Chapter

I

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ONE

Preliminary observations

This study deals with some important aspects of governmental regulation of the financial management of companies. Governments have always been concerned with problems of promoting economic growth and development, but the nature and magnitude of regulatory measures in the financial sphere has depended, *inter alia*, on the pattern of economic activity. When business and industry were carried on by private individuals, there was no need for financial regulation as such. With the emergence of the company and other entities dealing in business, the need arose for imposing financial regulatory measures, particularly because a company is (i) invisible in its nature, (ii) large in its size, and (iii) changing in its composition. These regulatory measures, representing the re-action of the State to the rise and fall of corporations and to the use and abuse of their power and position, have themselves grown in size, in tune with the growth of corporations. It is considered that the manner in which governmental measures impinge upon corporations in their financial aspects deserves a study in depth. So many strands have got entangled with one another, that a clear and comprehensive picture is difficult to obtain unless the strands are disentangled, and their contribution to the over-all pattern of regulation of corporate financial management brought out. The materials to be studied for this purpose do not present a smooth landscape. It is an uneven soil. At some places, the land is marshy; at a few places, one comes across dense forests; at other places, the land is barren or sparsely cultivated. In its totality, therefore, the picture that emerges may not be a consistent or harmonious one. Nevertheless it is necessary that such material as exists on the subject is presented, so that the main contours are delineated with reasonable certainty.

Governmental concern with regulation

As stated above, while Governments have always been concerned with problems of economic growth in their country, the subjects regulated, and the intensity and pattern of regulation enforced, vary from time to time and place to place. For example, for major developed nations, management of foreign exchange is hardly an issue and regulatory measures concerned with foreign exchange are rarely, if ever, to be found in the statute book of these countries in normal times. But, in lesser developed countries, control over foreign exchange transactions is a critical element of the strategy of economic regulation. Similarly. in a capitalist economy, regulation of industrial enterprises may be expected to be kept to the minimum. In contrast, in socialist countries, such regulation is likely to be much more intensive and extensive.

It is proper to draw attention to these appaiently elementary propositions, for the simple reason that to the new visitor to this area, the plethora of legislation may appear to be unnecessary and confusing, and he may even doubt the utility of studying the law and its administration in this particular sphere.

Scope and object of the study

In the following pages, the subject matter of financial management is discussed with a view to emphasising the legal control and regulation under which it is functioning in India. The discussion seeks to provide a survey of the legislative framework through which the objectives of the Government policy are to be achieved. An effort is also made to highlight certain problem-areas of control and regulation which have a wide impact on the financial functioning and decision-making process. Certain techniques used by companies for borrowing money and augmenting their financial resources, are also analysed in detail. The top management personnel have to play a significant role in the decision-making process at various stages of the financial management in a company. As such, the current and controversial issue of managerial remuneration is also examined in the light of the relevant legal provisions, administrative guidelines, and judicial exposition, along with the commercial and social justification of these materials. Concluding remarks deal with the rationale of the plethora of Governmental measures and their role in effectively tackling the complex financial management problems of the private corporate sector in India.

Strands that make up the web

The strands that go to make up the web of regulatory measure relevant to the financial management of companies may well be enumerated at the present stage. The principal strands appear to be the following :—

(a) Measures necessary for planned economic development of the country (including measures aimed at avoiding concentration of wealth or economic power), as applied to the corporate sector.

(b) Measures necessary for the protection of shareholders and the investing public.

(c) Measures necessary for the protection of depositors and other creditors, who might have placed deposits with, or advanced loans to, corporations.

(d) Measures necessary for the conservation of foreign exchange, in the context of its consumption by corporations.

(e) Measures necessary for the proper financial management of companies in their internal working.

Regulatory Measures in India

In India, Government policy has played an important role in controlling and guiding the growth of the corporate sector. The Directive Principles of State Policy as laid down in the Constitution of India, the assumption of the socialistic pattern of society as our national goal, the declared objective of planned industrial development and a paramount role for the public sector in our country and similar circumstances, have contributed to the imposition of various legislative and administrative controls on the corporate sector. The functioning of the private corporate sector is, to a large extent, determined by the parameters set by the Government. These parameters are usually sought to be justified by various socio-economic compulsions. The extent of corporate performance is thus vitally inter-related to its conformity with Government and legislative enactments.

Sources of regulation

An important aspect of the over-all Government regulation of the economy is the industrial policy as declared by the Government from time to time. In 1948, the Government of India announced, for the first time, its industrial policy. This was subsequently revised and enlarged, incorporating new ideas for the industrial growth in propér directions. In pursuance of the industrial policy, several legislative enactments were passed by the Parliament from time to time. It may be conveinent to mention here the declarations and legislative measures that have had a noteworthy impact on the trend of growth of industries—

1. The Capital Issues (Control) Act, 1947.
2. The Industrial Policy Resolution, 1948.

3. The Industries (Development and Regulation) Act, 1951.
4. The Industrial Policy Resolution, 1956.
5. The Companies Act, 1956.
6. The Securities Contracts (Regulation) Act, 1956.
7. The Monopolies and Restrictive Trade Practices Act, 1969.
8. The Industrial Licensing Policy, 1970.
9. The Industrial Policy Statement, 1973.
10. The Foreign Exchange Regulation Act, 1973.
11. Industrial Policy Statements (July 1977 and December 1977).
12. Non-Banking Financial Directions of the Reserve Bank of India.

Apart from these legislative enactments and policy declarations, various other regulatory measures, such as the Five Year Plans, Corporate Taxation Laws, declaration of fiscal policy, monetary policy, foreign collaboration policy, and price control policies, have also played a very significant role in shaping and implementing the industrial policy of the Government. Institutions created under these regulatory Acts have implemented the Government policy by controlling and regulating the growth of joint stock companies in India. Also worth mentioning is the contribution of the Planning Commission, and the part played by All India financial institutions and State financial institutions, in regulating and developing the growth of the corporate sector and its finances.

Financial management and its coverage

"Financial management" may be explained as that specialised activity which contributes to the decision-making of the top management of companies on subjects that have financial implications. Financial management holds key to all the corporate activities. Financial management is that managerial activity which is concerned with the planning and controlling of the financial resources of a corporation. Though the focus is on finance, it is difficult to separate the financial function from that of general company management. A policy decision regarding the proper utilisation of the funds of a corporation will have financial implications, whether it relates to production, marketing, personnel or any other segment of corporate activities. The decisions on the subject will have to be taken in the light of the financial viability of the various alternatives.

The financial requirements of companies are varied, depending on the nature and scope of their objectives and activities. But certain broad features may seem to be applicable to most companies. The sphere of activity of financial management includes the following :

1. Promotion and creation of the nature of capital for the company.
2. Knowledge of the elements determining the value of the alternative use of financial resources for furthering the corporate objectives.
3. Decision-making regarding the ways in which various means of raising funds can be combined to produce even greater values.
4. More efficient use of the existing stock of funds and their proper appreciation.
5. Proper regulation of the current conditions in the terms of the flow of funds, preparation of statements of income, balance sheets, profits and other informatory reports of company affairs for the purpose of control and review by the management.
6. Anticipating financial needs and mobilisation of resources for future requirements, and determining alternate programmes for the corporate growth.

An efficient management of the monetary resources of the companies comprises, *inter alia*, the mobilisation of resources, management of working capital and decisions as to investment. The problem of management of working capital is of great economic and financial significance. Both the production and the distribution of goods require the investment of fixed and working capital, in order to produce a proper flow of funds.

Impact of financial management on other activities of companies

Financial management has its impact on the other activities of the company, and this is an aspect which enhances its significance. No doubt, its primary concern is with discharging the financial functions successfully. Financial management safeguards the interests of the corporation, which really means the interests of the owners and other sections of the community which are directly concerned with the corporation. It is in the handling of these more complex financial problems, which are interwoven into the fabric of the management activities, that the effectiveness of financial management becomes significant.

The traditional approach to the subject of corporate finance laid stress on the investment banker, rather on the financial decision-maker in an enterprise. However, with the advent of modern industrialisation and huge amount of capital investment, companies are confronted with complex financial operations. The size and composition of the capital structure has therefore gained great importance. Apart from this, the modern financial management is also the product of the vast changes that have taken place in the socio-economic and legal environment. Its emphasis has shifted from traditional analysis of profitability to the genaration of flow of capital in the light of existing government control over corporate finance. For example, the limits imposed by the Government on the payment of dividends and floatation of share capital have resulted in a difficult situation concerning the supply of funds to the equity market. In consequence, companies are forced to look for their borrowings elsewhere as a dependable and solid method of finance. These aspects have contributed to the complexities of financial management, and have increased the impact of financial management (and of the relevant regulatory measures) on other segments of corporate activities.

Corporate organisation and the finance function

The raising of capital funds, and their use for generating returns and paying returns to the suppliers of funds, are called the finance functions of the company. In corporate organisations, there are two types of funds that a company raises : equity fund and borrowed fund. A company sells shares, for acquiring equity fund. Shares represent the ownership rights of their holders. The shareholders are the owners, though, in practice, they delegate their powers of management to the Board of Directors. With the growth of industrial organisations, the ownership is divorced from management and the shareholders perform a very limited function. The shareholders invest their money in the shares of a company in the expectation of returns, which is called dividend. Payment of dividend is not a legal obligation of the company: its payment is at the discretion of the Board of Directors, as regulated by the Companies Act. However, in practice, dividends constitute the main incentive underlying investment made by shareholders.

Another source of company finance is creditors or lenders. The lenders (in contrast with the shareholders) are not owners of the company. The return on loans or borrowed money is called interest. The company is legally bound to pay interest on loans—again a feature affording contrast between shareholders and creditors.

Functions relating to finance have many aspects. The managerial finance require skilful planning, control and execution of financial activities. Functions related to investment, financing and dividend are of great importance, as they influence the production, marketing and other activities of the organisation and have an impact on the growth of the company and the profitability of its ventures. The finance function further includes decisions as to the acquisition of fixed assets and management of long-term and short-term capital requirements.

Shareholders

The shareholders approve the contents of the Articles of Association. They approve matters relating to the amount and kind of capital, and the delegation to directors of the right to declare dividends. They authorise the directors to create resources out of net profits and for working capital and contingencies, and approve re-organisation plans, consolidation and mergers and plans for liquidation and so on. The matters mentioned in the preceding sentences are important aspects of financial management and in theory, shareholders are assigned an important role. In actual practice, however, the Board of Directors is the real brain of the corporate management. Important financial functions of a Corporatation are, in practice, discharged by its Board of Directors. The Board approves the financial policies, selects senior officers dealing with financial matters for implementing financial policies, declares dividend and takes necessary steps to meet the aspirations of stock-holders. The Board has the ultimate responsibility of contributing to good decision-making on issues that cut across the financial areas of an enterprise.

Credit crisis

Before proceeding to the next topic, it may be desirable to devote some paragraphs to the credit situation. The industrial sector today is reeling under an unprecedented credit crisis. Financial personnel find it extremely difficult to borrow money for the requirements of working capital to raise industrial production. The vital sectors of the economy are facing extremely stringent credit situation.

Various factors are responsible for the extremely tardy growth of bank deposits and their impact on industrial finance. It is well known that the Bearer Bonds' (second issue) money worth 580 crores, which formed a substantial portion of industrial capital and came from organised banking sector by withdrawals from benami accounts, is now with the Government. Attractive convertible debentures issued during this period have also contributed significantly to the declaration of deposits. Apart from these, the amount raised by various companies from the capital market by way of equity/preference shares and debentures during the nine months period from April to December 1981 amounted to over

Rs. 326 crores, as against Rs. 70 crores in 1979-80 and Rs. 113 crores in 1980-81. This is exclusive of funds raised by both private and public sector companies by way of deposits from the public. The aggregate deposits of commercial banks have also declined in 1981-82 as compared with 1980-81. The Reserve Bank's re-finances which were available to the banks' resources have also been under great strains, owing to its policy of introducing anti-inflationary measures by tightening to re-finance facilities.[1]

Oppressed by the continued severity of the credit squeez, industry has been waging a relentless attack on the Reserve Bank's tight money policy. These attacks have also been supported by some of the ministries, as the units under the administrative control of the Ministry have started feeling the pinch of the credit squeeze. Banks also started defaulting in the Cash Reserve Ratio (CRR) in a big way, thereby attracting heavy penalties even after severely curtailing credit.[2] Some of the banks had even to cut down credit across-the-board; and practically all banks have either refused to entertain new accounts, or they entertained new accounts very selectively or grant additional limits even to priority sectors and exports. Similarly, increase in the limits of existing borrowers are sanctioned depending upon the value of the account.

Appreciating the predicament of the industry—particularly, established industries like sugar and fertilisers, which were caught in the vortext of the credit squeeze—the Reserve Bank relaxed its credit policy a little. The Cash Reserve Ratio (CRR) was slightly reduced. These steps, as taken by the Reserve Bank of India, have kindled hopes among the credit-starved-borrowers that, at long last, their request for additional need based credit would now be met by their banks. New entrepreneurs who were disheartened by the embargo put by banks on the acceptance of new accounts also hoped that the worst financial crisis was over. The actual position, however, was not promising, because banks are still sitting on the fence. In short, normality in granting advances, as desired by the Reserve Bank of India, has not been restored.

Bank deposits

Banks can liberalise their credit only with the growth of their deposits, which unfurtunately is not picking up to the desired level.

1. See K.S. Ramachandran, "Diminishing Role of the Reserve Bank of India, Monetary Policy", *Financial Express*, November 24, 1984, p. 5.

2. See Benugopal and Somaskandan, "Why Banks Default on SLR, CRR", *Financial Express*, April 10, 1982, p. 5.

During the first week of January 1982, aggregate bank deposits decreased by Rs. 39 crores to Rs. 43.95 crores. While the decline in time deposit was Rs. 33 crores, demand deposit dwindled by Rs. 6 crores.[3] Deceleration in the incremental growth of bank deposits, witnessed throughout the second half of the financial year 1981-82, has prompted a review of Cash Reserve Ratio as well as re-finance, twice within a period of few months. The Ratio was raised from seven to 7.5 per cent on May 28, 1983, and eight per cent from July 30, 1983. It was further enhanced to 8.5 per cent from August 27, 1983. On February 4, 1984 the Cash Reserve Ratio was brought up to nine per cent. The deceleration is continuing and their is yet no sign of this trend being checked. Significantly, the usually large scale of disbursements by the Central and State Governments made in the closing weeks of the previous financial year were not reflected in the expansion of bank deposits. The higher scale of plan allocations for 1985-86 is yet to make its impact on bank deposit growth.

The policy of credit restraint pursued during the second half of 1981-82 has caused such a deceleration in bank deposit growth that the position cannot be retrieved without a substantial liberalisation of bank credit. Its current flexibility notwithstanding the Reserve Bank has failed to closely monitor the resources position of commercial banks. For the week ended March 15, 1985 aggregate deposits of scheduled commercial banks fell by Rs. 58.31 crores to Rs. 71077.45 crores. The inter-bank call money market continued to be tight. The banks increased their indebtedness to the Reserve Bank by Rs. 391.13 crores to Rs. 1968 crores.[4] Banks as well as their borrowers are paying a heavy price for this lack of planning. The case of private industry is that if deposits are to expand on a significant scale, advances to the non-food commercial sector should be liberalised substantially and in a sustained manner.

Credit situation

In the context of the exhortation of the Governor of the Reserve Bank to the bankers in his circular letter of the 8th April, 1982 that "the first quarter of the financial year 1982-83 should be considered as a period of restoration of normality in banking operations", and, in the absence of any quantitative restrictions on the expansion of credit as in the previous years, an impression has been gaining ground that banks are

3. See La Gopa, "Banks, Companies Tussle for Funds", *Financial Express*, June 12, 1982, page 5.

4. See "Money Market Tight", *The Economic Times*, April 1, 1985, p. 8.

perhaps more strict in the dispensation of credit than is warranted by the circumstances and the advice of the Reserve Bank. The apparent reluctance of bank to loosen their credit policy is due to their past experience with the Reserve Bank of India when they had to pay heavy penalties for their CRR (Cash Reserve Ratio) default, apart from inviting the wrath of the Reserve Bank.

They have also been warned by the Reserve Bank against unduly relying on volatile money market funds and have been directed to observe the sanctity of the reserve requirement. In the absence of a general relaxation of the credit curbs, the benefit of the comfortable funds position goes at present to the prime borrowers or selected clients who are able to approach the head offices of the banks.

Increasing involvement of banks in financing sick industries on a priority basis has also aggravated the credit situation of other industries in the private sector. According to banking circles, the recently introduced capital investment bonds will further erode deposits with banks. All these factors have contributed to financial distress and confusion amongst the industrial borrowers.

Impact of credit policy on enterprises

If the new entrepreneurs are denied working capital—as is happening now—the spirit of enterprises will be seriously eroded. Similarly, if the existing entrepreneurs are unable to meet their legitimate requirement of funds for their expansion or increased production, industrial growth will be severely curtailed. An equally pernicious consequence of credit stingency is its possible deterrent impact on the planning of future expansion and diversification, compelling units to stagnate, if not to regress, whereas, ideally speaking, liquidity should provide the *prima mobile* for the rapid growth of industrial production.

Credit stringency takes various forms in India. There is no dearth of instances of loss in production or investment activity which could be directly traced to the credit squeeze. Banks Chairmen themselves admit that sometimes under the credit squeeze even "worthy needs" are not being met.[5]

Any deceleration in capital investment in private sector industries, under the impact of monetary stringency, will do a great damage to the future growth of Indian economy. The financial management of companies has thus to deal with a very difficult situation for securing the necessary working capital of industries in the private sector.

5. See S.V. Char, "The Credit Squeeze", *The Economic Times*, June 9, 1982, page 5.