LESSON - 2

ENVIRONMENT OF FINANCE

OBJECTIVES

The objectives of this lesson are to :

☆ present various forms of business organisations and their features

☆ discuss the tax system and various provisions of the Income Tax Act, 1961

☆ explain various government regulations affecting the business enterprises

☆ present the financial system consisting of financial assets, financial intermediaries, and financial markets.

STRUCTURE :

2.1 Introduction

The modern business enterprises have to operate in a fast changing and more competitive env ronment. Managers of these enterprises are required to posses the ability to react quickly and correct to constantly changing market conditions. In this lesson, let us know about the environment of finan and government regulation.

2.2. Forms of organisation

There are four main forms of business organisation : (i) Sole Proprietorship (ii) Partnership fir (iii) Joint stock company, and iv) Cooperatives. In terms of numbers sole proprietary form ‹ organisations rank first, but in terms of volume of business company form stand first. Each of these briefly discussed in the following paragraphs.

2.2.1. Sole Proprietorship :

A sole proprietorship is a firm owned by an individual. He owns all assets and owes all liabilities of the business. These business organisations can be formed easily with few government regulations. When business is to run on small scale these forms of organisations are best suited.

The sole proprietorship form of organisations cannot raise large amounts of capital. The proprietor has unlimited liability. In this business form, if business debts could not be discharged with its assets, they must be discharged by personal assets. The business comes to an end if the proprietor ceases to exist. Limited resources, unlimited liability, lack of division of labour, lack of competitive edge, short life span, etc are the factors that keep these organisations backward.

2.2.2. Partnership Firm:

A partnership firm is a business unit carried on by two or more persons with an intention to share profits or losses. The major advantage is its low cost and easy formation. The limitations are similar to those associated with proprietorship: (1) unlimited liability (2) limited life (3) difficulty in transferring ownership and (4) limitations in raising funds.

The partners can potentially lose all of their personal assets. Each partner is liable for the business debts. Mutual conflicts, delay in decision making, low public confidence, disruption in continuity are some more negative features of partnership firms.

This form is suitable where the size of the business is small and capital requirement is low. It suits professions like medicine, accounting, legal, management, stock broking, etc.

2.2.3. Joint Stock Company:

A joint company is a legal entity created under the law and empowered to own assets, to incur liabilities, and to engage in business. It is an artificial person created by the law. The capital of a company is divided into small portions and each portion is called a "share". Investors who buy these shares are called shareholders and they are the owners of the company.

The liability of the shareholders is limited to the extent of share value. The shares of a public limited company are freely transferable and shares can be sold or bought. Important feature of company form of organisation is that ownership and management are in the hands of two different groups of people. The management of the company is vested in the hands of board of directors who are elected by the shareholders. A company runs for a long period, therefore has perpetual existence. Every company must be registered as per the provisions of Companies Act, 1956.

A person who makes efforts for bringing a company into being is called a promoter. Promotion is a process in which all factors of business are procured for the formation of a company. Promoters may be persons or institutions or a company. The company form of organisation emerges whenever large scale production or trading activity is taken up, requiring huge amounts of capital.

2.2.4. Co-operatives.

The philosophy behind cooperatives is "all for each and each for all." Cooperative societies are associations formed voluntarily by the people to render service to the members of their society. They are formed to protect and safeguard the economic interest of the weaker sections of the society from the exploitation of stronger sections of the society. Consumer cooperatives, producer cooperatives, marketing cooperatives, housing cooperatives, credit cooperatives, milk-producers cooperatives are some of the examples.

It is easy to form a cooperative society with simple legal formalities. Members have limited liability restricted to the extent of their share capital. Cooperatives offer services to their members. Supply of goods at cheaper reasonable rates, provision of credit facility at low rates of interest, construction of houses, distribution of seeds, fertilisers etc., are some of the services. Cooperatives enjoy perpetual existence.

However, cooperatives suffer from limited financial resources, lack of secrecy, competent management, rise of factionism and rivalries, domination of vested members, etc.

The choice of Form of organisation depends upon the following factors.

- ☆ Nature of business.
- ☆ Scale of operations.
- ☆ Control
- ☆ Risk and liability
- ☆ Tax considerations
- ☆ Financial requirement

2.3. Tax system :

By virtue of the implications of tax system, it has great relevance to finance function. Taxes are broadly classified as (i) direct taxes, and (ii) indirect taxes.

Direct taxes are directly paid by the person concerned, from his income or wealth. Income tax and wealth tax are direct taxes. Indirect taxes are paid indirectly because they are paid by one person but recovers the same from another person. Tax payer pays indirectly while purchasing goods, paying for services, etc. Central Excise (duty on manufacture) customs (duty on imports and exports); Sales tax, Octroi, Entry tax, Service tax, Expenditure tax are indirect taxes.

Various provision of Income Tax Act, 1961 which have a bearing on Financial Decisions are discussed here.

2.3.1. Investment Decision :

Decisions related to various investment projects have to be taken by considering tax incentives available under the Income Tax Act apart from considering return, risk aspects of the project. Following tax incentives are available to companies on various projects.

- ☆ Newly established undertakings in free trade zone, electronic software / hardware technology park or software technology park are eligible for a tax holiday for 10 years
- ☆ Newly established 100 per cent Export oriented undertaking are eligible for tax holiday for 10 years.
- ☆ New industrial undertakings established in North-Eastern Region are eligible for tax exemption for 10 years
- ☆ Business establishments can claim depreciation on (i) tangible assets : buildings (10%), Machinery (25%) and furniture (15%) and (ii) intangible assets like technical know-how, patents, copy rights, trade marks, licenses, franchises (25%). In some cases a higher rate of depreciation is also allowed. For example, in case of buildings for installing water supply

or treatment system in the business of providing infrastructure facilities, depreciation is allowed at 100%. In the case of computers, 60%,energy saving devices 80%; pollution control equipment 100%; are the rates of depreciation.

☆ Apart from normal depreciation, additional depreciation is also allowed at 15% of the actual cost of machinery.

☆ In the case of profit from projects outside India (foreign projects) the least of the following limits is allowed as a deduction (a) 20% of profits. (b) Amount credited to foreign project Reserve Account (c) amount brought into India in convertible foreign exchange.

☆ 50 per cent of profits from export of goods and mercandise are deductible

☆ 50 per cent of profits from export of computer software are deductible

☆ 50 percent of profits from films software are deductible

☆ 100% of the profits from industrial undertaking engaged the infrastructure development, telecommunication service, industrial park, special economic zones, power generations, transmission and distribution are allowed as deduction for 10 years.

☆ Profits from industrial undertaking which are not producing articles specified the Eleventh schedule like alchohol, cosmetic, tobacco products, chocolates, etc; hotels, industrial research institutes, minor oil etc are deductible.

☆ In respect of certain undertakings in Himachal Pradesh, Sikkim, Uttaranchal and North - Eastern States tax holiday is available

Investment decisions must be taken by giving due weight to the incentives listed above. Make or buy decision, buying by instalments or to hire, own or lease decision are some of the investment decision which have tax implications. To buy an asset with borrowed funds or equity (own) funds is an important decision with tax implications. Tax savings resulting from the above incentives must be taken into account while evaluating a project.

2.3. 2. Financing Decision : Before commencing a new project a crucial decision regarding selecting right type of capital structure has to be taken. An optimum capital structure is one which maximises shareholders wealth. Capital structure decision has a long-term implications. It should take into account financial risk, cost of capital, control and tax considerations.

Under the present tax laws, dividend on shares is not deductible, while interest paid on borrowed capital is allowed as deduction. Cost of raising borrowed funds is deductible in one year while cost of. raising equity funds is deductible over 5 years. Since, interest on debt is deductible, effective cost of debt is less than the actual cost of debt.

For example : If debentures are issued with a couponrate of 16.5 per cent per annum and corporate tax rate is 35%. The after-tax cost of debentures will be (16.5. X (1+35%) = 10.725 per cent. Investments in debentures or equity shares issued by companies engaged in the business of infrastructures, power, telecommunication, industrial park, special economic zones equity shares are eligible for a tax rebate under the Income Tax Act. Such companies can tap the capital market easily as there is an incentive to the investor.

2.3.3. Dividend Decision : Dividend decisions are crucial as they involve certain tax implications. As per the law existing now, the following points deserve consideration.

i) Dividends on shares from a domestic company are exempt in the hands of the shareholders.

ii) Long term capital gains arising out of transfer of listed equity shares purchased between 1-3-2003 and 1-3-2004 are exempt from tax in the hands of the shareholders.

iii) Domestic companies distributing dividends have to pay additional tax on distributed profits at a rate of 12.5 per cent (plus surcharge) in addition to normal tax.

2.4. Government Regulations

In India, a regulatory and monitoring framework is operated by the government and its agencies. Finance Manager has be familiar with these regulations.

2.4.1 Industrial Policy

Industrial policy refers to the policy of the government towards industries - their establishment functioning, growth and management. The policy indicates areas of large, medium and small scale sectors. It specifies the policy towards foreign capital, labour, tariff and the related aspects.

The following industrial policy resolutions were issued by the government since independence.

(a) Industrial Policy, 1948

(b) Industrial Policy, 1956

(c) Industrial Policy, 1991

Industrial policy, 1991 was aimed at drastic changes in the industrial scenario in our country. There are many changes which deviate from the policy followed till 1991. The objectives of the policy are

☆ Self - reliance to build on many sided gains already made

☆ Encouragement to Indian entrepreneurship, promotion of productivity and employment generation.

☆ Development of indigenous technology through greater investment in R & D and bringing in new technology to help Indian manufacturing units to attain world standards.

☆ Removing the regulatory system and other weaknesses

☆ Increasing the competitiveness of industries for the benefit of the common man.

☆ Incentives for the industraialisation of backward regions.

☆ Enhanced support to the small-scale sector.

☆ Ensure running of public sector undertakings (PSUs) on business lines and cut their losses.

☆ Protect the interests of workers.

☆ Abolish the monopoly of any sector in any field of manufacture except on strategic or security grounds.

☆ To link the Indian economy to the global market so that we acquire the ability to pay for imports, and to make us less dependent on aid.

In the following areas the government has taken initative to attain the above mentioned objectives.

(a) Industrial Licensing

(b) Foreign Investment

(c) Foreign Technology agreements

(d) M R T P Act.

(a) Industrial licensing :

☆ Industrial licensing is governed by the Industries (Development & Regulation) Act, 1951.

☆ Industrial licensing has been abolished for all industries except those specified.

☆ Specified industries are subject to compulsory licensing due to security, strategic, social, safety, environmental reasons. Manufacture of products of hazardous nature and articles of elitist consumption come under specified category.

☆ In case of projects where imported machinery or any capital goods are required, automatic clearance is given if foreign exchange availability is ensured through foreign equity and if the value of the imported capital goods required is less than 25 per cent of the total value of plant subject to a maximum of Rs 2 crores.

☆ In cities with population less than one million there is no requirement to get approval.

(b) Foreign Investment : In order to invite foreign investment in large private industries requiring huge investments and advanced technology, approval for foreign direct investment upto 51% foreign equity is provided.

(c) Foreign Technology Agreements : Automatic permission is given for foreign technology agreements in high priority industries upto a lum sum payment of Rs 1 crore, 5 percent royalty for domestic sales and 8 percent for exports, subject to total payment of 8 percent of sales over ten year period from the dates of agreement or seven years from the commencement of production

(d) Monoploies and Restrictive Trade Practices Act (MRTP Act) 1999 : To prevent concentration of economic power in the hands of few industrial houses and to check restrictive trade practices M R T P Act was promulgated. Majority of the restrictive provisions have been omitted after 1991 when reforms were introduced.

2.4.2. Foreign Exchange Management Act, (FEMA) 1949

FEMA aims at consolidating law relating to foreign exchange with the objective of facilitating external trade and payment and for promoting the orderly development and maintenance of foreign exchange markets in India.

FEMA is a regulation as well as a facilitator. It encourages Indian businesses to grow into strong Indian-based multinationals.

Following are the important points relating to regulation and management of foreign exchange.

- ☆ **Dealing Foreign Exchange :** No person shall deal in foreign exchange, make payment to person outside India, receive payment from person outside India and enter into any financial transaction for acquiring any asset outside India.
- ☆ **Holding of Foreign Exchange :** No person shall acquire, hold, possess or transfer any foreign exchange, foreign security, or any immovable property outside India.
- ☆ **Capital Account Transation :** Any person may sell or draw foreign exchange to or from Reserve Bank of India.

RBI may regulate :

--- issue of foreign security by person resident in India or out side India

--- borrowing / lending in foreign exchange

--- deposits

--- transfers of immovable property outside India

--- guarantees in respect of any debt

- ☆ **Export of goods of services :** Exporters shall furnish RBI, details of material and value of export. RBI ensures that export value is received without delay.
- ☆ **Realisation & Repatriator of Foreign Exchange :** Persons resident in India due to receive foreign exchange shall take necessary steps to realise and repatriate foreign exchange to India within the period specified by RBI.

Automatic Route : Automatic route is permitted for Indian enterprises subject to the fulfillment of the following conditions.

- ☆ Investment should not exceed $ 50 millions in a block of 3 years in a joint venture abroad
- ☆ Must be making profits in three preceeding years.
- ☆ Investment must be in foreign entity engaged in core activity area. Financial services, information technology, entertainment software, pharmaceuticals, biotechnology are permitted in automatic route

Non-Resident investors investing in Indian companies are permitted to take automatic route.

- ☆ Non resident investors are not allowed in regulated sectors
- ☆ Investment should be by way of fresh issue of shares
- ☆ Foreign direct investment into e - commerce, power, petroleum refining, 22 specified consumer goods is permitted.

2.4.3. The Securities And Exchange Board of India Act 1992

The S E B I Act 1992 was promulgated after withdrawing the Capital Issues (Control) Act. S E B I is broad in its application covering wide ranging issues. The powers and functions of S E B I Act are:

☆ Regulating the business of stock exchanges

☆ Registering and regulating the working of

--- Stock brokers

--- Sub brokers

--- Share transfer agents

--- Bankers to the Issue

--- Trustees of Trust deeds

--- Registrars to an issue

--- Merchant Bankers

--- Under writers

-- Portfolio managers

--- Investment advisors

☆ Registrering and regulating the working of

--- depositories

--- custodians of securities

--- credit rating agencies

☆ Registrering and regulating the working of

--- venture capital fund,

--- Collective Investment Schemes

--- Mutual Funds.

☆ Promoting self regulating organisations,

☆ Prohibiting fradulent and unfair trade practices

☆ Promoting investors education

☆ Prohibiting insider trading

☆ Regulating substantial acquisition of shares, takeover of companies

2.4.4. The Security Contracts (Regulation) Act, 1956

The objective of the Act in to prevent undesirable transactions in securities by regulating the business of dealing in securities.

☆ **Grant of Recognition to Stock Exchanges :** If the Central Government is satisfied that it would be in the interest of trade and also in the public interest to grant recognition to the stock exchange, it would grant subject to certain conditions.

☆ **Withdrawal of Recognition :** Central Government can withdraw recognition through a notification in the gazette after giving an opportunity of being heard.

☆ **Listing of securities :** A public company desirous of getting its securities listed shall apply along with

--- Memorandum and Articles of Association

--- Copy of the Trust Deed - in case of debenture issue

--- Copies of all prospectuses issued by the company

--- Copies of offer for sale, circulars, advertisements offering any securities during the last 5 years.

--- Statement of dividends, bonus shares of last 10 years

--- Certified copies of agreement between vendors and promoters, under writers, sub under writers, brokers, sub-brokers.

--- certified copies of agreement with managing agents, selling agents, managing directors, technical directors, general manager, sales manager, secretary.

--- brief history of the company

--- particulars of shares and debentures

--- List of highest 10 holders of each class of securities

At least 25 per cent of each class of securities should be offered to the public through advertisement in newspapers for two days.

2.4.5. The Companies Act, 1956.

The companies Act, 1956, is a control measure used by the Government to regulate the functioning of the corporate sector in India. A company is an association of individuals united for some common purpose, permitted by law to use a common name to change its members without winding up the association. Following are some of the provisions of the Companies Act, 1956.

☆ **Registration** : To obtain the registration of a company, an application has to be filed with the Registrar of companies, along with (i) Memorandum of Association (ii) Articles of Association and (ii) list of directors.

☆ **Certificate of incorporation :** The certificate of incorporation brings the company into existence as a legal person. Upon its issue the company is born.

☆ **Commencement of business :** A private company can commence business right from the date of its incorporation. But in the case of public company, a further certificate for the commencement of business has to be obtained. This becomes necessary where a company has issued a prospectus inviting the public to subscribe for its shares.

☆ **Memorandum of Association :** It is a document of great importance in relation to the company. It contains the following fundamental clauses (i) Name clause (ii) Registered office clause (iii) Objects clause (iv) Liability clause (v) Capital clause.

☆ **Articles of Association :** This document contains rules, regulations and bye-laws for the general administration of the company.

☆ **Public Issue** : Company can raise capital from the general public by means of a public issue. A listed public company means a public company which has any of its securities listed in any recognised stock exchange. A public company need not necessarily go to the public for money. The promoters may be confident of obtaining the required capital through private contracts. The process of issuing securities through a statement in lieu of prospectus is a kind of private placement.

- ☆ **Promoters** : Before a company can be formed there must be some persons who have the intention to form a company, and who take necessary steps to carry that intention into operation.

- ☆ **Shares** : Offers for shares are made on application forms supplied by the company. When an application is accepted, it is an allotment. A valid allotment has to comply with the requirements of the Act and principles of the law of contract relating to acceptance of offers.

- ☆ **Share Capital :** Capital must be divided into shares of a fixed amount. The Act permitted only two kinds of securities to be issued. (i) Equity shares (ii) Preference Shares. The Companies Amendment Act, 2000 has introduced some other categories of shares (1) Derivatives (2) Hybrid.

- ☆ **Directors** : Appointment - Removal - Powers - Duties - Remuneration

- ☆ **Meetings** : Statutory meeting (first meeting of the shareholders within six months from the date of commenment). Annual general meeting (one meeting of the shareholders each year) - extra ordinary general meeting.

- ☆ **Dividends** : Board of directors should deposit the amount of dividend declared in a separate bank account within 5 days from the date of declaration.

- ☆ **Compulsory reserves :** The company shall transfer to the reserves certain percentage of profits not exceeding 10 per cent before any dividend is declared.

- ☆ **Accounts** : Books of Accounts - Accounting record, - preservation of account books - Right of inspection.

- ☆ **Auditors** : Appointment - Remuneration - Qualification - Removal - Power and Duties.

2.5. Financial System

The financial system consists of a variety of financial instruments or assets, financial intermediaries and financial markets. An understanding of the financial system is essential in financial decision making. A company raises resources through the issue of financial instruments in a financial market. Financial intermediaries facilitate the movement of funds from the investor to the user by providing various services.

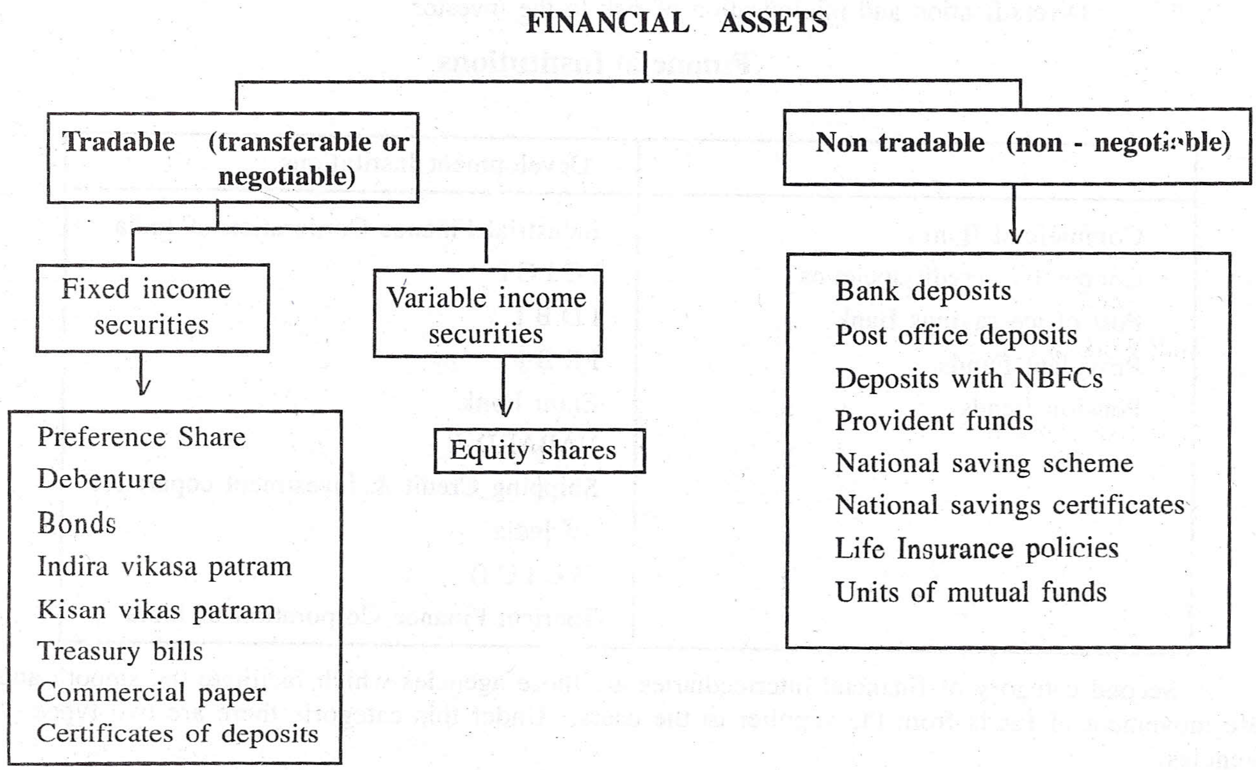
According to Robinson, "the primary function of the system is to provide a link between savings and investment for the creation of new wealth...". The objective of the financial system is to supply funds to various sectors and activities of the economy.

2.5.1. Financial Assets :

Financial assets are the basic products of the financial system. Movement of funds from the suppliers of funds takes place when they are exchanged for a financial asset issued by the user of funds. If equity shares are issued by a company, equity share is a financial product, the sale of which is facilitates the movement of funds.

Financial asset is a piece of paper evidencing a claim of the holder (investor) over the issuer (user). Currently financial assets are on de-mat form. They represent claim against the incomes and the assets of the issuing company.

Classification of Financial Assets :



These assets have different features with regard to the return (yield), risk (variability), liquidity, transferability, maturity, tax consideration, etc.

Financial Derivatives : Financial derivatives derive their value from underlying securities. They are financial contracts. In India stock exchanges have introduced index based derivatives to facilitate hedging of risk exposures and speculations with high leverage. Derivatives are short term in nature with less than a year to expiration issued by investors. Long term derivatives are issued by companies in the process of financing their activities. Options and futures are the examples for short term derivatives. Warrants and convertibles are the examples for long term derivatives.

2.5.2. Financial Intermediaries

In a market for funds, the intermediaries bring users and suppliers of funds together. In India there are two types of financial intermediaries.

Intermediaries who collect funds from the suppliers and lend to the users are one type. These are called financial institutions or development banks. In a market where the expectations of the suppliers and expectations of the users do not coincide, exchange of funds do not take place. For example, a small investor in India looks for a short - term investment which can provide a reasonable rate of return without any risk and with easy liquidity. Whereas, companies require funds for a long term and risk is inherent in long-term investments. Under these circumstances, financial institutions emerged as an intermediary between supplier and user. The service provided by them is called financial intermediation. They help in

- Promoting savings of the economy
- Channelling funds to sectors where funds can be put to best and efficient use.
- Building investor confidence
- Diversification and minimisation of risk to the investor

Financial Institutions

	Development Institutions
Commercial Banks	Industrial Finance Corporation of India
Cooperative credit societies	I C I C I
Post office savings Bank	I D B I
Provident Funds	I R B I
Pension Funds	Exim Bank
	NABARD
	Shipping Credit & Investment coparative of India (S C I C I)
	Tourism Finance Corporation of India

Second category of financial intermediaries are those agencies which facilitate the smooth and safe movement of funds from the supplier to the users. Under this categorie there are two types of agencies.

1. Regulatory Agencies	**2. Financial Service Providers.**
* Reserve Bank of India (R B I)	* Merchant bankers
* Securities & Exchange Board of India (SEBI)	* Underwriters
* Board for Industrial & Financial Reconstruction (B I F R)	* Credit rating agencies
	* Brokers
* Foreign Exchange Management Act (FEMA)	* Issue Managers

2.5.3. Financial Markets

A financial market is a market where exchange of funds for financial instruments take place. They perform the following functions.

☆ **Price determination :** Like any other market, financial market facilitate in the determination of prices of financial instruments.

☆ **Provision of liquidity :** An investor who acquired financial instruments must be in a position to convert it into cash whenever he wants. Financial markets provide the mechanism through which liquidity is ensured.

☆ **Minimisation of transation costs :** Market efficiency depends upon the availability of timely and accurate information. Transaction costs like, search cost, information cost, and middlemen brokerage can be minimised by financial markets.

There are different types of financial markets which are based on certain criteria

Criteria	Types	
1. Maturity Time	(a) Money market	(b) Capital market
2. Nature of instrument	(a) Equity market	(b) Debt market
3. Timing of delivery	(a) Spot market	(b) Future market
4. First or second hand	(a) Primary market	(b) Secondary market
5. Trading	(a) Exchange traded	(b) O T C market

☆ Market for short term financial instruments is money market e.g. call money market, bill market.

☆ Market for long-term financial instruments is capital market e.g : equity shares, debentures, preference shares.

☆ Market for equity shares is equity market.

☆ Market for all debt instruments or fixed financial claims whether short term or long term is debt market

☆ A secondary market where immediate delivery of the instrument takes place after the transfer is effected is cash or spot market.

☆ A secondary market where delivery occurs at a pre determined date in future, after the transfer is effected, is futures market.

☆ Market where fresh claims are traded is the primary market. When the financial instruments are issued for the first time, it is primary market.

☆ Market where already existing financial instruments are traded is secondary market. If a shareholders of X Y Z co. sells his shareholding to another person he is operating in a secondary market.

☆ Market which is characterised by a centralised organisation with standard procedures is exchange traded market. Bombay stock exchange, National stock exchange are some of the examples.

☆ A decentralised market with customised procedures is an over - the - counter (OTC) market.

2.6. Summary

Financial manager operating in a constantly changing environment should have the knowledge of the environment in which he is operating. The impact of the constituents of this environment on business decisions should be estimated before taking decisions.

Various forms of business organisation have different implications on business. Tax system, in existence in any economy, contains various provisions which are regulatory in nature. Certain provisions provide various tax incentives, knowledge of which and decision making taking into consideration these incentives, would help in minimising tax burden.

Financial system consisting of financial instruments, financial intermediaries, and financial markets provide the mechanism for channelling funds to the industry. It is a set of complex, closely connected institutions, agents, practices, markets, transactions, claims, liabilities in the economy.

2.7. Keywords

Financial assets : these are shares, debentures, lease obligations, borrowings from banks, financial institutions, etc.

Financial Derivatives : where buyers take delivery on payment of cash is called Financial Derivatives

2.8. Self Examination Questions

1. What are various forms of organisation ? Explain their salient features .
2. What are the tax provision that have a bearing on the investment decision ? Discuss.
3. Discuss the importance of Industrial policy, 1991 in the light of recent changes taking place in the Indian economy ?
4. Explain the main features of F E M A, 1999
5. "Companies Act 1956 regulates the functioning of the corporate sector in India" - Discuss.
6. What are the constituents of a financial system ?

2.9. Further Readings

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