

Box-76

What is P/V Ratio?

- → defined as contribution margin divided by sales
- → P/V ratio (%) = Profit /Volume Ratio

$$= \frac{\text{Contribution Margin}}{\text{Sales}} \times 100$$

- → shows the speed with which the company is moving towards its profit goal.
- → options open to improve PV ratio include :
  - ❍ selling price increase per unit
  - ❍ variable cost decrease per unit
- → <u>shows the rate at which surplus</u> (sales minus <u>variable costs i.e. contribution margin) is earned to recoup fixed costs and eventually contribute to profits.</u>

Box-77

What is Margin of Safety?

- → Margin of Safety (%) is defined as operating profit dividend by contribution margin.
- → Margin of Safety (%) $= \left\{ \dfrac{\text{Operating Profit}}{\text{Contribution Margin}} \right\} \times 100$
- → Margin of safety (%) is also defined as (Budgeted sales minus Break even sales) divided by Budgeted sales.
- → Margin of safety refers to the extent to which sales can be depressed before losses start.
- → Margin of safety also refers to the distance between budgeted or actual sales vis-a-vis break even sales.

Box-78

What is Turnover Ratio?

- → shows the efficacy with which capital is utilised;
- → shows how many times the capital has turned over or the velocity of capital;
- → 'result – resource ratio';
- → to improve the turnover ratio a business should :
  - improve sales (capital being constant – say) ;
  - reduce capital (sales being constant – say) ;
  - increase sales and reduce capital ; and
  - an unwanted situation would be a reduction in sales accompanied by an increase in capital.
- → can also be used to project the additional capital required to sustain planned additions to sales level;

  OR
- → can be used to project the additional sales required to sustain the planned additions to capital.

Box-78

What is Profit Margin (%) ?

Profit Margin (%) is an indicator of :

- → profit margin (%) $= \left\{ \frac{\text{profit}}{\text{sales}} \right. \times 100$;
- → marketing performance or productivity of every rupee of sales;
- → cost performance or cost productivity because (1 – profit margin %) represents the cost incidence as percent of sales; and
- → amount of profit generated for every rupee of revenue.

What is Financial Operations Ratio?

Financial Operations Ratio refers to two aspects of treasury management in particular and financial management in general. The relevant ratios include :

$$\left\{ \frac{\text{Profit before Tax}}{\text{Operating Profit}} \right\} \text{X } 100 \quad \text{And} \quad \left\{ \frac{\text{Capital Employed}}{\text{Net Worth}} \text{(times)} \right\}$$

- ⏭ Indicates the extent to which profit before tax is depressed on account of interest.
- ⏭ High borrowings and high Interest rates unduly depress operating profit.
- ⏭ Judicious use of debt and competitive pricing of borrowed funds is key to success.

- ⏭ Indicates the mix of finance i.e. Debt : Equity.
- ⏭ Higher the debt greater the risk and vice versa.
- ⏭ Risk - return relationship play their role.

WHAT IS TAX MANAGEMENT ?

$$\left\{\frac{\text{Profit after tax}}{\text{Profit before tax}}\right\} \times 100$$

- Indicates the role of taxes in depressing profit after tax.
- Successful tax planning will help transmission of profit before tax to shareholders in increasing proportion.
- Treasury management and line managers have to co-ordinate to time investment decisions to suit the cutoff points prescribed by income tax authorities to claim depreciation and other deductions.
- Supernormal profits, not finding itself reinvested into new ventures, get taxed for want of adequate deductions, including depreciation.

COMPUTATION OF WACC (k_o) and CAPM

The cost of capital is usually a weighted cost inasmuch as the portfolio of sources of finance of any business is made up of funds procured from different sources. Thus, WACC for any given capital structure is defined as follows :

$$\boxed{k_o = (k_e \times w1) + (k_p \times w2) + (k_i \times w3)}$$

where

k_o = WACC

k_e = cost of shareholders equity(%)

k_p = cost of preference shares capital(%)

k_i = cost of debt (%),

w1, w2 and w3 are proportions which the respective sources of finance viz preference share capital, shareholders equity and debt bear to the total sources of finance

AND

w1 + w2 + w3 equal unity

The cost of debt is a standard measure and is arrived at using the formula (l – t)i where t=marginal tax rate and i=interest rate, contracted for the loan. There may be variations in cost depending on the method used to value debt viz historic cost as against market value.

The cost of preference shares is again a contracted rate of dividend. However there is no tax deductibility in case of dividends. Hence the contracted rate of dividend is the cost of capital. However there can be variations in the cost of preference share capital depending on the method used-again historic cost as against market value of the preference shares. Alternative formula could be the yield concept defined as dividend per share divided by market price per share.

The computation governing cost of equity is beset with many difficulties and the issues are unresolved. There are many options as shown in Boxes 79 and 80.

Box 79

$$ke = \left\{ \frac{\text{dividends per share}}{\text{market price per share}} \text{ X } 100 \right\}$$

or

$$ke = \left\{ \frac{\text{earnings per share}}{\text{market price per share}} \text{ X } 100 \right\}$$

or

$$ke = \left(\frac{\text{dividends per share}}{\text{market price per share}} \right) + \text{ g (growth rate of dividend in per cent)}$$

Box 80

As a final improvement, the cost of equity is computed using the CAPM formula which defines cost of equity as follows :

$\mathbf{R_e = R_f + \beta_e (R_m - R_f) >}$

$\mathbf{R_e}$ = cost of equity

$\mathbf{R_f}$ = risk free rate

$\boldsymbol{\beta_e}$ = riskness of the stock and is known as Beta

$\mathbf{R_m}$ = Risk Premium Rate

N.B.

- CAPM establishes the relationship between risks and return.
- Risk of a portfolio is measured through Beta (**β**).
- **β** reflects a co-efficient which quantifies the tendency of stock to move up or down with the market :
- **β** can have a value as follows
  - **β**= 1 means Average Risk
  - **β** > 1 means Above Average Risk
  - **β** < 1 means Less than Average Risk

INTERPRETATION OF β

β =1 : Interpretation is that the extent of increase in market and stock prices are uniform.

Market	↑	by 10%	Market	↓	by 10%
Stocks	↑	by 10%	Stocks	↓	by 10%

β = 2 : Intepretation is that stock is twice as volatile as average stock

Market	↑	by 10%	Market	↓	by 10%
Stock	↑	by 20%	Stocks	↓	by 20%

β < 1: (say **β = 0.5**) Interpretation is that stock is half as volatile as average stock.

Market	↑	by 10%	Market	↓	by 10%
Stock	↑	by 5%	Stock	↓	by 5%

An average risk stock is defined as "one that tends to move up and down in step with the general market as measured by some index Dow Jones on S&P 500.Such a stock has a **β =1**

Illustrative list of β coefficients in India:

TABLE 20

STOCK	BETA
Merrill Lynch	1.85
AOL Time Warner	1.65
General Electric	1.30
Microsoft Corp.	1.20
IBM	1.05
Coca-Cola	0.85
Energen Corp.	0.75
Procter & Gamble	0.65
Heinz	0.55
FPL Group	0.45

Source : *E. F. Brigham and J.F. Houston, Fundamentals of Financial Management pp-189 to 195, Thomson, Tenth Edition - 2004*

TABLE TWENTY ONE

INDIA INC : β of Select Companies

Company Name	*BSE* β
Gujarat Ambuja Cements Ltd.	0.71
Hindustan Lever Ltd.	0.65
Hindustan Petroleum Corpn. Ltd.	1.14
I C I C I Bank Ltd.	0.78
I T C Ltd.	0.5
Infosys Technologies Ltd.	1.15
Oil & Natural Gas Corpn. Ltd.	1.03
Ranbaxy Laboratories Ltd.	0.76
Tata Motors Ltd.	0.86
Tata Steel Ltd.	1.14

Source : CMIE DATA BASE – PROWESS - 2006

Responsibility Centres

- **Responsibility Centre** means a subdivision of the organisation around which responsibility is measured by some yardsticks depending on the nature or status of the responsibility centre
- **Responsibility Centres** include Revenue Centres, Profit Centres, Cost Centres, Expense Centres and Investment Centres
- **Revenue Centres** are those segments of business or subdivisions of an organisation around which revenue is identified for purpose of control
- **Cost Centres** are segments of business around which costs which have an engineered relationship with output are identified for purposes of control. The costs collected are known as 'engineered costs' or 'variable costs'
- **Expense Centres** are those segments of business around which non-engineered costs are identified for purposes of control. The expenses identified include discretionary fixed costs and committed fixed costs
- **Profit Centres** are those segments of business around which profits, defined as revenue minus cost (engineered and non engineered) are identified for purpose of control
- **Investment Centres** are those segments of business around which profits and investment/ asset employed/ capital employed are identified for purposes of control investment centre is the segment of business where the ROI (return on investment) or 'return on assets' or 'return on capital defined as 'profits divided by investment/ assets/ capital' is measured.

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