Chapter-1: Indian Financial System

[1] Introductory:

All types of business units undertake different types of business activities like purchasing, manufacturing, marketing etc. with an objective of wealth maximisation. But all these business activities are made possible by finance. Without finance all the activities will come to standstill. Therefore, just like blood in human body, finance is the main energising force to keep the wheels of industries running. Money is needed for earning money. But both, the shortage of money and plethora of money are not the welcome and happy situations. Here lies the importance of financial management. In order to avoid the emergence of such type of extreme situations and make maximum utilisation of available fund financial management is needed. Therefore, a separate division known as Finance Department is created to look after the acquisition and uses of fund and managing the earnings. The department is headed by the financial manager.

[2] Finance Function:

All the production activities are collectively known as production function. Marketing management activities are known as marketing function and personnel management activities as personnel function. In the same way all the activities of financial management pertaining to raising of fund, using of fund and management of earnings are collectively known as finance function.

Meaning of Finance Function: With the passage of time and increasing size of the corporate sector and its complexity meaning of finance function has undergone a change. The concept of finance function prevailing upto the fifties of the twentieth century is known as traditional concept and thereafter it is known as a modern concept of finance function.

(A) Traditional Concept of Finance Function:

According to traditional concept finance function means financial activities related to raising of fund. It was considered to be the primary duty of the financial manager to estimate and raise necessary fund when a new company is incorporated or expansion programme is undertaken or in case of amalgamation and mergers. Estimating financial requirements, selection of proper means or securities for raising the fund, negotiations with different sources of fund, appointment of bankers, underwriters and brokers all combined together constituted finance function, in traditional sense. Using of fund was considered to be the sole responsibility of the board of directors and therefore, was falling outside the jurisdiction of financial manager. In this way the main focus of traditional approach was on raising the required fund.

Criticism of traditional Approach:

The traditional approach has been heavily criticised on the following grounds.

(1) Narrowly defined concept:

The traditional approach gave importance to only one aspect of finance and that was raising of funds whenever needed. Uses of fund or investment of fund in different types of assets were not included in the jurisdiction of financial manager. It was believed that decisions regarding uses of funds are to be made by the board of directors and not by financial manager. In this way the traditional approach was very narrow and one sided.

(2) Exclusion of uses of funds from the jurisdiction of financial management:

Raising and using of funds are equally important in finance functions. The success of business much depends upon how the fund is used. However, the traditional approach ignored this vital aspect of fund.

(3) Incidental Approach:

It was believed that the services of financial manager were needed on certain incidents like incorporation of a new company, launching of a new project by old company, expansion of the business, merger, amalgamation etc. In fact it is not incidental. It is the integral part of day-today management. It is a continuous process of financial planning, co-ordinating and controlling.

(4) Descriptive approach:

The traditional approach was descriptive in the sense process of funds or securities for raising the fund were selected on the basis of certain descriptions in the form of merits and demerits. It did not use the analytical and quantitative tools like cost of capital, financial leverage, operating leverage, break-even analysis, ratio analysis, fund flow analysis etc.

(5) Confined to long term funds:

It was confined to raising of long-term funds and ignored the vital problems of working capital. In reality, the problems of working capital are more exacting and financial manager more or less remains preoccupied in resolving the working capital problems.

(6) Corporate form of organisation is at the centre:

Traditional approach is centred around a company form of organisation and therefore, common title used for it was corporation finance. It ignored the financial problems of partnership firms and individual proprietorship.

(B) Modern Approach of Finance Function:

According to the modern concept finance function means raising of funds, using of funds and management of earnings. This is a broad concept including triple functions like fund raising function, fund using function and management of earnings. It has developed such a tool and technique which are useful for the management of long term and short-term funds like cost benefit analysis, optimisation of capital structure and working capital, ratio analysis, fund flow analysis, rate of return on investment control techniques etc. Not only that but the new approach useful for all types of business organisations. The modern approach considers finance function not as an incidental function but as an integral part of day-to-day business management.

(C) Scope of Finance Function as per modern approach:

Its scope includes the following functions regarding raising and using of funds and management of earnings.

(a) Raising of Funds: It includes the following functions:

(1) Estimating total long term and short-term financial requirements.

(2) Planning of optimum capital mix (capital structure) and optimum level of total working capital and its component parts.

(3) Negotiations with different sources of funds and deciding terms and conditions.

(4) Appointment of under writers, bankers and brokers for the issue of shares and debentures.

(5) Raising of fund by adopting proper procedure.

(b) Using of Fund: It includes the following:

(1) Capital budgeting.

(2) Selection of a proper project for investment.

(3) To complete the project within the time limit.

(4) To bring about financial co-ordination between different departments.

(5) Exercising control over uses of funds.

(6) Management of working capital.

(c) Management of Earnings: The following are included in the management of earnings:

(1) Tax planning.

(2) Allocation of profit between different types of reserves.

(3) Payment of dividend, interest and taxes.

(4) Payment of instalments of term loan.

It is clear from the above discussion that the modern concept is a broad concept and it is considered to be the integral part of day-to-day management of the business. It is an analytical approach in the sense that decisions are made not on the basis of description but on the basis of analytical tools like ratio analysis, fund flow analysis, break-even analysis etc. Working capital and its problems occupy an important place in the modern concept.

Traditional Approach	**Modern Approach**
1. It is narrowly defined concept which centres around fund raising functions only.	1. It is broad concept which includes within its scope functions regarding raising and using of funds and management of earnings.
2. It is confined to financial management of a new company, expansion programme, merger etc.	2. It considers finance function as an integral part of management.
3. Company form of organisation is at the centre.	3. It is useful for all types of business organisations.
4. It is a descriptive approach. Decisions are made on the basis of merits and demerits.	4. It is analytical approach. Decisions are based on cost benefit analysis and quantitative techniques.
5. Its main concern is for term funds.	5. It is concerned with long term and short-term funds.
6. Looks from the angle of external investors.	6. It considers the interest of the business unit as well as external financiers.

Traditional Approach	Modern Approach
7. Role of financial manager is considered as a role of a staff officer.	7. Financial manager has to play a dual role - as staff officer and also as line officer.

[3] Financial Management:

Meaning:

In the words of **Ernest Walter** financial management means controlling of managerial techniques like planning, organizing, controlling to make functions.

It means if different types of finance functions are undertaken with the help of managerial functions like planning, organizing, coordinating and controlling it is known as financial management.

According to the opinion of **Guthman and Dougall** financial management means managerial functions like planning, controlling pertaining to acquisition and using of funds needed in the business.

Financial management means planning, organizing, co-ordinating and controlling of financial activities like raising of long term and short-term capital, borrowing from banks and financial institutions, collection from debtors, payments to creditors, payment of dividend, interest and taxes, writing of books of accounts and maintenance of financial records. Effective and timely performance of different financial activities requires financial planning so that money and fund can be made available as and when needed and maximum use of the available fund can also be made. For orderly performance of financial activities an organization of finance department consisting of different positions with well-defined authority and responsibility is to be created. For the achievement of the ultimate objectives of the enterprise all the departments are supposed to perform their duties in a co-ordinated fashion. This is not possible without financial co-ordination.

Therefore to bring about financial co-ordination between different departments is also one of the functions of financial management. For successful implementation of financial planning and efficient use of funds financial controlling is equally important. In this way financial management is concerned with performance of finance functions, with the help of managerial functions like planning, organizing, co-ordinating and controlling.

[4] Objectives of Financial Management:

Financial management is an integral part of general management. Therefore, its goals should be complementary to the long-term objectives of the organisation or general management. It means it has to manage the funds in a way that leads to achievement of long-term objectives of the general management. Goals guide the decision making and provide direction to financial activities. All financial decisions like determining the financial requirements, selection of securities for raising required fund, allocation of financial resources among short term and long-term assets, policy decisions regarding credit terms, credit worthiness, payment of dividend etc should be made in such a way that ultimately, they result into goals achievement. But the question is what are those goals of financial management?

The main goals of financial management can be stated as under:

(A) Basic goals or objectives

(1) Profit maximisation goal
(2) Wealth maximisation goal

(B) Other goals or objectives

1. To ensure a fair return to shareholders.
2. Building up reserves for growth and expansion.
3. To ensure maximum operational efficiency in the organisation.
4. To ensure financial discipline in the organisation.

(A) Basic Objectives:

There are two alternative basic goals which each and every business firm aspires to achieve. One is the profit maximisation and the other is wealth maximisation.

(1) Profit maximisation: Every business firm, small or big is motivated by profit maximisation for the enhancement of economic welfare of the owners. Financial management has to complement the goals or objectives of the business enterprise. As per this goal of profit maximisation financial management is required to make financial decisions regarding the selection of sources of funds and securities for raising fund, investment of funds in different kinds of assets, decisions regarding inventory management and credit terms that lead to minimum cost and maximum earnings which leads to profit maximisation.

Profit maximisation is a quite natural objective and it is essential for promoting the economic welfare of the owners and undertaking developmental projects. It provides a measure of efficiency also.

Arguments in favour of profit maximisation (Merits):

(1) It is quite a natural and rational objective of any economic activity undertaken by a man of rational behaviour desiring to maximise utilities.
(2) On the basis of profit maximisation right and natural selection of project, product, location and sources of capital can be made.
(3) It leads to maximisation of social and economic welfare of the owners or shareholders.
(4) In a competitive market flow of capital can be directed towards productive and profit-making units and thereby prevents wasteful use of scarce financial resources of the nation.
(5) Profit maximisation can be used as a measure of efficiency.

Arguments against profit maximisation (disadvantages):

1. Profit maximisation is a vague concept. Profit maximisation means what? Profit before tax or after tax and how much? It lacks clarity.
2. Money has time value. Profit maximisation objectives do not take into account the time value of future cashflow. Therefore, it may give a misleading picture of profitability. Therefore, selection of the project on the basis of profit maximisation may not yield expected results.
3. It provides a very crude measure of efficiency.
4. It cannot be justified in a monopoly market.
5. It implies the exploitation of employees, customers and society at large.

Because of the above reasons the concept of profit maximisation has become obsolete and unacceptable. In its place second alternative of wealth maximisation is accepted as basic goal.

(2) Wealth maximisation: Wealth maximisation is more practical and realistic objective providing reliable measure of efficiency and social welfare. Wealth means real promotion of economic welfare of shareholders. Wealth means aggregate stock of wealth employed for the generation of further wealth. The objective of the business enterprise and that of financial management should be to make maximum addition to the present stock of wealth. But the question is what makes addition to the present stock of wealth? The present value of future cashflow means wealth. The net present value of future cashflow can be made for the generation of that future cashflow. For finding out the present value of future cashflow of different years it is discounted by a certain rate of discount. Discounting of future income means application of discount factor for finding out the present value of future incomes. From total present value of future income investment made for the generation of that income is deducted. Whatever remains after deduction is known as net present value. Net present value means stock of wealth. It means wealth can be maximised by making maximum addition of net present value to the existing stock of wealth. The goal of financial management should be to maximise the wealth, in this sense. In real sense wealth is measured by risk factor and rate of inflation because it takes into account the risk factor and rate of inflation. The net present value is arrived at by giving due consideration to risk factor and rate of inflation. They are reflected in the rate of discount.

Arguments favouring wealth maximisation (advantages):

1. It takes into account the time value of money and risk factor or future uncertainty of income. Rate of discount is determined in such a way that it reflects the uncertainty of income or risk factor and time value of money which reflects the rate of inflation. Therefore, wealth maximisation is more realistic objective.
2. It is consistent with the ultimate aim of maximising economic welfare of the shareholders.
3. It increases short term and long-term financial soundness of the enterprise which protects the interest of the creditors.
4. As the size of the birth day cake increases all the stakeholders like shareholders, employees, customers etc are benefitted.
5. It leads to rational allocation of national resources leading to economic development and social justice.

6. It affords to safeguard the interest of the society against environmental pollution.
7. It provides a real measure of efficiency. From the above discussion we come to the conclusion that wealth maximisation objective is more realistic and consistent with social responsibility of business. Therefore, it is widely accepted by the financial managers.

Arguments against wealth maximisation (disadvantages):

1. Some critics believe that it is an old wine in new bottle. How wealth maximisation can be possible without profit maximisation.
2. Rate of discount if determined arbitrarily and subjectively may not reflect true time value of money and risk factor.
3. It does not render social responsibilities automatically.

(B) Other goals:

1. To ensure a fair return to shareholders: In a company form of business organisation shareholders are the owners of the company. They undertake the risk of business by investing their hard-earned money in the company with an expectation of fair return on their investment. If their expectations are not met, they lose confidence and trust in the corporate sector and companies find it difficult to raise capital by way of issuing shares. In order to retain their trust it is essential to ensure fair rate of return to shareholders as one of the goals of financial management.

2. Building up reserves for growth and expansion: Development is one of the objectives of business. But development requires fund. In order to provide internal source of capital for future growth and expansion building up the reserves by retained profit is another goal of financial management.

3. To ensure maximum operational efficiency: Operational efficiency depends upon optimum allocation of funds over current and fixed assets and efficiency of working capital management. Therefore, in order to survive in competition financial management accepts the goal of ensuring maximum operational efficiency.

4. To ensure financial discipline in the organisation: Financial discipline lies in maintaining safety of cash, other valuables and in keeping clean financial records. Negligence in this regard may lead to misuse of cash and misappropriation of funds. In order to prevent financial malpractices financial management has to see that financial discipline is observed by the executives and employees.

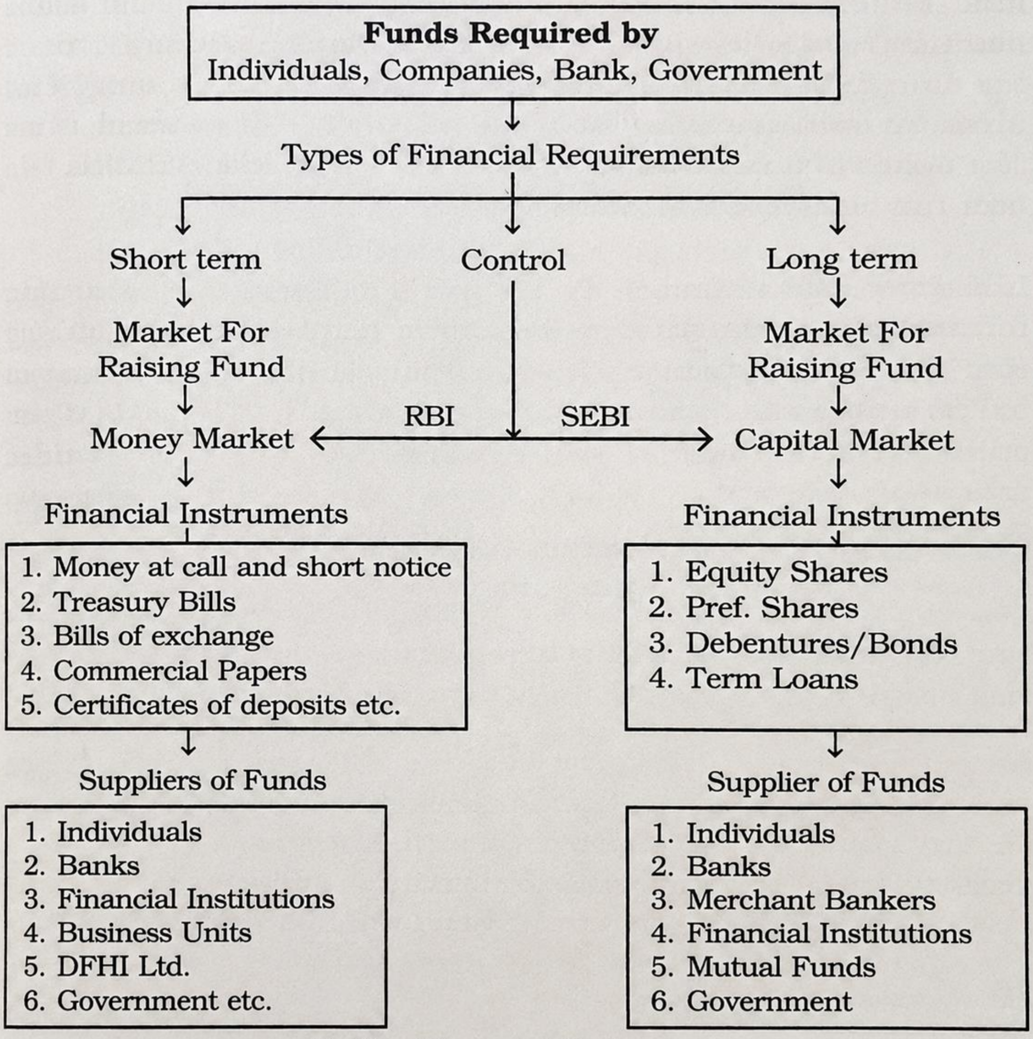
[5] Indian Financial System:

The basic concern of a financial manager is to raise the short term and long-term funds with minimum cost and invest them in assets mix leading to wealth maximisation. For acquisition of funds with minimum cost he has to plan optimum financial mix and for investment in assets he has to plan optimum assets mix. Such optimisation decisions should be taken in the context of environment provided by the financial system of the country. Financial manager is not only the line officer; he is a staff officer too. As a staff officer he enjoys the privilege of sitting in driver's chamber for guiding the driver about the route to destination. Over and above these he is required to play the role of maintenance manager of relations. He is expected to maintain healthy relations with banks, financial institutions and creditors. For playing the different roles effectively he is required to have full knowledge of the financial system of the country. Each country has its own financial system. India is not an exception to it. India has got its own financial system and hereunder an attempt has been made to highlight its major aspects.

[5.1] Financial System Defined:

A financial system is a complex unitary whole consisting of different parts connected with each other. The different parts of the financial system are individuals, banks, companies, government and the other institutions - some are in need of funds and some are with surplus funds for investment. The money market and the capital market are the important constituent parts of the system which provide the instruments and mechanism for borrowing and lending short term and long-term funds. The regulatory authorities like RBI and SEBI are also the integral parts of the system. These different parts of the system are interconnected. They influence each other. Relative demand and supply position of short-term funds in the money market determine short term rates of interest and relative position of demand and supply of long-term funds in the capital market determine long term rates of interest. The whole system works in an integrated fashion.

The Indian financial system can be depicted in the form of a chart as under:



Indian Financial System

As we see in the chart the main parts of the financial system are as under:

(1) Individuals, Institutions in need of Funds:

There are some individuals, companies, banks, government etc. who need funds for business.

Their fund requirements are of two types - short term and long term.

(2) Money Market for Short Term Fund:

Market in which funds are borrowed and lent for a short period of time, for less than one year is known as money market.

Instruments of Money Market: Short term funds are borrowed and lent in the market with the help of following instruments:

1. Money at call and short notice.
2. Repos (Repurchase Options)
3. Treasury Bills of 91 days.

4. Treasury Bills of 182 days.
5. Treasury Bills of 364 days.
6. Commercial papers.
7. Certificate of deposits.
8. Bills of exchange.

(3) Capital Market:

For raising long term fund capital market is used. The instruments for raising long term funds are -

1. Equity shares
2. Pref. shares
3. Debentures/Bonds
4. Term loans

(4) Suppliers of Funds:

Suppliers of short-term funds include component parts of money market like individuals, companies, banks, Discount and Finance House of India Ltd., Government etc. Those who have surplus funds for short term investment purchase the money market instruments and supply the funds.

Suppliers of long-term funds include individuals, banks, financial institutions, merchant bankers, mutual funds and companies. Those having surplus fund for long term investment purchase capital market instruments like equity shares, pref. shares or debentures/bonds and supply funds to the needy companies and institutions.

(5) Controlling Authorities:

In India for controlling the financial system two authorities have been delegated with necessary powers by the separate Acts.

Reserve Bank of India is empowered to control money market operations and its instruments.

For the control over capital market and its instrument a special body known as Securities and Exchange Board of India (SEBI) has been appointed. In this way Indian financial system works smoothly under the control of RBI & SEBI.

[5-2] Functions of Financial System:

Financial system performs the following functions:

1. Provides facility for payments: In the economy daily lakhs of trading transactions take place. Some involve payment of smaller amount but some involve payment of Crores of Rupees and that too at distant places which cannot be paid in cash. Financial system includes banks and the banks provide payment facility at distant places with the help of cheque, D.D., M.T., T.T. or e-mail.

2. Mobilisation of funds: Financial system provides an institutional set up for mobilisation of bank deposits and share capital or bond capital for different companies.

3. Fair distribution of resources: It provides information about the profitability of different companies and sectors. Such an information directs the flow of financial resources towards productive companies and sectors and prevents wasteful use of scarce resources in unproductive sectors.

4. Helpful in risk management: For risk management different devices have been evolved. Such devices include hedging, diversification, insurance etc. Financial system provides these facilities of hedging, diversification and insurance.

5. Provides information for decision making on decentralised basis: Information about prices of shares and debentures quoted on the stock exchange helps the investors to decide which shares to sell out, which to purchase and when.

6. Prevents the consequences of unilateral information: Management of the bank or a company or a mutual fund knows it's weakening financial position. But if the investors do not know, they go on investing their hard-earned money. When the bank or the company is closed down investors have to suffer. Ultimately investors lose confidence and trust in the whole corporate sector. Corporate sector has to suffer. But financial system by providing information about the credit rating of different companies to the investors prevents the emergence of such a situation arising from unilateral information.

[5.3] Some Aspects of Financial Management Environment:

Financial decisions are made under the influence of financial environment. And the financial environment consists of the following factors:

[A] Regulatory Framework
[B] Direct Taxes
[C]Indirect Taxes
[D]Import-Export Financing and
[E] International Financial Institutions
Now let us have brief idea about each one of them.

[A] Regulatory Framework:

Government policy and legal provisions of the different Acts which regulate the business activities are collectively known as regulatory framework. It affects the financial decisions.

There are three parts of the regulatory framework - Industrial Policy, Companies Act and Guidelines of SEBI.

(1) Industrial Policy:

Industrial policy of the government is an important factor affecting business decisions. For the first time industrial policy was declared in 1948. It was again revised in 1956. These both policies gave increasing importance to public sector in the economy. Again the policy was changed third time in 1991 which indicates a drastic deviation from the old policy. The new policy is known as liberalised policy because it removes many legal restrictions on licensing, reservation for public sector, foreign investment in India, MRTP Act etc. The main changes are as under:

1. Licensing Policy: Before 1991 it was compulsory to get government license for starting any new project or increase in production capacity or for expansion under Industrial Development Regulation Act of 1951. But now in the new policy only for five industries of defence and public health license is essential. For the remaining industries there is no need to obtain the license.

2. Reservation for Public Sector: In 1956 policy 17 industries were reserved for public sector but in the new policy of 1991 only four industries concerning defence and strategic importance have been reserved for public sector. Public sector loses its importance in the new policy.

3. Privatisation: Privatisation means disinvestment of public sector units. It envisages privatisation of government companies by selling government shareholding to private investors particularly employees, mutual funds and general public.

4. Participation of foreign private investment in equity capital: Formerly foreign capital investment was restricted to 49 p.c. But now in the new policy in certain projects like construction of roads and bridges and export-oriented units even 100 p.c. foreign equity capital is allowed.

5. Elimination of the provision of converting term loans into equity shares by the financial institutions: Formerly financial institutions were given the right of converting their term loans into equity shares. But now in the new policy this provision has been removed.

6. Amendment of M.R.T.P. Act: Drastic amendments have been made in the M.R.T.P. Act. Formerly any company with an asset of Rs. 100 crores or more was required to take the permission of the government for launching a new project or increase in production capacity, merger, amalgamation etc. But now in the new policy this provision has been cancelled. Because of this change a new process of industrial reconstruction in the form of mergers, acquisition, amalgamation, takeover etc. has begun.

Moreover, the meaning of service has been widened to include chit funds and mutual funds.

Prospectus has been included in the definition of goods. Any misrepresentation in it will be considered a serious offence.

Powers of the monopoly commission have been widened to include the powers of civil court. To promote healthy competition and protect the interest of consumers the competition Act of 2002 has been passed. It makes the provision for the appointment of **Competition Commission.**

(2) Companies Act:

Companies Act regulates the activities of the corporate sector. In the light of new policy certain amendments have been made in the Act. The main changes are as under:

1. Companies can issue only two types of shares, equity shares and preference shares.

2. For further issue of capital the rights shares should first be issued to the existing shareholders.
3. Public issue must be made through prospectus.
4. Issue of debentures with voting rights has been prohibited.
5. Borrowed capital should not be more than equity share capital and reserves.
6. Any company can purchase the shares of any other company subject to maximum limit of 10 p.c. shares. However, its total investment in other companies should not exceed 30 p.c. of its equity capital and reserve.

7. A company cannot give a loan more than 20 p.c. of its equity share capital and reserve to a company under the same management and 30 p.c. if companies are not under the same management.

8. Company can pay dividend out of profit only.

9. P. & L. a/c. and B/S should be prepared in the prescribed format.

10. Audited accounts should be sanctioned by the shareholders.

(3) Guidelines of SEBI:

In 1992 the control of capital Issues Act of 1947 was repealed. In its place SEBI issued a detailed guidelines regarding the issue of shares, debentures and their pricing, rights shares, bonus shares, payment of dividend etc. These guidelines are known as guidelines for disclosure and investors' protection. The main important points are as under:

1. Company making profit continuously for last five years can adopt free pricing policy for the issue of new shares.
2. In case of closely held and private companies, a company making profit continuously for the last three years can adopt free pricing for the issue of shares.
3. If the issue is of more than 100 crores promoter's quota should be minimum 25 p.c.
4. The share issuing company and the lead manager to the issue will have to justify the issue price.

[B] Direct Taxes:

Direct taxes include income tax, gift tax and the wealth tax. Income Tax in the form of corporation Tax applies to companies also. At present minimum alternate tax (MAT) for companies has been increased in the 2010-11 budget from 15 to 18 p.c. and surcharge has been reduced from 10 p.c. to 7.5 p.c. Besides, companies have to pay Dividend Tax at the rate of 15 p.c. on declared dividend. The rate of deductible R & D expenses has been increased from 150 P.C. to 200 p.c. in 2010-11 budget.

Computation of Tax:

1. Working out profit of the company for the financial year:

Total income including professional income if any is worked out. For determining the net profit allowable business expenditures should be deducted from the income.

Expenditures deductible from the business income includes the following:

Expenditures deductible from the business income includes the following:

(a) Business expenditures except capital expenditures and personal expenditures.
(b) Provisions for depreciation and bad debts.
(c) Certain allowable capital expenditures.
(d) R & D expenditure.

2. Addition of Other Income: Income from other sources like rent from house property, capital gains etc. are added to the business income.

3. Allowable deductions: Certain deductions are allowed under chapter 6A of I.T. Act. Such deduction include:

(1) Profit from units or hotels established in economically backward area.
(2) Income from small scale industries established in a backward area.
(3) Profit earned from projects promoted outside India.
(4) Reliefs available in respect of export turnover.
(5) Relief available in respect of intercompany dividend.
(6) In the budget of 2010 - investment related allowances have been applied to hotels with two or more stars.

4. Calculating tax liability: On the basis of net income and applicable corporation tax rate tax payable is worked out. Applicable tax rates are prescribed in the budget which are different for domestic and foreign companies.

5. Surcharge: To the tax liability worked out as above 7.5 p.c. surcharge on the tax is added to the tax for working out total payable tax.

6. Dividend Tax: The company has to pay the dividend tax at the rate of 15 p.c. of dividend declared and paid.

7. Business Loss: If the business expenses exceed business income there is a business loss. Such a loss can be set off against the profit balance of the past year. If loss remains even after setting off against profit can be set off by profit of the subsequent years upto 8 years.

[C] Indirect Taxes:

Indirect taxes are the taxes the financial burden of which can be shifted to other persons. Such taxes include the following:

(1) Central Excise.
(2) Value Added Tax (VAT) and Cen VAT.
(3) Custom duty on imports and exports.

(1) Central Excise Duty:
Central excise is levied by the central government. It is levied on the goods manufactured in the country. The main legal provisions are as under:

(a) Excisable Goods: Excise duty can be levied on any goods manufactured in the country except salt. Here two points are important: (1) Excise can be levied on goods and (2) It must have been manufactured.
(b) Classification of Goods: By adopting international standards of classification goods are classified into different groups and different rates applies to all the items of the same group.
(c) Types of excise duty: There are two types of excise duty:
1. Specific excise duty: Duty levied on the quantity of goods is known as specific excise duty. e.g. Rs. 200 per tonne of cement.
2. Advalorem excise duty: Excise duty levied on the value of goods is known as Advalorem excise. e.g. 5 p.c. of the value of medicines.

Modvat Scheme: Modified Value Added Tax: Sometimes a manufactured product consists of different parts like scooter. The manufacturer of scooter purchases some parts from outside and mirror, seat, leg guard, lighting system etc. are fitted at the time of final assembly of scooter, pays excise on these items. But they are included in the value of the scooter on which he has to pay the excise. In such a case on some item, double excise is paid. As a result price of the product increases, customers have to suffer and the competitive strength of the company declines. With such a high tax incidence it cannot compete in the global markets. In such cases, in order to give relief to the manufacturers the government has introduced Modvat Scheme. Under modvat scheme the manufacturer is required to prepare a list of the spare parts on which excise has already been paid. Against the item he has to mention the amount of excise duty paid at the time of purchase. Total of the excise paid at the time of purchase is deducted from the total excise payable. This amount is given as credit to the manufacturer. This scheme gives some relief to the manufacturer.

(2) Value Added Tax (VAT):
The second indirect tax is the sales tax which is now known as VAT. The sales tax comes within the jurisdiction of the state. Therefore, each state has passed its own Value Added Tax Act. (VAT). The main characteristics of the VAT are as under:
1. Scope of VAT:
VAT is levied on the sale of goods. Its scope includes the following:
(a) Sale of goods
(b) Works contracts
(c) Hire purchase and lease transactions
(d) Sale of food items in hotels and restaurants
2. Central Sales Tax:
The state has the right to levy sales tax but as per constitution it cannot levy sales tax on goods sold outside the state. For such goods central government has passed the Central Sales Tax Act which is applicable to interstate transactions. Now the central sales tax has been replaced by CENVAT.
3. Custom Duty:

The third indirect tax is the custom duty on imports and exports. The central government determines the rates of custom duty on imports and exports. Rates of custom duty are used to regulate our imports and exports.

Custom duty is levied on the value of goods mentioned in the Bill of Entry.

Concessions: In case of custom duty the following concessions are granted:

1. Goods destroyed or abandoned.
2. Goods impaired.
3. Reimport of goods produced in India.
4. Goods declared free of duty by notification.

Procedure: The importer has to fill in the form of bill of entry in triplicate. Value of imported goods is mentioned in the bill of entry. On the basis of this value custom duty is calculated. After clearance of custom duty importer is permitted to clear the goods. Of course, he has to pay the port dues also.

[6] Goods and Service Tax:

In India there is multiplicity of indirect taxes, e.g. central excise, cenvat, VAT of each state, custom duty etc. Because of this multiplicity of Acts, uniformity of rates, procedure and tax administration is not maintained in the country. Therefore, there is a strong opinion about the replacement of different taxes by a single Act, known as Goods and Service Tax (GST). Discussion is going on about the draft outline of the proposed new Act and it is expected that it will be passed by the Parliament within a short period of time.

[7] International Financial Institutions:

The financial management environment of a company includes international financial institutions also. The main three international financial institutions affecting financial decisions of a company are as under:

(a) International Monetary Fund.

(b) World Bank and

(c) Asian Development Bank.

(A) International Monetary Fund (IMF):

After the second world war the economies destroyed by the war faced the problem of reconstruction. Many colonial countries which were under developed also needed fund for development. Their imports far exceeded exports, as a result many countries were facing the problem of disequilibrium in balance of payments. In order to solve this problem of disequilibrium, countries imposed quantitative restrictions on imports, increased tariff walls and for increasing exports they devalued their currencies. Some resorted to bilateral trade agreements. All these measures were retaliated by the affected countries. As a result nations became narrow minded, thinking of self-defence only. Ultimately all these measures of self-defence like restrictions on imports, tariff walls, bilateral trade agreements and competitive devaluation of currencies proved to be inhibiting the growth of international trade. Problems were of such a big magnitude that a single nation itself cannot solve them. Solution required international co-operation. For this purpose a conference of the representatives of certain countries was held in Bretton Woods in 1944. After detailed discussion the conference recommended the establishment of three institution: (1) IMF (2) World Bank and (3) International Trade Organisation. The first two were agreed upon by the members and therefore they came into existence but for the third one certain member refused to sign and therefore, it could not come into existence. But efforts were continued.

As described above, to solve the problems of temporary and fundamental disequilibrium of balance of payments of different countries on co-operative basis and increase international liquidity to promote international trade International Monetary Fund was established in 1945.

Objective of IMF:

The objectives of IMF as clarified at the time of establishment can be stated as under:

1. To promote international co-operation for the solution of international monetary problems by mutual consultation and collaboration by making permanent institutional arrangement.

2. To provide necessary facilities for the balanced and expanded growth of world trade.

3. To promote exchange rate stability and prevent competitive devaluation of currencies.

4. To be helpful in the establishment of multilateral payment system.

5. To increase confidence of the member countries by providing short term financial assistance to solve their temporary disequilibrium problems of balance of payments.

6. To shorten the period of disequilibrium of balance of payments.

Financial Resources or Fund:

Quotas:

IMF requires fund for providing financial assistance to the member countries. The joint stock public limited companies issue shares and raise capital. But the International Monetary Fund does not issue shares and payment of shares. But it determines quota for each member country and against the prescribed quota to the IMF constitutes its capital fund. And therefore, its capital is known as Quotas.

In the beginning for the collection of fund quotas prescribed for the member countries were as under:

1. 2 p.c. of national income
2. 5 p.c. of gold and Dollar reserves.
3. 10 p.c. of average annual imports.
4. 10 p.c. of maximum variation in annual exports.
5. The sum of 1, 2, 3 and 4 increased by percentage ratios of average annual exports to national income.

Years for the calculation of each quota were also determined. Members were required to pay 25 p.c. of their quota in gold and remaining 75 p.c. in their own currencies. The price of gold was fixed at 35 American Dollars per an ounce.

For a member country quota is an important element of IMF system. Larger the quota means larger contribution, larger borrowing capacity, larger voting strength of the country and larger allocation of Special Drawing Rights (SDR). SDR is an international money created and allocated by IMF to member countries in proportion of their quota. Special Drawing Rights were created to increase international liquidity. They can be used by the member countries for international payments.

Measures taken by International Monetary Fund:

For improvement in the short term and fundamental disequilibrium of balance of payments and reduction in the rate of inflation are the main objectives of IMF. While maintaining continuity of these objectives, IMF concerned itself with economic growth and subsidies of the countries and with financial planning authority for improving the situation. IMF recommendations are not accepted without financial assistance if its recommendations are accepted and implemented.

1. To reduce budget deficit by curtailing government expenditures and increasing taxes.
2. To instruct to devalue the currency under unavoidable circumstances.
3. To recommend reduction in domestic and foreign debt of the government.
4. To liberalise foreign trade by reducing custom and non-custom restrictions.
5. To remove price controls.
6. To make changes in the rates of interest in order to make them realistic.

Measures suggested by the IMF and implemented by the financial and monetary authorities of the country affects the financial environment and financial decisions of the company. e.g. following the suggestion of IMF the RBI increases the rates of interest, consequently external sources of capital will become expensive and the company has to rely more really on internal sources which requires changes in dividend policy. The above-mentioned measures influence directly or indirectly the financial environment and financial decisions of a company.

Since inception IMF has passed through many critical stages and has faced many criticisms like domination of capitalist countries in its management, interference in the monetary policy of central bank, granting loan against strict conditions, partiality in lending, failure in controlling inflation and maintaining stability of exchange rate etc. In spite of facing many critical situations and severe criticism it is surviving and performing its job which indicates its importance even today.

(B) World Bank: International Bank for Reconstruction And Development (IBRD):

We noted earlier that World Bank too came into existence in 1945 as a part of Britton Woods System. During the Second World war the economies of many European countries were almost ruined. After the end of the war problem of their reconstruction arose. But reconstruction of economy was beyond the capacity of a single country solution required external help. But the external help was needed by many developing countries also for their economic development. Therefore the thinkers of Britton Woods System conceived the idea of establishing International Bank for Reconstruction And Development and the idea become the fact in 1945. The IBRD is also known as World Bank.

The World Bank started with twin major objectives has widened its scope with the passage of time to meet the needs of the time and today it addresses to a variety of issues like social, economic, environmental pollution, climate change health care and food security in both developed and developing countries.

The Functions of World Bank:

The world bank provides finance and technical assistance to the member countries to carry out the following functions:

1. Financial assistance for reconstruction: To provide long term financial assistance for the reconstruction of economics ruined in the Second World War was one of the prime objectives of the Bank. But since the launch of Marshal Plan European countries moved to the other sources, the reconstruction objective became the subsidiary objective.

2. To Eradicate extreme poverty and hunger: In Asian and African countries many people live in extreme poverty and hunger and about 90 p.c. of the children are found undernourished. If the government launches any project for the eradication of poverty and hunger and also for the nourishment of children world bank provides financial help for the implementation of project or programme.

3. To provide assistance for the development infrastructure facility: Development of infrastructure facility is the key to economic development. If the government of any member country launches project like construction of roads, railways, dams, thermal power projects, nuclear power project, communication network etc. and desires loan from the world bank, it provides funds for the implementation of the project.

4. Achieve universal primary education: In the year 2005 about 72 million children of primary school age. 57% of them girls were deprived of primary education facility. If the government of any members country plans for the spread of primary education and desires help from the world bank, it provides fund for that noble purpose.

5. To Promote Gender Equality: In many societies of many countries, today we find man domination and wife are suffering due to the status of housewife. To promote equality between men and women, unpaid family work of women is treated more than man. Many empowering steps in this direction need to be taken. If any government takes positive action and needs funds the World Bank is ready to provide.

For promoting gender equality equal opportunities should be given to women in employment and administrative posts. For this World Bank Group Gender Action Plan has been launched in Asian and African countries.

6. To improve maternal health: In Asian and African countries almost half million women die during pregnancy or maternal deaths. There are numerous causes responsible for maternal death rate. To improve maternal health care a variety of institutions regarding health care are provided by the world bank and its associates.

7. To Combat AIDS, Malaria and other diseases: Abolition of Aids, malaria and the other infectious diseases require collective actions world over for which World Bank extends its help to the member countries.

8. Save environment campaign: Air, soil and water are polluted by poisonous gas and affluent waters coming out of factories. The environmental pollution is a burning problem of today. The problem of climate change is also associated with it. It requires collective consciousness and the World Bank also helps in creating public awareness.

9. To Develop global partnership for development: Problems of economic development, eradication of poverty, prevention of environmental pollution etc. are of such a magnitude that it is beyond the capacity of a single country to cope up with them. All round development requires global partnership. The World Bank Group is working in the direction of developing global partnership.

10. Food Security: The World Bank has implemented the global food crisis response programme in April, 2010. Under this programme it provides finance for agricultural development, research and development and trade of agricultural products.

Financial Resources of World Bank:

Share capital provided by the member countries is the main source of capital. Member countries have provided share capital in different proportions. The share of America is the largest. In case of need it can raise the debt capital by issuing bonds in international capital markets. The members countries have voting rights in proportion of their shareholding. At present 188 countries are the members of the Bank. The member of the World Bank is also the member of IMF.

Board of Directors and its President are managing the Bank. Besides President there are two executive vice presidents, three senior vice presidents and 24 vice presidents who are acting as managers of sectoral or regional branches of the Bank.

World Bank Group:

World Bank Group means a group of five international institutes which are as under:

1. International Bank for Reconstruction and Development IBRD.
2. International Development Association IDA.
3. International Finance Corporation IFC.
4. Multilateral Investment Guarantee Agency - MIGA.
5. International Centre for Settlement of Investment Disputes - ICSID.

All the five institutions work in a co-ordinated fashion as a World Bank Group. Their functions are complementary to each other.

The headquarters of the World Bank and IMF are situated in Washington D.C.

Though working for the all-round development of the world its working has been heavily criticised. In the beginning it was argued that its advances will increases the rate of inflation. American domination over it will protect the interest of America and those of capitalist countries. Bank concentrates on giving loans and ignores the achievement of loans. Loans are given on commercial terms.

(C) Asian Development Bank (ADB):

Asian Development Bank is a regional bank established on 22 August 1966 the head quarter of which is situated in Metro Manila, Philippines. It is modelled closely on the World Bank and has a similar weighted voting system where votes are distributed in proportion members capital subscription.

Asian Development Bank was established by the initiative of Japan. Japanese people felt that their interest in Asia was not served by the World Bank and wanted to establish a regional bank. A group of Japanese people formulated a private plan for that in 1962. On receiving the consent of governments of Asia Countries, Asian Development Bank was established in 1966 to facilitate economic development of countries in Asia. The Bank has 67 member countries of the United Nations Economic and Social Commission for Asia and the Pacific (Formerly known as ESCAP). Out of 67 members 48 are from the region and 19 from non-region. Since

Japan has a dominating position in the bank. The President of the bank up to now has been from Japan.

Capital Resources of the Bank:

Capital resources of ADB consists of two parts. One is ordinary capital resources or share capital subscribed by the member countries. Second part is made up of Special Fund contributed by the members for special purpose. Special Fund can be used for special purpose specified by the donor.

By the end of 2012 the U.S.A. and Japan held the two largest proportions of shares each holding 12.78 p.c. China held 5.45 p.c. and India 5.36 p.c.

Management:

The Board of Governors made up of representatives from member countries. The board members elect its president. The Board of Governors takes policy decisions. For administrative functions there is a Board of Directors. Board members are elected by the board of Governors. President of Board of Governors is also the President of Board of Directors.

Financial Assistance:

Asian Development Bank provides financial assistance in the form of loan for the development of infrastructure facilities such as construction of roads, dams, railway communication network, educational and health facilities. It has played an important role in member countries. The Bank has also helped countries by developing infrastructure facilities which have attracted Japanese companies for investment in Asian countries.

Asian Development Bank provides loans for financing the projects from its ordinary capital resources on commercial terms and at market rate. It is so but assistance from concessional resources is also available. The Asian Development Fund (ADF) provides soft loans. The special fund for special projects. The receivers of the assistance include Indonesia, Thailand, Malaysia, South Korea and Philippines. Japan had crucial trading ties with these countries.

Japan is the best benefitted country by ADB because it has provided an opportunity to the surplus private capital of Japan for investment in the Asian countries. International trade of Japan with Asian countries has also increased because of financial assistance by ADB to Asian countries.

Exercise

1. Explain in brief the traditional and modern concepts of finance function.
2. Distinguish between traditional approach and modern approach of finance function.
3. What is financial management? Explain its objectives.
4. Critically examine the profit maximisation objective of financial management.
5. "Profit maximisation leads to exploitation while wealth maximisation objective leads to economic welfare of the stakeholders." Discuss.
6. Define Indian financial system and explain in short, its functions.
7. What is regulatory framework affecting financial decisions?
8. What are the direct and indirect taxes?
9. Throw light on new industrial policy of 1991.

10. Write short notes on
    (a) VAT and CenVAT
    (b) Wealth maximisation
    (c) Functions of financial system
    (d) Components of Indian financial system
11. State the objectives of International Monetary Fund.
12. What measures does IMF suggest for the improvement of disequilibrium of balance of payments?
13. State the functions of world bank.
14. Write short note on Asian Development Bank.