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**Unveiling the Paradigm Shift and Progress of Banking Sector  
in India : A Data-Based Appreciation**  
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**Towards A Better Dividend Policy**  
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SUKHEN KALI AND LALIT KUMAR JOSHI



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# Unveiling the Paradigm Shift and Progress of Banking Sector in India: A Data-Based Appreciation

*Nigamananda Biswas\**

**ABSTRACT:** The purpose of this paper is to explore the progress of Indian banking sector after liberalization to till date. The paper includes a conceptual discussion backed by relevant data and quantitative analysis on innovation and development from the perspective of paradigm shift in the global scenario of banking sector. Banking sector in India is rapidly adopting the new dimension for customer retention. The paper identifies the major growth trends of banking industry in India. It also highlights the qualitative and quantitative shift in this sector. The paper's originality and value lies in suggesting adaptation to emerging banking innovations to survive in the competitive environment.

**Key Words :** *Banking Sector, Paradigm Shift, Banking Progress, Technology.*

## 1. INTRODUCTION

Banking in India came into existence with 'The General Bank of India' in the year 1786. RBI came into being in 1935 and became the central banking authority in 1965. Banking Companies Act was passed in 1949. Formation of State Bank of India (SBI) took place in 1955.

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Nationalization of 14 major banks was done in 1969 and further nationalization of 6 more banks took place in 1980. Indian banking sector has witnessed a paradigm shift in its operation with initiation of banking sector reform measures since 1991. The floodgate of economy was opened and liberalization in the banking sector took place. Opening up of economy marked the entry of private and foreign players with modern technology. It intensified the competitive ambience. Quantity of banking products increased and the quality became more sophisticated over the period of time. The nature of banking activities got shifted from social banking to commercial banking, traditional class banking to mass banking, brick and mortar banking (banking at fixed branch premises) to electronic banking, local banking to universal banking. 'Queue banking' has been replaced by 'click banking' and 'computerized banking' substituted the 'manual banking'. Many Innovative solutions in retail and corporate banking such as plastic money, electronic banking, phone banking, SMS banking, internet banking, core banking, etc. have become the need of the hour. Customer Relationship Management (CRM) has been transformed into electronic Customer Relationship Management (e-CRM).

There has been a radical shift in the market power from banks to their customers. Effectiveness and efficiency became the buzzword of the success of banking operation particularly in respect of providing services to the customers (Reddy *et. al.* 2000). There has been a paradigm shift in scope, context, structure, functions and governance of banking. Indian banking industry, today is in the midst of an IT revolution. The information and communication technology revolution is radically and perceptibly changing the operational environment of the banks. "Technology-driven" products and services have now become common parlance in the corridors of the banking industry. Universal banking, virtual banking, mergers and acquisitions are increasingly becoming the order of the day. For customers, it is the realization of their "anywhere, anytime, anyway, banking dream". For the banks, technology has emerged as a strategic resource for achieving higher efficiency, control of operations, productivity and profitability. The recent trend shows that most banks are shifting from a 'Product-Centric Model (PCM) to a Customer Centric Model (CCM)' as they develop their new e-banking capability. Customers are now demanding multiple channels through which they can interact with their providers including face-to-face contact, phone, websites, e-mail, mobile devices, etc. This has forced the banking sector to explore new distribution channels, so that ordinary customers have more information about multiple banking products than even before. This is aimed not only to prevent the customers from taking their business elsewhere but also to ensure that they are offered with the products and services that are most appropriate and most likely to result in new revenue for the bank. There is phenomenal change towards customer services over the past five decades (Tripathy 2009). Table-1 reflects the same.

Banking all over the world is undergoing significant change. In India too, steps are being taken to improve the banking system to suit the changing requirement of the customers. The Indian banking is at the start of second banking revolution. Economic and structural reforms on the basis of Narasimhan Committee Report (1991) herald a new era in the economic history of India. Nineties as a whole witnessed rapid changes in the Indian Banking



scenario. 'Anywhere banking' and 'anytime banking' have become a reality in Indian financial sector. At the time of nationalization, the primary importance was given to 'more banking'. Now the thrust is on 'better banking' than 'more banking'. Table-2 depicts the qualitative shift of banks before and after 1991.

**Table 1: Paradigm Shift towards Customer focus of Banking over the decades**

Decade	Focuses on Customer
1950-1960	Serving the customer
1960-1970	Satisfying the customer
1970-1990	Pleasing the customer
1990-2000	Delighting the customer
2000 and beyond	Retaining the customer

Source: Tripathy, N. P. (2009). Financial Services. New Delhi: PHI Learning Limited.

**Table 2: Paradigm Shift of Banking in India before and after Liberalization**

Before 1991	After 1991
Seller's market	Buyer's market
Protected market	Open market
Not many global brands	Increase in number of global brands
Friendly competition	Cut-throat competition
Patient customers	Demanding customers
Customer unawareness	Customer awareness
Limited choice for customers	Multiple choice for customers
Limited media promotion	Extensive media promotion
Cost plus pricing	Competitive price cutting
Limited customer services	Increased customer services
IT-competitive advantage	IT-enabler
Focus on new customer	Focus on new customer as well as retaining existing customer
Monologue	Dialogue
Transactional banking	Relationship banking
Product orientation	Orientation to product innovation
Short time scale	Long time scale
Little customer commitment	High customer contact
Quality is primarily the concern of a few	Quality is the concern for all

Source: Tripathy, N. P. (2009). Financial Services, New Delhi: PHI Learning Limited,

Banks in India have traditionally offered mass banking products and services. Most common deposit products are savings bank account, current account, term deposit account and lending products being cash credit and term loans. Further, remittance products are limited to issuance of drafts, telegraphic transfers, banker's cheque and internal transfer of funds etc. Other than



the traditional banking services like various types of accounts and loans, modern banks have already introduced customized banking products like de-mat accounts, investment advisory services, photo-credit cards, debit cards, Automated Teller Machine (ATM), biometric ATM, smart card, internet banking / online banking, Tele-banking, Electronic Fund Transfer (EFT), National Fund Transfer (NFT), Real Time Gross Settlement (RTGS), Point of Sale (POS) terminals, cyber-cash, e-cheque, shared payment network system (SPNS), Electronic Data Interchange (EDI), clearing house automated payment system (CHAPS), society for World Wide Internet Banking Fast Transfer (SWIFT), Digital Payment System (DPS), Cash Management Services (CMS), investment products and tax advisory services, flexi deposits, bancassurance services etc. Present customers are availing the facilities of all types of modern banking facilities with the advent of information and communication technology. This advancement has also been reflected in the recent ranking of Indian banks in comparison to global banks (Table -3). The ranking has been made based on performance indicators of banks over the period of time. As far as ranking is concerned only SBI was within 100 rank few years back.

**Table 3: Indian Banks: Recent Global Ranking**

Bank	Rank	
	2009	2010
SBI	70	36 (34)
ICICI	110	70 (40)
HDFC	153	141(12)
PNB	192	174 (18)
Bank of India	228	195 (27)
Bank of Baroda	260	196 (64)
Canara Bank	251	213 (38)
Axis Bank	269	239 (30)
UBI	531	274 (257)
Kotak	280	287 (-7)

Source: The Economic Times, Kolkata Edition, 2nd Feb. 2010.

Figures in bracket showing change of ranking over the previous year.

Keeping this changing scenario of Indian banking industry, the present paper aims to unveil the paradigm shift of banking sector in India before and after the liberalization, privatization and globalization (LPG) in general and also to assess the progress of banking sector in India in the last two decades.

## 2 RESEARCH METHODOLOGY

This present empirical discourse is based on secondary data sourced from 'RBI bulletins' and Trend and Progress Reports on Banking in India' for several years. In this study, the banking growth has been calculated using exponential function and linear function in



appropriate case. Most of the banking-growth parameters (particularly quantitative) have been considered in the present study. In this study, the strength of relationship (with  $R^2$ ) between two variables is also calculated. The choice of exponential or linear or polynomial growth calculation depends on the maximum value of  $R^2$  (Details are not reported). Growth rate in connection with banking activities are calculated using the trend analysis formula:  $y=a+b^x$ . ('y' is a dependent variable, which denotes the growth rate; 'a' is constant factor, which denotes values of the preceding period/year; 'b' denotes the values of the subsequent period/year; and 'x' is the time period/specific number of year(s) to be considered for measuring the growth). Analysis made in this paper is based on the figures mentioned in the tables under appendix A and B.

### 3. PROGRESS OF INDIAN BANKING OVER THE YEARS AT A GLANCE

Indian banking sector has witnessed a real paradigm shift and a stunning revolution. It has undergone a major and rapid structural transformation over the years. The twist of rapid alteration is blowing in the banking sector since 1991. The year 1996 to 1998 marked the technology adoption phase. The real penetration of computer in banking increased to a greater height and technology friendly atmosphere was observed during this period. In 1996, online banking was introduced by ICICI bank. The swift growth and development of information technology and communication systems have made banking services accessible to every customer at the click of mouse. A combination of regulatory and competitive reasons has led to escalating importance of total banking automation in the Indian banking industry. Since the day of social control and nationalization of banks, the banking system in India has been improving very fast which was given a further boost up by liberalization of economy. Due to emergence of private sector banks and foreign banks, the adoption of technology and new innovation has become a basic feature of modern banking. Earlier a customer had little choice in availing facility of banking, but now the bank itself is in search of customers. That is why now banks have been trying to provide the fastest and cheapest mode of services. The Public sector banks (PSBs) have been forced to adopt the way of marketing to survive in the market which further compelled the bank employees to change their mind set towards more improved services. As a result, the future banking will be more technological and innovation oriented (Chauhan 2006).

Looking at the Table- 4, it can be said that

- Though, the number of commercial banks over the years is decreasing due to merger and acquisition, but growth rate of bank branches (1.5%) exhibits an exponential growth. Compared to last decade, the present decade has shown a higher growth rate of bank branch (2.3%) because of the policy adopted by the banks to expand it with a view to achieving financial inclusion.
- The growth rate of employee (-1%) is showing negative value (over 2001-09) due to more emphasis given on technology-based fast and modern services instead of manual services.



During the present decade (2001-09) the growth rate of employees is declining (from 0.5% to -1%) because of advent of technology and communication network and adoption of Self Service Technology (SST) by the banks through ATMs and internet / online banking as well as changing banking habits of customers over the years.

**Table 4: Progress of Banking in India at a Glance**

Years	No. of CB	No. of branch offices of CB	No. of Employees	Banking Business of SCBs				SCBs' Advances to Priority Sector (Rs. crore)
				Deposits (Rs. crore) (i)	Credit (Rs. crore) (ii)	Investment in India (Rs. crore) (iii)	Total (Rs. crore) (i+ii+iii)	
1991	276	60220	975697	201199	121865	88345	411409	44572
1995	284	62367	997601	386859	211560	149254	747673	69209
2000	298	67868	1006631	851593	454069	311697	1617359	155779
2005	289	70373	900433	1700198	1100428	739154	3539780	381476
2009	170	82408	833214	3834110	2775549	1166410	7776069	932459
Growth @								
91-09		1.5%	1%	16%	17.4%	14.9%	16.3%	17.1%
91-00		1.1%	0.5%	15.7%	14.8%	14.2%	15.1%	13.4%
01-09		2.3%	-1%	17%	21.9%	13%	17.9%	21.4%

@ Growth has been calculated using exponential function. (Details are presented in Appendix- A).

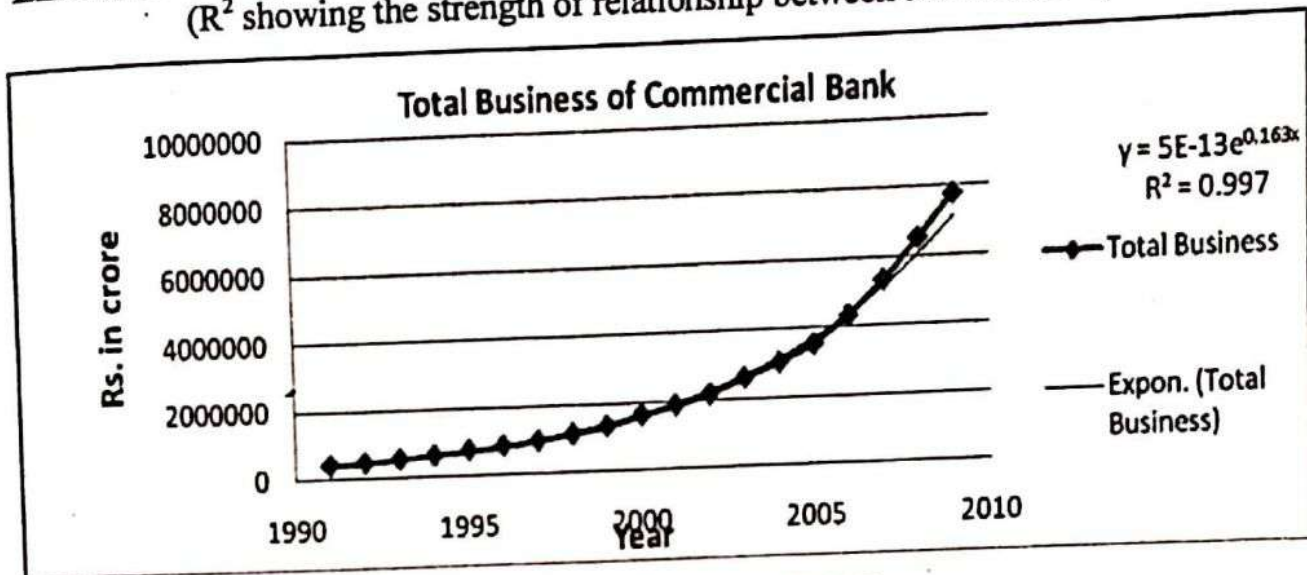
CB= commercial banks; SCB= scheduled commercial bank.

- Deposit growth rate in both the decades are showing an exponential growth. Currently the rate is (17%) bit higher than the earlier rate (15.7%) of growth, and even the rate of growth (16%) over the years.
- Credit growth rate in the last and present decades are showing an exponential growth. Currently the rate is (21.9%), higher than the earlier rate (14.8%) of growth and the rate of growth is (17.4%) over the years.
- Growth rate of investment in both the decades are showing an exponential growth. Currently the rate is (13%) lower than the earlier rate (14.2%) of growth. The rate of investment growth (14.9%) over the years is higher than the present growth rate (13%) because of the fact that the LPG policy measures forced banking to invest more in the government projects for expansion activity and infrastructure development in the country.
- Deposit, credit and investment constitute the total business of the banking sector. Here also the growth is exponential in nature. During two decades, the growth rate remains high (16.3%). As compared to the growth of the present decade (17.9%), growth of last decade was slower (15.1%). It means that the total business of banks over the years is growing exponentially due to the policy measures adopted by the central bank (RBI) and



the government. Deposit, credit and investment are exhibiting the overall business growth of banks over the decades (Exhibit-1).

**Exhibit 1: Change in Business of Scheduled Commercial Banks over the period**  
( $R^2$  showing the strength of relationship between two variables)



Source: Computed, Based on the data available in RBI Bulletin 2008-09.

The graph is showing the exponential growth curve of SCBs' business over the period of time from the year 1991 to 2009 (curve showing 5 years gap in each case). As far as Banks' business is concerned, the major ingredients are credit deposit and investment in government projects.

Further, advance to priority sector over the years increases by 17.1%. Compared to last decade (13.4%), the present decade is experiencing more growth (21.4%), which is even higher than the average growth rate than overall growth because of banking initiatives towards the growth of agriculture, small-scale industries, small business finances, educational and housing loans etc. As per the RBI's norms, banks need to extend nearly 40% of their total adjusted net bank credit to the priority sector. The bank has exceeded the 40% pre-determined lending to the priority sector. Although there was a substantial increase in adjusted net bank credit over the years, a matching growth in priority sector advances has been registered to ensure the required share in overall lending.

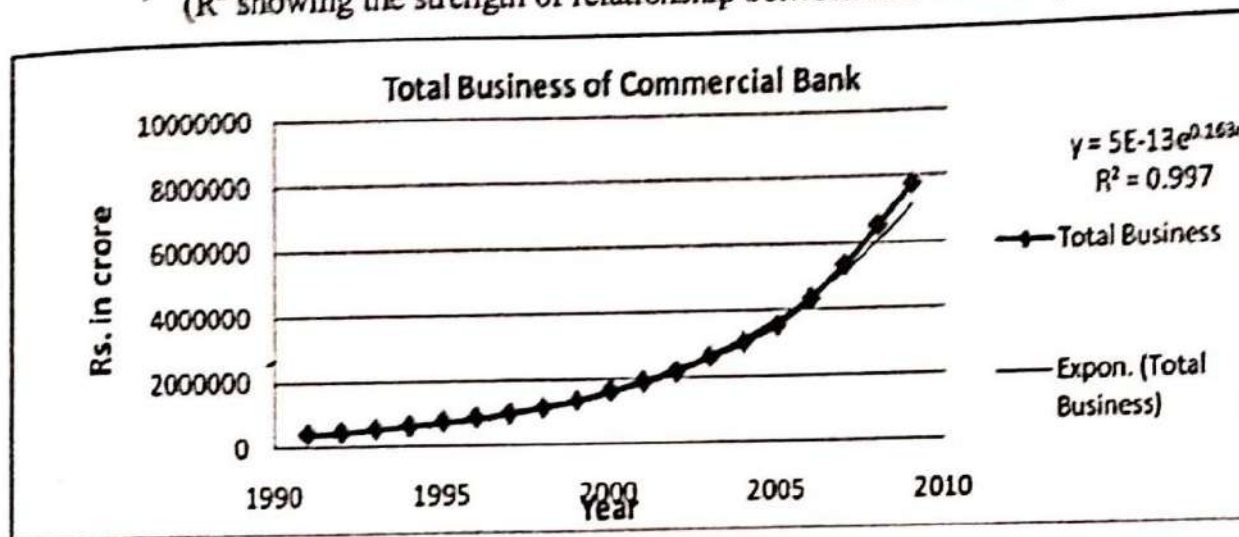
There is a positive correlation between number of branches with deposit, credit and investment i.e. total business of a bank. But, there is a negative correlation between number of employee with deposit, investment and total business of bank. Further, there is negative correlation between the numbers of bank branches with number of employees serving customers in the bank (Table-5).

The Correlation metrics is developed among branches, employee, deposit, credit, investment and total business of commercial banks in India. From the above correlation matrix, we get the Pearson's correlation coefficient value for two-tailed test at 5% level of significance. From the output, it can be seen that correlation coefficient between Deposit and



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Branch, Total Business and Branch, Total Business and Deposit, and Total Business and credit are highly correlated with 0.557, 0.652, 0.743 and 0.712 respectively. From these figures we can conclude that there is a strong positive correlation between the above stated pairs. As far as progress of banking in India is concerned, it also considers size of population per branch, deposits per office, credit per office, per capita deposit, credit - deposit ratio and investment - deposit ratio table - 6 (details are presented in Appendix-B).

**Table 5: The Correlation Metrics among Branch, Employee, and Total Business of Bank**

	Branch	Employee	Deposit	Credit	Investment	Total Business
Branch	1					
Employee	-.224	1				
Deposit	.557*	-.129	1			
Credit	.338	.048	.341	1		
Investment	.154	-.302	-.205	-.439	1	
Total Business	.652*	-.196	.743*	.712*	.063	1

\* Correlation is significant at 0.05 level (2-Tailed).

**Table 6: Progress of Banking in India at a Glance**

Year	CBs' Population per office ('000)	Banking Business of SCBs				CD Ratio (%)	Investment-Deposit Ratio (%)
		Deposits per office (Rs. lakh)	Credit per office (Rs. lakh)	Per capita Deposit (Rs.)	Per capita Credit of (Rs.)		
1991	14	334	202	2368	1434	60.6	37.7
1995	15	620	339	4242	2320	54.7	38.6
2000	15	1255	669	8542	4555	53.3	36.6
2005	16	2574	1700	16281	10752	62.6	47.3
2009	14	4980	3615	34372	24945	73.9	35.7
Growth @							
91-09		14.8%	16.5%	14.4%	16%	93.9% (lin)	102% (lin)
91-00		14.6%	13.6%	13.9%	13%	- 51.7% (lin)	- 26% (lin)
01-09		15.6%	20.4%	15.8%	20.5%	319% (lin)	-53.6% (lin)

Source: Various issues of RBI Bulletin and Trend & Progress Report of Banking in India, from 2000-01 to 2008-09. CB= commercial banks; SCB= schedule commercial bank; CD= credit deposit. @ Growth has been calculated using exponential function. (lin)growth has been calculated using linear function. (Details are presented in Appendix- B).

- The average population served by a single bank branch changed to 14,000 in 2009 as compared to 15000 in 2008 (Appendix-B). However, the average population served by a single bank branch remained unchanged at 14,000 in 2009 as in 1991.



- Over the period of time commercial banks' population has shown a polynomial growth trend, which is erratic in nature. Per thousand population served by a single branch since 1991 to 2009 has not changed considerably. Number of customers served by the banks during 2003 to 2007 was highest (16000 / branch) [Appendix-B], when actual technology adoption took place customer base increased in comparison to branch expansion. During 2008 and 2009 (Appendix-B) there is a further fall, which means the expansion of bank branches took place during 2008 and 2009 with a view to offer better services to customers.
- Deposits per branch have also exhibited an exponential pattern of growth. Over the years during 1991 to 2009 the growth rate (14.8%) is quite healthy because of changing banking habits of customers. As a result of implementation of policies for financial inclusion during present decade (2001 to 2009), the deposits rate (15.6%) has increased more than the last decade (14.6%) and the two decades taken together.
- Per capita deposits by banks are showing the increasing (15.8%) trend in the present decade during 2001-2009, which is comparatively better than the previous decade (13.9%) and the two decades (14.4%) together.
- Credit per branch in the current decade (during 2001 to 2009) has improved a lot and the growth rate has been (20.4%) quite encouraging for the customers as the amount of credit is in the increasing trend compared to the last decade (13.6%). It implies that the percentage of credit availed by the customers has increased significantly. Per branch disbursement of credit to customers is also towards the growth trajectory.
- Per capita credit has also increased exponentially during this decade (20.5%), which is very high compared to last decade (13%) and shows a kind of positive attitude towards customer services by the banks. It also means the increasing trend of banking business over the years.
- Statistics published by the Reserve Bank of India (RBI) show that the incremental credit-deposit ratio has increased considerably during the post liberalization era. The 'Expert Group on Credit – Deposit (CD) Ratio' (Chairman: Shri. Y. S. P. Thorat -November 2004), suggested that as the CD ratio should realistically reflect efforts of the banking system in contributing to the economic development of the States, the investments made by banks in State Government securities and bonds of State level enterprises should also be factored into the concept. Following this recommendation, in addition to the CD ratio, the investment plus credit to deposit ratio is also being used widely. Continuing the trend witnessed during 2008 (74.6%), CD ratio declined further to 73.9% at the end-March 2009, reflecting some deceleration in the overall credit growth. The CD ratio of commercial banks touched a highest of 74.6% in 2008. Credit deposit ratio, an indicator of the health of banking system, was 60.6% during 1991 for the Indian commercial banks, which is comparatively less than in 2009. A declining CD ratio implies that banking sector was flushed with funds without any corresponding demand for credit affecting the bank's



profitability in the long run as they had to pay interest to depositors without corresponding income from the credit outflow. The trend of dipping CD ratio of the commercial banks experienced for the last several years has undergone a transformation. The year 2005-09 witnessed a definite reversal of the trend with the CD ratio recording a quantum jump.

### 3.1. Foreign Banks in Indian

In India, the presence of foreign banks dates back to the pre-independence period. Established in 1858, Standard Chartered Bank is the oldest foreign bank in India. Since 1991, the entry of foreign banks has been liberalized. The number of foreign banks in India increased from 24 in 1990 to 41 in 2000 but their number declined to 32 in 2009 largely due to mergers and acquisitions in the global banking industry. The number of branches of foreign banks increased from 138 in 1990 to 207 in 2003 and further to 272 in 2007.

**Table 7: Foreign Banks in India**

Year	No. of Foreign Banks	No. of Branches	Share of Total Commercial Banking Operation (%)	Share in Total Assets of Commercial Banks (%)
1980	14	129	9.5	3.9
1990	24	138 (6.98)	8.8	5.6
1995	29	156 (13.04)	10.2	7.3
2000	41	186 (19.23)	13.9	7.5
2003	36	207 (11.29)	12.9	6.9
2005	29	251 (21.26)	13.6	6.5
2006	29	262 (4.38)	16.5	7.2
2007	29	272 (3.81)	16.5	8

Source: Reserve Bank of India Bulletin, 2008-09.

Figures in bracket showing percentage change over the previous year.

Year 2005 has shown maximum growth (21.26%) in bank branches in comparison to the growth in the year 2003 (11.29%) and 2007 (3.81%). So far as the growth of foreign banks are concerned, it is not growing and failed to expand their businesses in rapid speed.

## 4. MAJOR FINDINGS AND CONCLUSION

- Nineties, as a whole, witnessed rapid changes in the Indian banking scenario. There has been a paradigm shift in the Indian banking services and as a result, the same has undergone a major structural transformation over the two decades.
- The nature of services in terms of quantity and quality has been altered over the time period. The floodgate of economy was opened and liberalization in the banking sector



took place. Opening up of the economy marked the entry of private and foreign players with modern technologies. It intensified the competitive ambience.

- Quality and quantity of banking service, number of bank offices / bank branches, number of employees, amount of deposit, credit, investment in the government projects, and advances to priority sector have been changed. Many innovative solutions are also evolved in this sector. There has been a paradigm shift in the governance of banking in the midst of an IT revolution.
- The information and communication technology revolution is radically and perceptibly changing the operational environment of the banks. India has also taken some measures to improve the banking system to suit the changing requirement in the global context. The services sector is growing at the faster pace and the banking sector must not be lagging behind. •

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### Appendix A: Progress of Banking in India at a Glance (Complete List)

Year	No. of CB	No. of branch offices of CB	No. of Employees	Banking Business of SCBs				SCBs' Advances to Priority Sector (Rs. crore)
				Deposits (Rs. crore) (i)	Credit (Rs. crore) (ii)	Investment in India (Rs. crore) (iii)	Total (Rs. crore) (i+ii+iii)	
1991	276	60220	975697	201199	121865	88345	411409	44572
1992	276	60570	976931	237566	131520	90334	459420	47318
1993	276	61169	985213	274938	154838	104563	534339	51739
1994	276	61803	994459	323632	166844	133314	623790	59097
1995	284	62367	997601	386859	211560	149254	747673	69209
1996	293	63026	999872	429003	254015	164782	847800	80831
1997	299	63550	1021023	499763	278401	190514	968678	93807
1998	300	64218	1023971	598485	324079	218705	1141269	108905
1999	303	64939	1017490	714025	368837	254594	1337456	107200
2000	298	67868	1006631	851593	454069	311697	1617359	155779
2001	300	67937	926518	989141	529271	367184	1885596	182255
2002	297	68195	901288	1131188	609053	437482	2177723	205606
2003	292	68500	901149	1311761	746432	547546	2605739	254648
2004	290	69170	881722	1504416	840785	677588	3022789	263834
2005	289	70373	900433	1700198	1100428	739154	3539780	381476
2006	222	71685	900124	2109049	1507077	717454	4333580	510175
2007	183	74346	899407	2611934	1931190	791516	5334640	632647
2008	174	78666	838769	3196940	2361913	971714	6530567	738686
2009	170	82408	833214	3834110	2775549	1166410	7776069	932459
Growth@	91-09	1.5%	1%	16%	17.4%	14.2%	15.1%	13.4%
	91-00	1.1%	0.5%	15.7%	14.8%	14.2%	17.9%	21.4%
	01-09	2.3%	-1%	17%	21.9%	13%		

@Growth has been calculated using exponential functions.

### Appendix B: Progress of Banking in India at a Glance (Complete List)

Year	CBs' Population per office ('000)	Banking Business of SCBs				CD Ratio (%)	Investment-Deposit Ratio (%)
		Deposits per office (Rs. lakh)	Credit per office (Rs. lakh)	Per capita Deposit (Rs.)	Per capita Credit of (Rs.)		
1991	14	334	202	2368	1434	60.6	37.7
1992	14	392	217	2738	1516	55.4	38
1993	14	449	253	3111	1752	56.3	38
1994	15	524	270	3596	1854	51.6	41.2
1995	15	620	339	4242	2320	54.7	38.6
1996	15	681	403	4613	2719	59.2	38.4
1997	15	786	438	5261	2931	55.7	38.1
1998	15	932	505	6170	3356	54.2	36.5
1999	15	1100	568	7286	3763	51.7	35.7
2000	15	1255	669	8542	4555	53.3	36.6
2001	15	1456	779	9770	5228	53.5	37.1
2002	15	1659	893	11008	5927	53.8	38.7
2003	16	1925	1143	12253	7275	56.9	41.3
2004	16	2265	1330	14089	8273	55.9	45
2005	16	2574	1700	16281	10752	62.6	47.3
2006	16	3047	2209	19130	13869	70.1	40
2007	16	3675	2757	23382	17541	73.5	35.3
2008	15	4344	3222	28610	21218	74.8	35.5
2009	14	4980	3615	34372	24945	73.9	35.7

CB= commercial banks; SCB= scheduled commercial bank; CD= credit deposit.





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# Towards A Better Dividend Policy

*Kiranjit Sett\**

**ABSTRACT:** Corporate dividend policy is, generally, influenced by a number of factors. The pre-tax rate of return on corporate investment, tax on payment of dividend, tax on long-term capital gain and cost of capital make vital contribution towards formulating corporate dividend policy. This paper seeks to develop a dividend model, which incorporates these factors after analyzing the closeness of association between them.

**Key Words :** *Dividend Policy, Corporate Tax, Tax on Dividend, Tax on Capital Gains, Cost of Capital.*

## 1. INTRODUCTION

One of the vital issues in corporate finance is formulation of dividend policy. All other things remaining the same, an optimal dividend policy is one, which maximizes the shareholders' wealth (Van Horne and McDonald 1971). The dividend policy of a company is generally, influenced by a number of factors like availability of profitable projects, rates of dividends declared in the past years, expected profitability in the coming years, preferences of the investors for dividends over capital gains (Van Horne and McDonald 1971), efficiency of the capital market, etc. Besides these factors, the expected rate of return on investment and rates of tax on payment of dividend and capital gains also influence the dividend policy significantly.

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In India, domestic companies are required to pay tax on payment of dividend and such dividend is exempted from tax in the hands of the recipients. On the other hand, short-term capital gains arising from the transfer of equity shares are taxable and the base rate of tax is equal to the dividend distribution tax. The long-term capital gains arising from the transfer of equity shares are exempted from tax in some cases and taxable in some other cases. The present paper seeks to develop a dividend model which incorporates certain factors such as, the required rate of return on investment, the rates of tax on dividend distributed and capital gains, rate of tax on corporate income and cost of equity share capital. While formulating the model the paper also examines the relationship between the required rate of return on investment, the rates of tax on dividend distributed and capital gains, rate of tax on corporate income, cost of equity share capital and retention ratio.

## 2. SURVEY OF LITERATURE

Under the assumption of perfect and frictionless capital market with symmetry of information, Miller and Modigliani (1961) argue that dividend policy has no influence on the value of the firm. The crux of their argument is that the appreciation in the price of shares, if earning is retained, will be just equal to the amount of dividend if entire earning is distributed among shareholders (Van Horne 2006). But if the rate of return on investment of an all-equity share capital financed company exceeds the cost of capital, price of shares increases as retention ratio increases and vice versa (Gordon 1962; Walter 1963). But these models assume that incomes are not subjected to tax. In reality, corporate income, dividend and capital gains may be chargeable to tax at different rates. The other determinants of dividend policy include the current year's and future expected profitability, past years' dividends, amount of retained earnings needed to finance the available investment opportunities, capital market conditions including floatation and transaction costs, asymmetry of information between insiders and outside investors, preferences of the shareholders for dividends over capital gains (Horne and McDonald 1971).

## 3. TAXATION OF DIVIDEND AND CAPITAL GAINS IN INDIA

In India, as per the Finance Bill 2010, the rate of corporate tax is 30% for domestic companies and 40% for foreign companies. Surcharge (SC) @ 7.5% is applicable to domestic companies if total income exceeds Rs.1 crore and the rate of surcharge is 2.5% for foreign companies if that condition is satisfied. Education Cess (EC) on income-tax @ 2% and Secondary and Higher Education Cess (SHEC) on income-tax @ 1% are also applicable. The effective rate of corporate tax for domestic companies comes to  $(30+2.25+0.645+0.3225)\%$  or 33.2175% for the assessment year 2011-12, if they are not subjected to MAT. In case of foreign companies, the effective rate of corporate tax (excepting certain incomes) comes to  $(40+1+0.82+0.41)$  or 42.23% for the assessment year 2011-12, if they are not subjected to MAT. If the tax liability of the company (Indian or foreign) is lower than  $(18 + SC + EC + SHEC)\%$  of the book profit, MAT is applicable to that company and  $(18 + SC + EC + SHEC)\%$  of the book profit will be deemed to be the tax liability of the company for the assessment year 2011-12 [Sec. 115JB].



A company may retain after-tax profit or distribute it as dividend among equity shareholders or issue bonus shares or any other instrument or buyback the existing equity shares. In case of buyback of shares, the difference between the consideration received by the holder of shares on account of transfer of shares to the company and the cost of acquisition of such shares is treated as capital gain [Sec. 46A].

Since our objective is to determine the effect of tax on required rate of return on investment and retention policy so we concentrate on tax on dividend distributed and capital gains.

A domestic company shall be liable to pay tax @  $(15 + 1.125 + 0.3225 + 0.16125)\%$  or 16.60875% of the amount distributed, declared or paid by it as dividend during April 1, 2010 to March 31, 2011 (This tax is not applicable if the dividend is declared, distributed or paid before May 31, 2011 by a developer of a Special Economic Zone out of current income or an enterprise out of current income generated from a unit which is established in a Special Economic Zone and has started its operations after March 31, 2005.) [Sec.115-O]. Such dividends are exempted in the hands of the recipient [Sec. 10(34)/ (35)]. Dividend received from a foreign company is liable to tax in the hands of the shareholders.

If a company retains the after-tax profit, in a perfect capital market, the price of equity shares is expected to increase. In that case, equity shareholders can realize an income in the form of capital gains by selling the equity shares. If equity shares are held for a period which is more than 12 months before their transfer, the gain (i.e., Sale Proceed – Expenses on Transfer – Indexed Cost of Acquisition) arising from such sale is treated as long-term capital gain which is not chargeable to tax if such sale is covered by securities transaction tax [Sec. 10(38)]. The securities transaction tax (STT) is applicable if the purchase or sale of equity shares is entered into in a recognized stock exchange in India. But if the equity shares are held for a period which is not more than 12 months, the gain is treated as short-term capital gain and is taxable @  $(15 + SC + EC + SHEC)\%$  if STT is chargeable to the sale [Sec. 111A]. The benefit of indexation is not available in case of short-term capital gain. If the sale of equity shares is not entered into in a recognized stock exchange in India, long-term capital gain is liable to tax @  $(20 + SC + EC + SHEC)\%$  with indexation benefit or @  $(10 + SC + EC + SHEC)\%$  without indexation benefit at the option of the shareholder [Sec. 112] (Finance Bill 2010; Singhania and Singhania 2009).

Let us point out the assumptions, which are necessary in order to construct the model.

### 3.1. Assumptions

We make the following assumptions:

- i) The company finances its projects entirely with equity share capital at time  $t=0$  and with retained earnings thereafter. It follows a fixed investment policy from the year 1 onwards.
- ii) It is a case of a domestic company (as per the Indian Income-tax Act) and is expected to have perpetual existence. Tax on dividend distribution is paid by the company.



- iii) Capital market is characterized by informational efficiency. Investors have homogeneous expectations about the future earnings, dividend and price of shares of the company. Investors are also assumed to be rational.
- iv) There is no agency cost.
- v) The rate of return on investment remains constant forever and the retention ratio once decided will remain unchanged forever. Thus the rate of growth in dividend will remain constant forever.
- vi) There are no transaction and floatation costs.

### 3.2. Notations Used

The following notations are used in this paper:

$P_0$  = Price per share at the beginning of year 1 = Investment per share at the beginning of year 1 =  $I_0$ ,

$P_1$  = Price per share at the end of year 1,

$I_1$  = Investment per share at the end of year 1,

$k_e$  = Cost of equity share capital,

$E_1$  = Profit per share after corporate tax at the end of year 1,

$D_1$  = Dividend per share net of dividend tax at the end of year 1,

$b$  = Retention ratio,

$t_c$  = Rate of tax on corporate income,

$t_d$  = Rate of tax on dividend distributed,

$t_g$  = Rate of tax on long-term capital gain,

$r_d$  = Required rate of return on investment after corporate tax but before dividend tax when  $b=0$ ,

$r_d'$  = Required rate of return on investment before corporate and dividend tax when  $b=0$ ,

$r_g$  = Required rate of return on investment after corporate tax but before long-term capital gains tax when  $0 < b < 1$ ,

$r_g'$  = Required rate of return on investment before corporate and long-term capital gains tax when  $0 < b < 1$ ,

$GD_2$  = Gross dividend per share at the end of year 2,

$NCG_1$  = Long-term capital gains net of capital gains tax per share at the end of year 1,

$W_0$  = Equity shareholders wealth per share at the beginning of year 1.



#### 4. THE MODEL

Let us develop the model with the objective to find the relationship between the pre-tax rate of return on corporate investment, rate of corporate tax, rate of dividend distribution tax, rate of tax on capital gains, retention ratio and cost of equity share capital under different alternatives with respect to dividend and capital gains.

If the entire earnings at the end of year 1 (i.e.,  $E_1$ ) is paid out as dividend, the present wealth per share of the investors equals to the present value of net realization (i.e., realization net of corporate and personal income taxes) per share, assuming that the share will be sold at the end of year 1. At equilibrium, we shall get,

$$W_0 = P_1 (1 + k_e)^{-1} + P_0 r_d (1 + t_d)^{-1} (1 + k_e)^{-1} \quad \text{--- (1)}$$

$$\text{Or, } P_0 = P_1 (1 + k_e)^{-1} + P_0 r_d (1 + t_d)^{-1} (1 + k_e)^{-1}$$

At equilibrium, if the entire profit after-tax at the end of year 1 is paid out as dividend,  $P_1$  will be equal to  $P_0$ , assuming that there will be no change in dividend per share in future. Then, we get -

$$P_0 = P_0 (1 + k_e)^{-1} + P_0 r_d (1 + t_d)^{-1} (1 + k_e)^{-1}$$

Multiplying both sides with  $(1 + k_e) P_0^{-1}$  we get -

$$(1 + k_e) = 1 + r_d (1 + t_d)^{-1}$$

$$\text{Or, } r_d = k_e (1 + t_d) \quad \text{--- (2)}$$

The pre-tax rate of return on corporate investment will be -

$$r_d' = r_d (1 - t_c)^{-1}$$

$$= k_e (1 + t_d) (1 - t_c)^{-1} \quad \text{--- (3)}$$

Secondly, if a part of  $E_1$  is paid out as dividend and another part is retained in the business, the present wealth per share equals to the sum of the present values of net dividend, net capital gain and price per share at the end of year 1, assuming that the share will be sold at the end of year 1. Thus, at equilibrium, we shall get the following:

$$W_0 = (D_1 + NCG_1 + P_1) (1 + k_e)^{-1}$$

$$\text{Or, } P_0 = [P_0 r_d (1 - b) (1 + t_d)^{-1} + (P_1 - P_0) (1 - t_d) + P_1] (1 + k_e)^{-1}$$

Multiplying both sides with  $(1 + k_e)$  we get -

$$P_0 (1 + k_e) = P_0 r_d (1 - b) (1 + t_d)^{-1} + P_1 (2 - t_d) - P_0 (1 - t_d) \quad \text{--- (4)}$$

Following the Gordon's (1962) model, the price per equity share at the end of year 1 is derived as follows -

$$P_1 = GD_1 (1 + t_d)^{-1} (k_e - b r_d)^{-1}$$

$$= I_1 r_d (1 - b) (1 + t_d)^{-1} (k_e - b r_d)^{-1}$$

$$= (I_0 + I_0 b r_d) r_d (1 - b) (1 + t_d)^{-1} (k_e - b r_d)^{-1}$$

$$= P_0 (1 + b r_d) r_d (1 - b) (1 + t_d)^{-1} (k_e - b r_d)^{-1}$$



$$= P_0 (1 + b r_g) r_g (1 - b) (1 + t_d)^{-1} (k_e - b r_g)^{-1} \quad \text{--- (5)}$$

Substituting  $P_1$  in (4), we get -

$$P_0 (1 + k_e) = P_0 r_g (1 - b) (1 + t_d)^{-1} + P_0 (1 + b r_g) r_g (1 - b) (2 - t_d) (1 + t_d)^{-1} (k_e - b r_g)^{-1} - P_0 (1 - t_d)$$

Dividing both sides with  $P_0$  we get -

$$(1 + k_e) = r_g (1 - b) (1 + t_d)^{-1} + (1 + b r_g) r_g (1 - b) (2 - t_d) (1 + t_d)^{-1} (k_e - b r_g)^{-1} - (1 - t_d)$$

$$\text{Or, } (1 + k_e) + (1 - t_d) = r_g (1 - b) (1 + t_d)^{-1} + (1 + b r_g) r_g (1 - b) (2 - t_d) (1 + t_d)^{-1} (k_e - b r_g)^{-1}$$

Multiplying both sides with  $(1 + t_d)$  we get -

$$[(1 + k_e) + (1 - t_d)](1 + t_d) = r_g (1 - b) + (1 + b r_g) r_g (1 - b) (2 - t_d) (k_e - b r_g)^{-1}$$

$$\text{Or, } \{[(1 + k_e) + (1 - t_d)](1 + t_d) (1 - b)^{-1} = r_g \{1 + (1 + b r_g) (2 - t_d) (k_e - b r_g)^{-1}\}$$

$$= r_g \{k_e - b r_g + (2 - t_d) + 2b r_g - b t_d r_g\} (k_e - b r_g)^{-1}$$

$$= r_g \{k_e + (1 + 1 - t_d) + b r_g - b t_d r_g\} (k_e - b r_g)^{-1}$$

$$= r_g \{(k_e + 1) + (1 - t_d) + b r_g (1 - t_d)\} (k_e - b r_g)^{-1} \quad \text{--- (6)}$$

Let  $a = (1 + k_e)$ ,  $m = (1 + t_d)$  and  $n = (1 - t_d)$ .

Then, putting these in equation (6) we get -

$$(a + n) m (1 - b)^{-1} = r_g \{(a + n) + b n r_g\} (k_e - b r_g)^{-1}$$

Multiplying both sides with  $(1 - b) (k_e - b r_g)$ , we get -

$$\text{Or, } k_e (a + n) m - b r_g (a + n) m = r_g (a + n) (1 - b) + n b (1 - b) r_g^2$$

$$\text{Or, } n b (1 - b) r_g^2 + r_g (a + n) (1 - b) + b m (a + n) r_g - m k_e (a + n) = 0$$

$$\text{Or, } n b (1 - b) r_g^2 + r_g (a + n) (1 - b + b m) - m k_e (a + n) = 0 \quad \text{--- (7)}$$

If  $b=0$  then  $r_g = k_e (1 + t_d) = r_d$  and if  $b=1$  then  $r_g = k_e$ .

Let  $A = n b (1 - b)$ ,  $B = (a + n) (1 - b + b m)$  and  $C = m k_e (a + n)$ . Then, we get,  $A r_g^2 + B r_g - C = 0$

Multiplying both sides with  $4A$  we get -

$$4A^2 r_g^2 + 4A B r_g - 4A C = 0$$

$$\text{Or, } (2A r_g)^2 + 2 \times 2A r_g \times B + B^2 - B^2 - 4A C = 0$$

$$\text{Or, } (2A r_g + B)^2 = B^2 + 4A C$$

$$\text{Or, } r_g = \{-B \pm (B^2 + 4A C)^{1/2}\} (2A)^{-1} \quad \text{--- (8)}$$

The pre-tax rate of return on corporate investment will be -

$$r_g' = r_g (1 - t_c)^{-1} \quad \text{--- (9)}$$

As a case study, let us consider the rates of different taxes presently in force in India.

$t_c = 0.332175$ ,  $t_d = 0.1660875$ ,  $t_g = 0.206$  (In case of individuals, surcharge is nil). Let us assume  $b = 0.4$  and  $k_e = 0.10$ .



Therefore,  $a = (1 + k_e) = 1 + 0.10 = 1.10$ ,  $m = (1 + t_d) = 1 + 0.1660875 = 1.1660875$  and  $n = (1 - t_c) = 1 - 0.2085 = 0.7915$ .

Therefore, we get  $A = nb(1 - b) = 0.3176 \times 0.6 = 0.19056$ ,

$B = (a + n)(1 - b + bn) = 1.894 \times 1.066435 = 2.01982789$ ,

And  $C = mk_e(a + n) = 0.11660875 \times 1.894 = 0.220856973$

Therefore,

$$r_k = (-2.01982789 + 2.06107999) / 0.38112$$

$$\text{Either, } r_k = (-2.01982789 + 2.06107999) / 0.38112$$

$$= 0.108239 \text{ or } 10.8239\%$$

$$\text{Or, } r_k = (-2.01982789 - 2.06107999) / 0.38112$$

$$= -10.70767 \text{ or } -1070.767\% \text{ which is theoretically not possible.}$$

$$\text{And } r_k' = 10.8239 \times (1 - 0.332175)^{-1} \% = 16.2077\%$$

Therefore, after-tax rate of return on corporate investment will be 10.8239% and pre-tax rate of return on corporate investment will be 16.2077%. If the rate of tax on long-term capital gain is zero, we get that  $r_k$  is equal to 10.8092% and pre-tax rate of return equals to 16.1857%.

For the given set of data, when the entire profit after-corporate tax is distributed as dividend, the after-tax rate of return on corporate investment will be 11.660875% (i.e.,  $r_k = k_e(1 + t_d) = 0.10 \times 1.1660875 = 0.11660875$ ) and pre-tax rate of return on corporate investment will be  $[11.660875/0.667825]$  or 17.461%.

Since the pre-tax rate of return on corporate investment in case dividend alternative is higher than that of the alternative involving dividend and capital gain so the second alternative is financially beneficial to the investors, all other things remaining the same. And higher the retention ratio, higher will be the financial benefit of the investors. Thus, the optimum retention ratio should be 100%, all other things remaining the same.

## 6. CONCLUSION

With the help of equation (3) we can find out the pre-tax rate of return on corporate investment, which a domestic company (as per the Indian Income-tax Act) must earn in order to satisfy the after-tax (corporate and personal) rate of return required by the equity shareholders when the retention ratio is nil. And with the help of equation (9) we can find out the pre-tax rate of return on corporate investment when company's retention policy is greater than zero but lower than one.

It is observed from the case study that a domestic company is required to generate a lower rate of pre-tax return on investment when retention ratio is greater than zero but lower than one, than a domestic company which follows a 100% dividend payout policy even when the rate of tax on long-term capital gain is higher than the rate of tax on dividend distributed. Alternatively, for a given pre-tax rate of return on corporate investment, higher the retention ratio higher will be the net return of the equity shareholders. Thus, a 100% retention policy



will be financially superior to the equity shareholders of a domestic company in India, all other things being the same. •

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# Overdue in Agricultural Credit: A Case Study

*Rabindra Kumar Mishra*\*

**ABSTRACT:** This research paper strives to unravel the requirement, utilisation and aftermath of institutional agricultural credit availed by farmers. However, it expounds the strength of Indian economy as well as plight of farmers who remain defaulters without paying off loans for unwarranted crop failure and improper use of loan. In this research article, in order to analyse the flow of institutional agricultural credit by different banks to the farmers and their overdue profile, a field study of three villages of Bargarh district (Orissa), India, has been done. Bargarh district is an agriculturally developed district and considered the rice bowl of western Orissa. To know the significant difference in the overdue loan with the farmers across the villages and farms TWO-way ANOVA test has been used.

**Key Words :** *Credit, Overdue, Willful default.*

## 1. INTRODUCTION

**V**ictimised by natural calamities and being deprived of proper requisite for developed farming, the farmers of India are situationally pressurised to take loan to manage their agricultural activities in subsequent years of the crop failures, but ultimately use major part of the loan amount in their livelihood. May be for poor financial background or for hesitant

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attitude to repay the incurred loan, the farmers remain defaulter for which the government, in lieu of growing sympathetic to their genuine cause, frames acts to collect loan amount at any cost. Though, the government and financial institutions including the cooperatives make arrangements for availability of high yielding seeds, effective fertiliser, install market yards, etc., but all of these efforts go in vein and number of defaulters multiply.

An Indian farmer borrows year after year but he is not in a position to clear off the loan. As per the report of National Sample Survey Organisation of India on farmers indebtedness (2003) 48.6% are indebted. Among them 61% has occupational holding below one hectare. So, the problem of overdue in agricultural credit continues to be an area of concern. The recovery of agricultural advances by various institutions is also not satisfactory. As a result of this, the credit agencies are becoming wary of granting loan to the farmers. Besides, the credit delivery is a daunting task in rural area of India. There are 10 crores odd farmer families in the country and all the credit institutions put together have provided credit to 4.67 crores odd families and the rest have borrowed money from moneylenders. The normal rate of interest of moneylenders varies from 36% to 120% per annum. So, all the agricultural sectors are in the debt trap of moneylender (Chidambaram 2005). The planning commission of India regretfully admitted "Willful default" and overdues are mounting in number of states. Sometimes Government starts schemes of debt waiver and debt relief for the Farmers (Babu and Subash 2009). It has been proposed in the budget 2008-09 for debt waiver and debt relief with an amount of 60 thousand crores for marginal and small farmers. In farm sector, rural indebtedness is an obstacle for development which requires in-depth analysis so as to address the problems in its entire dimension (Dwarakanath 2010).

## 2. LITERATURE REVIEW

Samuelson and Solow (1953) say if agriculture stagnates, it acts as a break on industrial expansion and halts the real growth of the country. Sharma (1967) has concluded in his work that for agricultural development credit is an important input, which ensures adequate working capital as well as infrastructural development. Adequate credit leads to increase significantly agricultural production, which leads to increase in the economic development of the cultivators and the people attached to cultivation. Thus it appears that adequate availability of real finance and credit is the main enabling factor that ensures effective implementation of developmental schemes in agricultural sector. Mosher (1986) in his study concludes institutional credit agencies as efficient agencies in extending credit to the farmers for production purposes. It serves as an important accelerator for agricultural development. Muniraj(1987) has observed in his work that farm-finance is the money extended to the farmer to stimulate the productivity of limited farm resources. It is not a mere loan or credit or advance, but also an instrument to promote the well being of the society. Farm-finance is not just a science to manage the money but is an applied science of allocating scarce resources to derive the optimum output. It is a lever with forward and backward linkage to the economic development both at micro and macro levels. Agricultural finance is required to support infrastructure for adoption of new technology. Srivastav (1995) has



emphasized on the importance of institutional credit and suggested that bank should provide adequate credit to agricultural sector for increasing production and productivity which leads to the prosperity of the nation. Parida (1998) has concluded that in order to raise productivity of agriculture, there should be an improvement of institutional agricultural credit. Chaudhuri (2001) has also concluded in his study regarding interaction of formal and informal credit market in backward agriculture. The formal credit is very much essential for improving agricultural productivity and welfare of the farmers. However, Karmakar (2011) has emphasized on poor outreach of institutional credit. The poor outreach of formal institutional credit structure is a serious issue that needs to be corrected expeditiously.

A plethora of studies has been conducted on the needs of institutional credit for agricultural development. But, the studies dealing with credit outstanding and its causes are found to be lacking. So in this research paper an attempt has been made to analyse the overdue of agricultural credit with its causes.

### 3. OBJECTIVES OF THE STUDY

The objectives of the study are:

- i) to examine the amount of overdue in agricultural credit;
- ii) to compare the overdue in agricultural credit across the villages and farm sizes;
- iii) to analyse the causes as to why the farmers become defaulter in paying off the loans;
- iv) to deduce certain findings that would be helpful for financial institutions and policy makers.

### 4. SURVEY DESIGN, DATABASE AND METHODOLOGY

The present study is confined to Bargarh district and its rice (Paddy) cultivation. Bargarh district is one of the westernmost districts of the state of Orissa in India. It lies between 20° 43' N and 22° 11' N latitudes and 82° 39' E and 85° 13' E longitudes. This district forms a part of eastern plateau and hills as far as agro climatic zone is concerned. It is an area underlain by crystalline rocks and receives fairly heavy rainfall. Topographically the district is divided into two distinct natural tracts – one being the open landscape covering Bargarh subdivision and the other being the forest area covering Padampur subdivision. The entire district experiences extreme type of climate with hot and dry summer followed by humid monsoon and severe cold. The temperature varies from 10° C to 46° C. The district is basically composed of two distinct agro-climatic zones – one is canal irrigated and the other one composed of rain fed farms.

In this study both the primary and secondary data have been collected. However, the study is mainly based on the primary data collected through a pre-designed questionnaire. Moreover, help of secondary data collected from the published/unpublished records of



primary Agricultural Societies/ Cooperative Banks, Commercial Banks and other sources has been taken to cross check the primary data pertaining to credit and certain other aspects for the year under study 2009-10. The villages were selected by stratified random sampling method. The selections of the sample cultivators of the sample villages are made on the basis of census method. It means all the farm households (based on their operational holdings) of the selected sample villages are considered for the present study. Based on the operational holdings, the farms in each village under study are divided into 3 categories such as Small (Upto 5 acres), Medium (5.01 to 10 acres) and Large (more than 10 acres) farms. Altogether 454 samples were collected from three sample villages under study. Three villages with varying degree of agrarian development and irrigation facilities drawn from 3 different blocks of the district are considered for the present study. One village is chosen from irrigated (double crop area) pocket, the other one from semi-irrigated (where irrigation for one crop i.e. khariff crop is assured) and the other from rain fed (non-irrigated) pocket. The institutional agricultural credit (Short-term credit i.e. crop loan) availed of by the farmers of different villages during the year under study has only considered for the purpose of the present study. The information on short-term institutional agricultural credit along with overdue amount for one agricultural year 2009 -2010 (that is June 2009–December 2009) for Khariff and (January 2010 –June 2010) for Rabi have been collected. Besides this, the discussions with the farmers in the respective villages have also been made while collecting data as informal conversation is convenient to understand various problems and constraints related to the causes of overdue in agricultural credit.

To test the significant difference in the overdue agricultural credit across the villages and farm sizes and the 'F' value is found out by TWO-Way ANOVA Table where the Villages (3 villages - irrigated, semi-irrigated and non-irrigated) and Farm sizes (3 size classes - Small, Medium and Large) are known as Column and Row elements respectively.

$$F_c = \frac{S_c^2}{S_E^2} \quad \text{with } (k-1), (h-1)(k-1) \text{ degrees of freedom for column (i.e. villages)}$$

For the study,  $df = k-1 = 2$  and  $(h-1)(k-1) = 4$

$$F_r = \frac{S_r^2}{S_E^2} \quad \text{with } (h-1), (h-1)(k-1) \text{ degrees of freedom for row (i.e. farm sizes)}$$

For the study,  $df = h-1 = 2$  and  $(h-1)(k-1) = 4$

An alternative hypothesis ( $H_1$ ) is accepted/null hypothesis ( $H_0$ ) is rejected if calculated value of F is greater than its tabulated value at the corresponding degree of freedom (df) and level of significance.

#### 4.1. Hypotheses

The hypotheses taken for the purpose of the present study are mentioned below-

1.  $H_0$ : There is no significant difference in the percentage of overdue in agricultural credit across the villages.

$H_1$ : There exists a significant difference in the percentage of overdue in agricultural credit across the villages.



2.  $H_0$ : There is no significant difference in the percentage of overdue in agricultural credit across the farm sizes.

$H_1$ : There exists a significant difference in the percentage of overdue in agricultural credit across the farm sizes.

## 5. RESULT ANALYSIS

The flow of institutional agricultural credit (i.e. short-term credit) along with the overdue credit across the villages and farm sizes are represented in Table-1.

In the irrigated area, the amount of overdue for all sizes of farms under study is nil. However, the percentage of overdue for medium farmer in semi irrigated village is negligible i.e. 2.05% and in non-irrigated village is nil. But the percentage of overdue for the small farmers in semi-irrigated and non-irrigated area are 17.24% and 18.18% respectively followed by the overdue of large farms of these respective areas i.e. 14.23 % and 14.67% respectively.

It is observed that the amount of overdue in the irrigated area for all sizes of farms is nil. This may be due to higher cropping intensity i.e. double cropping for which the farms need farm credit for each of the cropping seasons with a little gap in between these two. But this may not be considered as reduction in rural indebtedness because amount overdue with credit institution might have been cleared out of their lending from informal credit market so as to avail of the institutional credit for the subsequent cropping seasons. This may be considered as a very good symptom of the use of institutional credit to the maximum extent for production purpose in the irrigated villages. However, the percentage of overdue with the small farms of the non-irrigated area is found highest compared to the other categories of farms in the same and other villages. This may be attributed to the improper utilization of the credit or forced diversion of major part of the credit towards consumption or suffering from a circular chain like, small rain fed farm size - less quantum of production/ productivity - less use of modern technology/input being risk averter due to rain fed nature of farm - less cost of production - surplus from borrowed fund - diversion of the surplus for consumption to maintain a subsistence level of living of the low income small rain fed farms i.e. due to poverty - low investment on agriculture - low return from production - defaulted in repayment - overdue. The small farms of the semi-irrigated area are also suffering from the problem of overdue which may be attributed to the improper utilization of the credit and low cropping intensity due to lack of adequate irrigation facilities. The large farms of both the irrigated and semi-irrigated villages respectively are also suffering from the overdue problem, which may also be attributed to improper utilization of the credit or low cropping intensity in semi-irrigated area or their willful defaulting nature.

### 5.1. Testing of Hypotheses

The hypotheses taken for the study are tested as follows based on the result of F-Test shown in the Table -1.

#### Hypothesis No.1

There exists a significant difference in the percentage of overdue in agricultural credit across the villages. The alternative hypothesis ( $H_1$ ) is accepted at 5% level of Significance for  $F(2,4) = 7.67$  (Null hypothesis is rejected).



**Table 1: Flow of Institutional Agricultural Credit (Short-Term Credit) and Overdue Credit**

	Village / Farm Size	Total flow of institutional agricultural credit in Rs.	Total flow of institutional agricultural credit (%)	Overdue in agricultural credit in Rs.	Overdue in agricultural credit in percentage (%)
V <sub>1</sub>	Irrigated				
	Small	1456000.00	100	0.00	0.00
	Medium	2028800.00	100	0.00	0.00
	Large	475000.00	100	0.00	0.00
	Total	3959800.00	100	0.00	0.00
V <sub>2</sub>	Semi- Irrigated				
	Small	830000.00	100	143092.00	17.24
	Medium	919000.00	100	18839.50	2.05
	Large	660000.00	100	93918.00	14.23
	Total	2409000.00	100	267158.10	11.09
V <sub>3</sub>	Non- Irrigated				
	Small	372000.00	100	67629.60	18.18
	Medium	520000.00	100	0.00	0.00
	Large	658000.00	100	96528.60	14.67
	Total	1550000.00	100	150040.00	9.68
	All Villages				
	Small	2658000.00	100	224866.00	8.46
	Medium	3467800.00	100	20113.24	0.58
	Large	1793000.00	100	190058.00	10.60
Total	7918800.00	100	449787.84	5.68	
'F' Value column df (2,4) (i.e. across Villages)					7.67*
'F' Value Row df (2,4) (i.e. across Farms)					6.52**

Source: 1) Field Survey; 2) Records of commercial and cooperative banks.

- Note:-
1. \* Significant at 5% level of Significance.
  2. \*\* Significant at 10% level of Significance.  
Tabulated Value =  $F_{0.05} (2,4) = 6.94$   
 $F_{0.10} (2,4) = 4.32$
  3. In Column the 3 villages i.e. V<sub>1</sub>, V<sub>2</sub> and V<sub>3</sub> were considered.  
In Row the 3 size classes of farms i.e. small, medium and large farms were considered
  4. Rs. = Rupees (Indian currency)



## Hypothesis No.2

There exists a significant difference in the percentage of overdue in agricultural credit across the farm sizes. This alternative hypothesis ( $H_1$ ) is accepted at 10% level of Significance for  $F_{(2,4)} = 6.52$  (Null hypothesis is rejected).

## 6. MAJOR FINDINGS AND CONCLUSION

From the calculation above, it can be said that the percentage of overdue in agricultural credit is significantly differing across the villages (at 5% level of Significance) and farm sizes (at 10% level of Significance) under the study.

It is thus found from the analysis of overdue in agricultural credit that the farms availing of formal farm credit and the credit institutions providing farm credit in the irrigated area are facing the problems of overdue to the minimum extent compared to that of the non-irrigated and semi-irrigated areas. Similarly the among the farm sizes, medium farms in all the categories of villages are facing the problems of overdue to the minimum extent compared to the large and small farms.

It is not only the exemption of loan that enkindles a tendency in farmers to refrain from repaying the loans but their regular instinct to neglect payment in proper time. Moreover, it can be stated that the easy finance in the name of prosperity of the farmers later on becoming the indirect cause of their ruin and hence, judicial steps are to be taken to sanction the loans and to monitor their proper utilisation and repayment. •

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# Determinants of Working Capital: An Empirical Inquest with reference to Some Selected Public Sector Companies in India

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**ABSTRACT:** The corporate finance literature has traditionally focused on the study of long-term financial decisions, particularly investments, capital structure, dividends or company valuation decisions. However, short-term assets and liabilities are important components of total assets and needs to be carefully analyzed. Management of these short-term assets and liabilities warrants careful investigation since the working capital management plays an important role for the firm's profitability and risk as well as its value. Efficient management of working capital is a fundamental part of the overall corporate strategy to create the shareholders' value. Firms try to keep an optimal level of working capital that maximizes their value. In general, from the perspective of Chief Financial Officer (CFO), Working capital management is simple and a straightforward concept of ensuring the ability of the organization to fund the difference between the short term assets and short term liabilities. In practice, working capital management has become one of the most important issues in the organizations where many financial executives are struggling to identify the basic working capital drivers and the appropriate level of working capital (Lamberson 1995). Consequently, companies can minimize risk and improve the overall performance by understanding the role and drivers of working capital. A firm may adopt an aggressive working capital management policy with a low level of current assets as percentage of total assets or it may use high level of current liabilities as percentage of total liabilities. Excessive levels of current assets may have negative effect on the firm's profitability whereas a low

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level of current assets may lead to lower level of liquidity and stock outs resulting in difficulties in maintaining smooth operations. The main objective of working capital management is to maintain an optimal balance between each of the working capital components. Business success heavily depends on the ability of financial executive to effectively manage receivables, inventory, and payables. Firms can reduce their financing costs and/or increase the funds available for expansion projects by minimizing the amount of investment tied up in current assets. Most of the financial managers' time and effort are allocated in bringing non-optimal levels of current assets and liabilities back toward optimal levels. An optimal level of working capital would be the one in which a balance is achieved between risk and efficiency. It requires continuous monitoring to maintain proper level in various components of working capital i.e. cash receivables, inventories, etc. The impact of working capital policies on profitability is highly important, however, a little empirical research has been carried out to examine this relationship. This paper investigates the potential relationship of aggressive/conservative policies with the accounting and market measures of profitability as well as the risk factor of Indian firms. The present study is expected to contribute to the better understanding of these policies and their impact on profitability especially in an emerging market like India. Under the above backdrop, let us present before you an interesting discourse for your cerebral exercise. It will spot on some financing techniques for financing working capital and also management of the same in the determining the optimum capital structure of a corporate undertaking.

**Key Words :** *Working Capital Management, Profitability, Liquidity, ROA, ROE, Tobin's q*

## 1. INTRODUCTION

The corporate finance literature has traditionally focused on the study of long-term financial decisions, particularly investments, capital structure, dividends or company valuation decisions. However, short-term assets and liabilities are important components of total assets and needs to be carefully analyzed. Management of these short-term assets and liabilities warrants careful investigation since the working capital management plays an important role for the firm's profitability and risk as well as its value (Smith 1980). Efficient management of working capital is a fundamental part of the overall corporate strategy to create the shareholders' value. Firms try to keep an optimal level of working capital that maximizes their value. In general, from the perspective of Chief Financial Officer (CFO), Working capital management is simple and a straightforward concept of ensuring the ability of the organization to fund the difference between the short-term assets and short term liabilities (Harris 2005). In practice, working capital management has become one of the most important issues in the organizations where many financial executives are struggling to identify the basic working capital drivers and the appropriate level of working capital (Lamberson 1995). Consequently, companies can minimize risk and improve the overall performance by understanding the role and drivers of working capital.



A firm may adopt an aggressive working capital management policy with a low level of current assets as percentage of total assets or it may use for the financing decisions of the firm in the form of high level of current liabilities as percentage of total liabilities. Excessive levels of current assets may have negative effect on the firm's profitability whereas a low level of current assets may lead to lower level of liquidity and stock outs resulting in difficulties in maintaining smooth operations (Van Horne and Wachowicz 2007). The main objective of working capital management is to maintain an optimal balance between each of the working capital components. Business success heavily depends on the ability of financial executive to effectively manage receivables, inventories and payables (Filbeck and Krueger 2008). Firms can reduce their financing costs and/or increase the funds available for expansion projects by minimizing the amount of investment tied up in current assets. Most of the financial managers' time and effort are allocated in bringing non-optimal levels of current assets and liabilities back toward optimal levels. An optimal level of working capital would be the one in which a balance is achieved between risk and efficiency. It requires continuous monitoring to maintain proper level in various components of working capital i.e. cash receivables, inventories, etc.

In general, current assets are considered as one of the important component of total assets of a firm. A firm may be able to reduce the investment in fixed assets by renting or leasing plant and machinery, whereas the same policy cannot be followed for the components of working capital. The high level of current assets may reduce the risk of liquidity associated with the opportunity cost of funds that may have been invested in long-term assets. The impact of working capital policies on profitability is highly important, however, a little empirical research has been carried out to examine this relationship. This paper investigates the potential relationship of aggressive/conservative policies with the accounting and market measures of profitability as well as with the risk factor of Indian firms. The present study is expected to contribute to the better understanding of these policies and their impact on the profitability of select Indian companies.

## 2. REVIEW OF THE AVAILABLE LITERATURE

Many researchers have studied financial ratios as a part of working capital management; however, very few of them have discussed the working capital policies in specific. Some earlier works by Gupta (1969) and Gupta and Huefner (1972) examined the differences in financial ratio averages between industries. The conclusion of both the studies was that differences do exist in mean profitability, activity, leverage and liquidity ratios amongst the industry groups. Johnson (1970) extended this work by finding cross-sectional stability of ratio groupings for both retailers and primary manufacturers. Pinches et al. (1973) used factor analysis to develop seven classifications of ratios, and found that the classifications were stable over the 1951-1969 time periods. Chu et al. (1991) analyzed hospital sectors to observe the difference of financial ratio groups between hospital sectors and industrial firms sectors. Their study concluded that financial ratio groups were significantly different from those of industrial firms' ratios as well as their relative stability over the five-year period. In literature, there is a long debate on the risk/return tradeoff of working capital policies (Pinches 1991, Brigham and



Ehrhardt 2004, Moyer et. al. 2005, Gitman 2005). More aggressive working capital policies are associated with higher return and higher risk while conservative working capital policies are concerned with the lower risk and return. Working capital management is important because of its effects on the firm's profitability and risk, and consequently on its value (Smith, 1980). Greater the investment in current assets, the lower the risk, but also the lower the profitability obtained. In contradiction, Carpenter and Johnson (1983) provided empirical evidence that there is no linear relationship between the level of current assets and revenue systematic risk of US firms. However, some indications of a possible non-linear relationship were found which were not highly statistically significant. For the first time, Soenen (1993) investigated the relationship between the net trade cycle as a measure of working capital and return on investment in U.S firm. The results of chi-square test indicated a negative relationship between the length of net trade cycle and return on assets. Furthermore, this inverse relationship between net trade cycle and return on assets was found different across industries depending on the type of industry. A significant relationship in about half of the industries studied indicated that results might vary from industry to industry. Another aspect of working capital management has been analyzed by Lamberson (2005) who studied how small firms respond to changes in economic activities by changing their working capital positions. Current ratio, current assets to total assets ratio were used as measure of working capital while index of annual average coincident economic indicator was used as a measure of economic activity. Contrary to the expectations, the study found that there is very small relationship between changes in economic conditions and changes in working capital. In order to validate the result found by Soenen (1993) on large sample and with longer time period, Jose et al. (1996) examined the relationship between aggressive working capital management and profitability of US firms using Cash Conversion Cycle (CCC) as a measure of working capital management where a shorter CCC represents the aggressiveness of working capital management. The results indicated a significant negative relationship between the cash conversion cycle and profitability meaning that more aggressive working capital management is associated with higher profitability. The current study further investigates the impact of the degree of aggressiveness of working capital policies on market measure of profitability.

### 3. RESEARCH DESIGN

#### 3.1. Methodology of the Study

The study used aggressive investment policy and aggressive financing policy as measuring variable of working capital management.

Aggressive Investment Policy (AIP) results in minimal level of investment in current assets fixed assets. In contrast, a conservative investment policy places a greater proportion of capital in liquid assets with the opportunity cost of lesser profitability. In order to measure the degree of aggressiveness, following ratio will be used:

$$\text{AIP} = \frac{\text{Total Current Assets}}{\text{Total Assets}}$$

Where a lower ratio means a relatively aggressive policy.



Aggressive Financing Policy (AFP) utilizes higher levels of current liabilities and less long-term debt. In contrast, a conservative financing policy uses more long-term debt and capital. The degree of aggressiveness of a financing policy adopted by a firm will be measured by:

$$\text{AFP} = \text{Total Current Liabilities} / \text{Total Assets}$$

Where a higher ratio means a relatively aggressive policy.

The impact of working capital policies on the profitability will be analyzed through frequently used profitability measures i.e. Return on Assets (ROA) and Return on Equity (ROE) as well as market measure i.e. Tobin's q by running cross sectional regressions. The regression models to be estimated are:

$$\text{ROA}_{it} = \alpha + \beta_1 (\text{TCA}/\text{TA}_{it}) + \beta_2 (\text{TCL}/\text{TA}_{it}) + \epsilon \dots\dots\dots (1)$$

$$\text{ROE}_{it} = \alpha + \beta_1 (\text{TCA}/\text{TA}_{it}) + \beta_2 (\text{TCL}/\text{TA}_{it}) + \epsilon \dots\dots\dots (2)$$

$$\text{Tobin's } q_{it} = \alpha + \beta_1 (\text{TCA}/\text{TA}_{it}) + \beta_2 (\text{TCL}/\text{TA}_{it}) + \epsilon \dots\dots\dots (3)$$

Where:

$\text{ROA}_{it}$  = Return on Assets of Firm i for time period t

$\text{ROE}_{it}$  = Return on Equities of Firm i for time period t

Tobin's  $q_{it}$  = Value of q of Firm i for time period t

$\text{TCA}/\text{TA}_{it}$  = Total Current Assets to Total Assets Ratio of Firm i for time period t

$\text{TCL}/\text{TA}_{it}$  = Total Current Liabilities to Total Assets Ratio of Firm i for time period t

$\alpha$  = intercept

$\epsilon$  = error term of the model

The impact of the working capital assets management and financing policies on the relative risk will be measured by applying regression models for the risk of the company and its working capital management policies over the period of 2005-2010. The regression equations are:

$$\text{SD sales}_i = \alpha + \beta_1 (\text{TCA}/\text{TA}_i) + \beta_2 (\text{TCL}/\text{TA}_i) + \epsilon \dots\dots\dots (4)$$

$$\text{SD ROA}_i = \alpha + \beta_1 (\text{TCA}/\text{TA}_i) + \beta_2 (\text{TCL}/\text{TA}_i) + \epsilon \dots\dots\dots (5)$$

$$\text{SD ROE}_i = \alpha + \beta_1 (\text{TCA}/\text{TA}_i) + \beta_2 (\text{TCL}/\text{TA}_i) + \epsilon \dots\dots\dots (6)$$

$$\text{SD } q_i = \alpha + \beta_1 (\text{TCA}/\text{TA}_i) + \beta_2 (\text{TCL}/\text{TA}_i) + \epsilon \dots\dots\dots (7)$$

Where:

$\text{SD}_i$  = Standard Deviation representing risk of Firm i.



The study analyzes the working capital management practices and its impact on profitability and risk of some select Indian Firms for the period of 2005 to 2010.

### 3.2. Collection of Samples

The total population of the study consists of all non-financial firms listed in the Stock Exchanges in India, as collected from the website [www.indiaonline.com](http://www.indiaonline.com). As first step, 10 non-financial firms from the different industrial sectors in India have been selected as samples, whose financial data are available for the study period i.e. 2005-2010. The industries represents 10% of the total industrial sector in India.

### 3.3. Collection of Data

The required financial data of these firms are obtained from the companies' annual reports and publications, whereas the market prices data have been collected from the aforesaid website.

### 3.4. Study Period

The study period has been chosen from the financial years 2005-06 to 2010-11, Related secondary data have been collected from different websites like [www.rbi.org.in](http://www.rbi.org.in) and [equity/timesofmoney.com](http://equity/timesofmoney.com) and also from other books, journals and reports collected from different libraries and electronic form of sources, as available.

### 3.5. Tools for Analysis

The above data is being analysed through the statistical package PASW version 18.0. The data analysis mainly includes running the above regression models apart from simple mathematical calculations e.g. mean and standard deviations, which are computed in MS-EXCEL.

## 4. STATISTICAL ANALYSIS

Equation (1) has been estimated for 10 non-financial firms for the period 2005-06 to 2010-11 and results are reported in Table 1. For each year, TCA/TA and TCL/TA ratios have been regressed against ROA values and we have eight regression models indicating the impact of working capital policies on the profitability of firms in India. The model F-values and the Durbin-Watson statistics indicate overall best fit of the model. The t-statistics of both TCA/TA and TCL/TA are statistically significant at 1% level for ROA except for the year 2005 and 2010. The positive coefficient of TCA/TA shows an inverse relationship between the degree of aggressiveness and the return on assets. Therefore, there is negative relationship between the relative degree of aggressiveness of working capital investment policies and return on assets. The negative value of  $\beta$  coefficient for TCL/TA also points out the same negative relationship between the aggressiveness of working capital financial policy and return on assets. Higher the TCL/TA ratio, more aggressive is the financing policy, the yields negative return on assets.



**Table 1: Regression Analysis of Working Capital Policies and Return on Assets (ROA)**

Year	Investment Policy		Financing Policy		F-Value	Durbin-Watson
	$\beta$ coefficient	t-value	$\beta$ coefficient	t-value		
2005	0.546	1.753*	-0.371	-3.841***	2.968**	2.818
2006	0.437	6.866***	-0.452	-6.203***	26.901***	2.028
2007	0.388	5.478***	-0.263	-5.114***	19.369***	1.886
2008	0.342	6.485***	-0.305	-4.192***	18.819***	2.348
2009	0.289	2.352**	-0.378	-7.138***	20.256***	2.266
2010	0.686	9.134***	-0.621	-9.335***	49.883***	2.059

\*\*\*Significant at 1%, \*\*Significant at 5%, \* Significant at 10%.

The results of regression model (2) have been reported in Table 2, where the dependant variable is return on equity with the same independent variables of working capital investment policy and working capital financing policy. As the degree of aggressiveness of working capital policies tends to increase, the returns are likely to decrease. Though, the results are statistically less impressive which is apparent from the low level of significance of  $\beta$  coefficients, we can predict a negative relationship between the degree of aggressiveness of working capital policies and the accounting measure of returns.

**TABLE 2: Regression Analysis of Working Capital Policies and Return on Equity (ROE)**

Year	Investment Policy		Financing Policy		F-Value	Durbin-Watson
	$\beta$ coefficient	t-value	$\beta$ coefficient	t-value		
2005	-0.083	-0.935	0.019	0.321	0.415	2.483
2006	0.281	3.686***	-0.181	-2.428**	6.731***	1.634
2007	0.084	0.977	-0.161	-2.029**	6.173***	1.535
2008	0.341	4.913***	-0.314	-4.227***	14.488***	2.074
2009	0.048	0.459	-0.206	-2.742**	0.921	1.987
2010	0.188	1.899*	-0.356	-4.448***	6.331***	1.995

\*\*\*Significant at 1%, \*\*Significant at 5%, \* Significant at 10%.

To further validate the above-mentioned results, the impact of working capital investment and working capital financing policy has also been examined on the market returns. Tobin's q has been used as a measure of market return for each year from 2005 to 2010. A q value of greater than 1 indicated the greater perceived value given by investors to the firm. The results of equation (3) have been presented in Table 3. The results reported in first panel of Table 3 are



in accordance with results of Table 1 and Table 2 highlighting that the market returns using Tobin's q decreases as the firms follows the aggressive investment policy by keeping low level of current assets in the firm. This similarity in market and accounting returns confirms the notion that investors do not believe in the aggressive approach of working capital management, hence, they don't give any additional value to the select firms in India. However, there are some dissimilarities that have been found in the relationship of financing policy and Tobin's q. In the year 2002 to 2006, the relationship between working capital financing policy and Tobin's q is positive, indicating that higher the degree of aggressiveness of working capital financing policy, greater is the investor's value given to the firm.

**TABLE 3: Regression Analysis of Working Capital Policies and Tobin's Q**

Year	Investment Policy		Financing Policy		F-Value	Durbin-Watson
	$\beta$ coefficient	t-value	$\beta$ coefficient	t-value		
2005	0.131	1.765*	0.23	2.664**	9.235***	1.938
2006	0.086	0.886	0.251	2.109**	5.120*	1.878
2007	0.203	0.957	0.223	1.538*	4.223**	2.193
2008	0.198	2.228**	-0.222	-0.222	8.512***	2.616
2009	0.21	2.835***	-2.552*	-2.552*	3.899**	2.202
2010	0.28	3.232***	-2.838*	-2.838*	2.868**	2.253

\*\*\*Significant at 1%, \*\*Significant at 5%, \* Significant at 10%.

Finally, to empirically test the theory of Van Horne and Wachowicz (2004), impact of working capital policies on risk of the firms have been investigated by running the ordinary least square regressions for equations 4-7. The operating and financial risks are measured by standard deviation of sales and standard deviations of different return measures respectively. The standard deviation has been estimated over the six years from 2005 to 2010 and then four regressions have been run for working capital investment and working capital financing policy. The results thereof are reported in Table 4 (for sales only). The positive  $\beta$  coefficients of SD-sales indicate inverse relationship between the risk measurements and the working capital investment policy. On the other hand, similar relationship has been found for the working capital financing policy. The increased variation in sale is attributed to the increasing level of current assets and the decreasing level of current liabilities in the firm. However, these are not statistically significant except in the case of the Tobin's q (details not reported). In general, there is no statistically significant relationship between the level of current assets and current liabilities and the operating and financial risk of the Indian firms.



**TABLE 4: Regression Analysis of Working Capital Policies and Risk**  
(in case of Sales only)

Year	Investment Policy		Financing Policy		F-Value	Durbin-Watson
	$\beta$ coefficient	t-value	$\beta$ coefficient	t-value		
2005	0.179	1.864*	0.18	2.546**	8.665***	1.813
2006	0.062	0.817	0.161	1.819**	4.293*	1.868
2007	0.067	0.865	0.223	1.626	3.223**	1.853
2008	0.192	2.846***	-0.121	-0.121	4.178**	2.116
2009	0.18	2.425**	-1.578	-1.578	2.869*	2.024
2010	0.23	2.832***	-1.838*	-1.838*	3.448**	2.543

\*\*\*Significant at 1%, \*\*Significant at 5%, \* Significant at 10%.

Although, results of all return variables are significant, however, model (1) produced more broader and consistent results as compared to model (2) and (3), where F-value and  $\beta$  coefficients are highly significant. Market returns (Tobin's q) are slightly less significant in our study, which may be attributed to the more volatile stock market of India and hence, the results based on market share price data are more inconsistent.

## 5. FINDINGS, CONCLUSION AND RECOMMENDATIONS

The study has investigated the relative relationship between the aggressive and conservative working capital policies for 10 public limited companies listed in any one of the stock exchanges in India for a period of 2005-2010. The impact of aggressive and conservative working capital investment and financing policies has been examined through cross-sectional regression models between working capital policies and profitability as well as risk of the firms. After careful analysis of the selected data for the selected study period, we arrived at the following conclusions:

1. A negative relationship has been found between the profitability measure of firms and degree of aggressiveness of working capital investment and financing policies. This shows that the firms yield negative returns if they follow an aggressive working capital policy.
2. These results are further validated by examining the impact of aggressive working capital policies on market measure of profitability which has not been tested before. The results of Tobin's q are in line of the accounting measures of profitability and have produced almost the same results.
3. Moreover, we also confirm the findings of Carpenter and Johnson (1983) that there is no significant relationship between the aggressiveness and conservativeness of working policies of firms and their operating and financing risk.



4. As we used a new measure of profitability i.e. Tobin's q to estimate the relationship of working capital management and firms returns in India, the present study is expected to have a significant contribution in finance literature.

5. Moreover, theoretical discussion on risk and working capital management has also been tested on empirical basis in the emerging market of India.

## 6. SCOPE FOR FURTHER STUDY

Although the results of present study are in contradiction to some of the earlier studies on the issue, this phenomenon may be attributed to the inconsistent and volatile economic conditions of India. The reasons for this contradiction may further be explored in upcoming researches and this topic is left for future. •

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**APPENDIX - I****TABLE SHOWING THE AVERAGES**

Years	TOTAL ASSETS	TOTAL CA	TOTAL CL	SALES	NET INCOME	EQUITY	TCA/TA
2005	7863.12	3133.67	1976.08	4279.08	805.12	779.06	0.5889
2006	9928.08	3697.04	2612.49	5316.14	1073.06	812.05	0.64
2007	14337.97	5518.64	3290.02	6542.21	1419.26	821.32	0.75
2008	22321.28	9889.76	4293.95	8392.62	1565.93	1396.62	0.72
2009	29069.45	8440.89	4833.11	10881.79	1832.44	1398.1	0.6
2010	34406.39	9711.92	5672.53	11584.55	2096.59	873.39	0.61

Source: Compiled from the Annual Reports of the selected companies from [indiaonline.com](http://indiaonline.com).

**TABLE SHOWING THE AVERAGES (Contd.)**

Years	TCL/TA	H+J	EQUITY MV	EQUITY BV	TOBIN'S Q	ROA	ROE
2005	0.3545	0.9434	62051.4	779.06	33.16	0.1362	5.3272
2006	0.37	1.01	62051.4	812.05	20.66	0.1655	6.1755
2007	0.34	1.09	62051.4	821.32	17.86	0.15208	5.96657
2008	0.3	1.02	62051.4	1396.62	13.07	0.12235	6.74886
2009	0.29	0.89	62051.4	1838.58	10.99	0.115537	5.861016
2010	0.33	0.94	62051.4	873.39	10.26	0.122619	7.357204

Source: Compiled from the Annual Reports of the selected companies from [indiaonline.com](http://indiaonline.com).





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## Some Conceptual Issues on Direct Taxes Code

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**ABSTRACT:** New Direct Taxes Code is a debatable issue and a matter of concern not only for the taxpayers but also to the tax consultants and tax administrators. This code is expected to come into force from 1<sup>st</sup> April 2012. It is not an improvement or amendment but the replacement of the present Acts on the direct taxes. The main objective of the Code is to consolidate and amend the law relating to all existing direct taxes, that is, income tax, dividend distribution tax and wealth-tax. Government wants to upgrade the direct tax laws mainly to change the 50-year old Income Tax Act, 1961. The new Direct Taxes Code is expected to abolish the unnecessary exemptions, moderate the tax rates increase the scope of tax base and reduce the scope for disputes and minimize litigation. The first draft of the Direct Taxes Code was published in 2009 for public comments. The revised Direct Taxes Code has been published in June 2010 after considering the valuable suggestions of various committees and individuals. As per the revised version, EEE (exempt-exempt) method of taxation, i.e. exemption on savings, accretions and withdrawals has been restored instead of EET method of taxation for some popular investment schemes like, Provident Funds – GPF, PPF, EPF, new pension scheme administered by the PFRDA, pure life insurance policies. This paper attempts to identify the changes proposed in the new Direct Taxes Code and the effect thereof on taxpayers, especially on individual assessee.

**Key Words:** *DTC, Tax Incentives, EEE, EET, GAAR, Wealth Tax*

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## 1. INTRODUCTION

**D**irect taxes are those which are collected directly from the assessee who has taxable income or wealth in any previous year. Income Tax and Wealth Tax are two familiar names of direct taxes. Income Tax was first introduced in India in the year 1860 by Sir James William. After that, various amendments took place from time to time. A new Income Tax Act was introduced in the year 1922 and remained in force upto the financial year 1961-62 and then the present Income Tax Act, 1961 took over. Wealth Tax, at present, is governed by the Wealth Tax Act, 1957. Dividend Distribution Tax and Fringe Benefit Tax were included in the Income Tax Act with effect from 1<sup>st</sup> June, 1997 and 1<sup>st</sup> April, 2006 respectively.

Taxpayers, tax consultants and tax administrators have expressed their concern about the complexity of the present structure of Income Tax Act. Amendments inserted from time to time have created a serious problem to the common taxpayers and has made the original Act a voluminous one. The problem has also been increased by the verdicts given by the Courts to solve the ambiguity in the Act.

Over the last decades or so, Government has seriously thinking about the reform of current tax laws. If we are carefully looking through the tax rates then it will be clear to us that the tax rates have been continuously decreasing over the last 15 years. Any further cut down of tax rates may not be possible without widening the tax base that is also essential to increase revenue productivity of the tax system. In order to widen the tax base, three points should be addressed properly:

- a) Withdrawing the facility of exemptions or tax incentives as far as possible after providing safeguards about the small and marginal taxpayers;
- b) Clearing the ambiguity of the Act so that incidence of tax avoidance can be tackled properly;
- c) Setting up a mechanism to stop tax evasion.

New Direct Taxes Code (DTC) was placed in the Parliament in August 2009 and it's revised version has been tabled in the Parliament in August 2010. It is necessary to clear the concept that it is not an amendment but a replacement of the 50-year old Income Tax Act, 1961 to consider and incorporate the best practices of the other countries and to eliminate some old, outdated provisions of the existing Act.

## 2. THE SALIENT FEATURES OF THE CODE

a) **Single Code:** Income Tax Act, 1961 and Wealth Tax Act, 1957 have been merged into a single Direct Taxes Code. This will help to introduce a single unified taxpayer reporting system.

b) **Simple Language:** One of the major objectives of the DTC is to widen the tax base and for this purpose, number of taxpayers should be increased significantly. The content and the



explanations under the various sections are in simple language so that each taxpayer will be able to understand the same properly.

c) Minimum cost of compliance: Most of the taxpayers are marginal taxpayers paying little amount of tax. Cost of compliance will be low, as far as possible, to grow the habit of paying tax or even submitting a nil return.

d) Flexibility: Direct Taxes Code is designed in a flexible manner so that any change required from time to time can be inserted immediately. Therefore, the essential and general principles and provisions have found place in the main body of the statute, whereas, the detailed matters are contained in the schedules.

e) Aggregation of provisions: Another important objective of the DTC is aggregation of definitions, incentives, procedures and the rate of taxes. That's why it will be simple to the non-expert, general public to understand the Code and apply the same to solve their practical problems.

f) Stability: As per the provisions of the present Income Tax Act, 1961, tax rates are determined by the Finance Act of the relevant year. In order to avoid uncertainty and instability in the prevailing rate of taxes, all rates of taxes will be prescribed in the DTC itself and thereby avoiding the need of having annual Finance Bill for that purpose. Such changes will be done through appropriate Amendment Bill in the Parliament.

g) Appropriate Form: The structure of the DTC has been designed in such a way so that it is capable of being reproduced in a form.

### 3. GENERAL CHANGES IN THE CODE

a) As per the present provisions of the Income Tax Act, 'Assessment Year' and 'Previous Year' have been used to determine the tax liability of an assessee. In Direct Taxes Code, instead of these two terms, only 'Financial Year' will be used.

b) As per current provisions, residential status for individuals has been classified into three categories: Ordinarily Resident, Resident but not Ordinarily Resident, Non Resident. In DTC, only two types of status exist, viz. Resident and Non Resident.

c) Apart from the seven categories (Individual, HUF, Firm, Company, AOP and BOI, Local Authority, and any other Artificial Juridical Person) in the present definition, Government, Trust, Co-Operative Society, any other society and any Non-Profit Organization are also included in the definition of the 'Person' in DTC.

d) DTC is proposed to include any person to whom any amount of refund is payable and any person who voluntarily files a return of tax in the definition of 'Assessee'.



## 4. SPECIFIC CHANGES

### 4.1. Income Tax

#### 4.1.1. Important changes in the sources of income

In DTC, incomes are broadly classified into two groups: i) income from ordinary sources and ii) income from special sources. Ordinary sources are divided into five heads. For computation of Income under these sources, following points should be kept in mind:

A) Income from Employment: Any sum received by a person (i.e. employee) for services rendered to another person (i.e. employer) is computed under the head of 'income from employment'. In the existing Income Tax Act, this head is known as 'Income from Salary'.

- i) Employer's contribution to approved provident fund, superannuation fund, new pension scheme and retirement benefits (gratuity, commutation of pension, encashment of leave salary, benefit received on voluntary retirement) shall be exempted from salary subject to specified limits;
- ii) Primarily no exemption is allowed on House Rent Allowance, Leave Travel Concession and Medical reimbursement in the original draft of DTC but the revised draft provides these facilities to the employee as enjoyed by them as per the present Act.

B) Income from House Property: The annual value of the property shall be chargeable under this head provided that the property should not be used for the purpose of any business or profession carried on by the assessee and the profit of which is chargeable to tax.

- i) Income from let out house property only will be considered for the purpose of computing income under this head. For the let out house property, rent received or receivable will be taken as the gross rent and it will not be considered at a presumptive rate at 6% of ratable value or the cost of construction/ acquisition as prescribed in the original draft. Annual value of self-occupied house property will be taken as nil;
- ii) Assessee of a self-occupied house property will continue to enjoy the benefit under clause 74 towards the payment of interest on loan taken for construction or acquisition of house;
- iii) 20% of gross rent will be deducted as standard deduction in respect of repair and maintenance instead of 30% as per the existing provision.

C) Income from business: Income arises from business, vocation or profession will be considered under the head of 'Income from Business'.

- i) Income from business will be classified into two categories: Income from specified business and Income other than specified business;
- ii) All assets will be classified into two groups, business assets and investment assets. Business assets again are classified into two categories- business trading



assets and business capital assets. DTC seeks to tax the gain in the year of conversion of an investment asset into business trading asset instead of the year of sale as per the provision of current Act;

- iii) Balance amount of 'Block of Assets' after the transfer of all assets to the block will also be eligible for deduction. Deduction will be allowed on certain specified expenses over a period 6 years on straight-line method. In-house Research and Development expenditure qualifies for weighted deduction @ 200%;
- iv) It is proposed to charge Minimum Alternative Tax (MAT) @ 0.25% to 2% of the gross assets in the first draft of DTC. Now it is decided to levy MAT @ 20% on book profit as per the revised DTC. MAT credit is reinstated and allowed to be carried forward upto 15 years. SEZ units will now also be liable to pay MAT as per revised DTC. Tax benefits will be allowed to the SEZ units who are starting their operations on and before 31.3.2014;
- v) In case of financial lease, the lessee will be considered as the deemed owner of the business capital assets and depreciation will be available on such business capital assets. Advance received on long-term lease will be treated as gross earnings and deduction will be available at the time of refund of the advance;
- vi) Controlled Foreign Company (CFC) provisions have been introduced to tax passive income earned by a foreign company.

D) Capital Gains: Profits or gains arising on the transfer of a capital asset shall be chargeable under the head of 'Capital Gain'.

- i) Income under this head will be taxed at the normal rates applicable to the taxpayers as against the current Act, where long-term capital gain attracts special tax rate;
- ii) Tax is payable on 50% of capital gain in case of sale of equity shares or units of an equity-oriented mutual fund held for less than one year if Securities Transaction Tax (STT) is paid on transfer. However, no capital gain tax is required to pay if such instrument is held for more than one year;
- iii) Base date for calculation of indexed cost of acquisition, in case of transfer of long-term capital assets, is shifted from 01.04.1981 to 01.04.2000. If cost of acquisition of an asset cannot be determined then it will be considered as nil;
- iv) Assessee can claim exemption on capital gain on transfer of assets if he/she acquired a residential house provided that not more than one residential house is owned on the date of transfer of original asset. However, this exemption will be withdrawn if the acquired residential house is transferred within a period of one year from the date of purchase.



E) **Income from Residuary Sources:** Any income that does not fall under any other head of ordinary sources and under the head of special sources are taken under this head, such as, interest, dividend etc.

- i) Total income under this head will be the gross residuary income if it is received after specified deductions as stated under the DTC;
- ii) Any amount (exceeding Rs.20,000) taken or accepted or repaid on loan or deposit other than by account payee cheque or draft shall be deemed to be the income and included under this head;
- iii) If the annual premium of Life Insurance Policy exceeds 5% of the sum assured for any of the years during the tenure of the policy then the sum received including bonus, if any, will be included under this head of income.

Income from Special Source is a new head of income as laid down in the Direct Taxes Code. Income of this source includes: i) winning from race including horse race, winning from lottery, card games, crossword puzzles or from any other game and winning from gambling and betting; ii) income from interest, dividends on which dividend distribution tax has not been paid, royalty or fees for technical services and any other income for non-residents; iii) Income by way of participation in any games in India, advertisement or contribution of articles in newspapers, magazine, etc. will be considered as the income from special sources in the hands of non-resident sportsman who is not a citizen in India.

Income from special sources would be taxable on the gross amount of income while the income from ordinary sources would be reduced by the incentives as per the provision of new code.

#### 4.1.2. Computation of Total Income

A) Current income from Ordinary Sources (aggregate of incomes under the different heads of income from ordinary sources)

Less: Unabsorbed losses of immediately preceding financial year, if any

Gross Total Income from Ordinary Sources (if such result is negative then gross total income will be taken as negative and the negative value will be treated as unabsorbed loss to be carried forward for any number of financial years.

Less: Incentives

Total Income from Ordinary Sources

B) Income with respect to each of the special sources as per the Fourth Schedule

Less: Unabsorbed loss of immediately preceding financial year, if any

Gross Total Income from Special Source (No incentive is available from this source)

Aggregate the gross total income from all special sources to determine the Total Income from Special Sources.



Total Income= Total Income from Ordinary Sources + Total Income from Special Sources.

#### 4.1.3. Tax Incentives

Tax incentives take form of deductions under the Chapter VIA of the current Income Tax Act, 1961. In the first draft, major incentives are proposed to be EET (Exempt- Exempt- Taxed) form instead of present EEE (Exempt- Exempt- Exempt) form i.e. amount received will be taxable at the time of maturity in the hand of the assessee. But the revised draft proposed that the EEE structure will be continued for the schemes of Provident Fund (GPF, EPF, and PPF) and contribution towards the Life Insurance Policy if the premium paid is not more than 5% of the sum assured. Contribution eligible for overall investment exemption of Rs.1, 00,000 applies for contribution to approved funds, like GPF, Superannuation Funds, Gratuity Fund, etc. An additional amount of Rs.50,000 is eligible for exemption towards the payment of life insurance premium, health insurance premium, and tuition fees for children. Reimbursement of medical expenses will be enhanced from Rs.15,000 to Rs.50,000. New Pension Scheme (NPS) was introduced by the Central Government w.e.f. 01.01.2004 and several State Governments have also implemented the scheme for their new recruits. Investments towards the new pension scheme through the PFRDA approved agencies are eligible for deduction subject to a maximum of Rs.1, 00,000 per year (Government employees covered under NPS: maximum 10% of salary, where salary includes salary plus dearness allowance). Exemptions regarding maintenance of dependents, Donation, Interest on loan taken for higher education, handicapped individual will be continued as per the provisions of the present Income Tax Act, 1961.

#### 4.1.4. Tax Rates for Individuals

Income slab as per Revised DTC	Income slab for the F-Y 2011-12	Rate of Tax
Rs. 0-2,00,000	Rs. 0-1,80,000	Nil
Rs. 2,00,001-5,00,000	Rs. 1,80,001-5,00,000	10%
Rs. 5,00,001-10,00,000	Rs. 5,00,001-8,00,000	20%
Above Rs. 10,00,000	Above Rs. 8,00,000	30%

In DTC, same tax slabs will be applicable for both the men and women assessee. For senior citizen, 2<sup>nd</sup> slab begins from Rs.2,50,001. In the financial year 2011-12, 2<sup>nd</sup> slab begins from Rs.1,90,001 for women and from Rs.2,50,001 for senior citizen (attaining 60 or above but below 80 years) and Rs.5,00,001 for most senior citizen persons (age of 80 or above).

#### 4.1.5. Corporate and other Tax Rates

	For F-Y 2011-12	As per revised DTC
Domestic Company	33.22%	30%
Foreign Company	42.23%	30%



Branch Profit Tax	NIL	15%
Minimum Alternative Tax (MAT)	19.93% on book profit	20% on book profit
Dividend Distribution Tax	16.61%	15%

#### 4.2. Wealth Tax

Wealth tax is a tax on net wealth i.e. the excess of aggregate value of assets over the aggregate value of debts related to the said assets on the valuation date i.e. the last day of the corresponding financial year. Direct Tax Code proposes the following changes as compared to the existing Act.

i) Wealth Tax will be charged on the net wealth of Individual, Hindu Undivided Family and Private Discretionary trusts (non-profit organizations are exempted from levy of tax)

ii) Assets chargeable to wealth tax will mean the all assets including financial assets and deemed assets but not on exempted assets (like assets used as stock-in-trade, any one house or part of a house or a plot of land belonging to an individual or HUF which is acquired or constructed on or before 01.04.2006).

iii) Assets, like watch having value in excess of Rs.50,000, archaeological collections, drawings, paintings etc., are introduced for levying wealth tax, Cash in hand in excess of Rs.2,00,000 for individual and HUF. The valuation of financial assets will be the cost or market price whichever is lower.

##### 4.2.1. Rate of Wealth Tax

1% on net wealth exceeding Rs.1 crore instead of 1% on net wealth exceeding Rs. 30 lakhs as per the existing provision of Wealth Tax Act,1957. This limit will not be applicable to a private discretionary trust.

#### 4.3. General Anti-Avoidance Rule (GAAR)

GAAR will be introduced in the New Direct Tax Code to solve the problem of tax avoidance. The DTC provides the provision of GAAR, where the Commissioner of Income Tax has been empowered to declare an arrangement as impermissible if it has been entered into the objective of obtaining a tax benefit in an illegal way and lacks commercial substance. The Forum of Dispute Resolution Panel is available in cases wherein GAAR provisions are invoked. However, GAAR would be helpful against the tax evasion since sophisticated form of tax avoidance is being adopted by the taxpayers and the tax advisors in the liberal Indian economy.

In DTC, taxpayer is required to file a consolidated return of its tax bases including return of income, net wealth, dividend and income distributed. The Forum of Dispute Resolution Panel will be available to all classes of persons in case of any dispute. Application for rectification will be within six months from the end of the month such application is filed. Application can be filed if rectification application is not disposed off.



#### 4.4. Due dates for tax returns as per DTC

For Non-business or non-corporate:	30 <sup>th</sup> June
For Others :	31st August

### 5. CONCLUSION

Direct Taxes Code is a burning issue. The first draft of the New Direct Taxes code had promised to change the old scenario in direct taxation, especially by withdrawing the most of the EEE exemptions (by converting to EET structure) and at the same time lowering the tax burden. Savings would have got a major set back by the introduction of EET methodology. But, revised draft brought back most of the exemptions by restoring EEE method. The proposed DTC Bill has 319 Sections and 22 Schedules as compared to 298 Sections and 14 Schedules of the present Act. So, the objective of simplification in terms of volume has not been achieved. Again, rates of Income Tax at individual level in India are still low as compared to the foreign countries like U.S.A: 35%, China: 45%, and Japan: 50%. But the corporate tax rates are high than the other countries like Singapore: 18%, China: 25%, and UK: 28%. In order to meet the challenge in the global market, there is ample scope to reduce the corporate tax rates but the issue is still to be addressed. In general, tax rates are prescribed in the Annual Finance Bill. DTC proposed to fix the rates independently but there will be no guarantee that the rates remain unchanged over a certain year, at least for 3-5 years. Revised DTC compromises some areas like, exemption methodology, tax rates and income slabs, which ultimately go against the objective of the tax reforms. Although certain changes are made in the revised draft, it is not still complete in nature. Many more aspects are expected to bring challenges like, corporate tax rates, MAT, definition of residential status, etc. A simple, slim in volume, expressed in short and simple language (in case of defining sections, sub-sections, clauses), and publicly accepted DTC should be issued so that it can be easily understandable not only to the experts and advisors but also to the general taxpayers. •

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