Module-7
Special issues in financial management

Financial modeling is the task of building an abstract representation (a model) of a real world financial situation. This is a mathematical model designed to represent (a simplified version of) the performance of a financial asset or portfolio of a business, project, or any other investment. Financial modeling is a general term that means different things to different users; the reference usually relates either to accounting and corporate finance applications, or to quantitative finance applications. While there has been some debate in the industry as to the nature of financial modeling—whether it is a tradecraft, such as welding, or a science—the task of financial modeling has been gaining acceptance and rigor over the years. Typically, financial modeling is understood to mean an exercise in either asset pricing or corporate finance, of a quantitative nature. In other words, financial modeling is about translating a set of hypotheses about the behavior of markets or agents into numerical predictions; for example, a firm's decisions about investments (the firm will invest 20% of assets), or investment returns (returns on "stock A" will, on average, be 10% higher than the market's returns).

Industrial sickness is defined in India as "an industrial company (being a company registered for not less than five years) which has, at the end of any financial year, accumulated losses equal to, or exceeding, its entire net worth and has also suffered cash losses in such financial year and the financial year immediately preceding such financial year

Causes of industrial sickness

- Unfavorable external environment the firm may be affected by one or more of the following external factors over which it may hardly have any control
- Shortage of key inputs like power and basic raw materials
- Changes in governmental policies with respect to excise duties, customs duties, export duties, reservation etc.
- Emergence of large capacity leading to intense competition
- Development of new technology
- Sudden decline in orders from the government
- Shift in consumer preferences
- Natural calamities
- Adverse international developments
- Reduced lending by financial institutions

Managerial deficiencies- Management can be deficient in many ways. They can be classified function-wise. These, shortcomings , singly or in combination, can induce sickness:

<u>PRODUCTION:</u>

Improper location
Wrong technology
Uneconomic plant size
Unsuitable plant and machinery
Inadequate emphasis on research and development
Weak production and quality control

MARKETING:

Inaccurate demand projection
Improper product-mix
Wrong product positioning
Irrational price structure
Inadequate sales promotion
High distribution costs
Poor customer service
Financial management of sick units

Definition of sickness:banking institutions, financial institutions and regulatory authorities in india have by and large defined sickness in terms of well defined financial indicators. However it is necessary to offer a more broad based definition along the following lines:

An industrial unit may be regarded as sick if (i) it faces financial embarassment (arising out of its inability to honour its obligations as and when they mature), and (ii) its vaiability is seriously threatened by adverse factors.

Causes of sickness: a firm remains healthy if it (i) operates in a reasonably favourable environment, and (ii) has a fairly efficient management. When these conditions are not satisfied, the firm is likely to become sick. Hence sickness may be cause by – unfavourable external environment and

FINANCE:

Wrong capital structure
Bad investment decisions
Weak budgetary control
Absence of responsibility accounting
Inadequate management information system
Poor management of receivables
Bad cash planning and control
Strained relationship with suppliers of capital
Improper tax planning

PERSONNEL:

Ineffective leadership
Bad labour relations
Inadequate human resources
Overstaffing
Weak employee commitment
Irrational compensation structure

Sickness does not occur overnight, but develops gradually over time. A firm which is becoming sick shows symptoms which indicate that trouble lies ahead of it. Some of the common symptoms are:

- Delay or default in payment to suppliers
- Irregularity in the bank account
- Delay or default in payment to banks and financial institutions
- Non-submission of information to banks and financial institutions
- Frequent requests to banks and financial institutions for additional credit
- Decline in capacity utilisation
- Poor maintenance of plant and machinery
- Low turnover of assets
- Accumulation of inventories
- Inability to take trade discount
- Excessive turnover or personnel
- Extension of accounting period

Resort to 'creative accounting' which seeks to present a better financial picture than what it really is decline in the price of equity shares and debentures

Prediction of sickness

While the different symptoms suggest that the unit is in difficulty and may become potentially sick. it is not easy to reach a definitive conclusion about impending sickness on the basis of these symptoms. considerable amount of empirical research done suggests that financial ratios can be used fo predicting industrial sickness with greater reliability. this research, in general involves two types of analysis: univariate analysis and multivariate analysis. univariate analysis: in univariate analysis an attempt is made to predict sickness on the basis of single financial ratios. univariate analysis examines financial ratios individually but does not assess the joint predictive power of various combinations of ratios.

Multivariate analysis, on the other hand, seeks to predict industrial sickness using a methodology that considers the combined influence of different financial ratios.. the multivariate technique commonly used in predicting business failure or sickness is the techniqueof multiple discriminate analysis. this is a statistical technique which helps in classifying an observation into one of the several pre-specified groups or classes on the basis of certain characteristics of the observation. it essentially involves estimating a function which discriminates best between the groups the discriminant function is usually a linear one:

$z = a_1x_1 + a_2x_2 + \ldots\ldots + a_n x_n$ where z = discriminant index

x_i = *independent variable* ($i = 1, \ , n$)

a_i = *co-efficient of variable* ($i = 1, \ , n$)

Revival of sick units

When an industrial unit is identified as sick, a viability study should be conducted to assess whether the unit can be revived/rehabilitated within a reasonable period. if the viability study suggests that the unit can be rehabilitate, a suitable plan for rehabilitation must be formulated. if the viability study indicates that the unit is "better dead than alive", steps must be taken to liquidate it expeditiously.

A viability study involves a reasonably comprehensive assessment of the various aspects of the working of a unit which could cover:

Market analysis:

– Market share behaviour over the past few years
– Growth rate of the total market
– Emergence of competition
– Comparative price and cost analysis
– Order book position
– Unique selling proposition, if any, employed by the firm
– Consumer attitudes, preferences and needs
– Promotional strategies of the firm and its consumers
– Distribution channels used by the firm
– Distributor cost analyis

PRODUCTION /TECHNICAL ANALYSIS:

– Technological capability of the firm
– Plant condition
– Degree of balance in the capacities at different stages of manufacturing
– Manufacturing process
– Plant maintenance system
– Availability of power, water, fuel and other utilities
– Supply of raw materials

FINANCE:

- Liquidity position
- Leverage analysis
- Turnover of assets
- Profitability
- Estimate of working capital needs
- Balance sheet and income statement projection
- Budgetary control and responsibility accounting
- Cost control and reduction

PERSONNEL ORGANISATION:

- Human resources
- Employee motivation, morale and commitment
- Leadership
- Manpower in relation to needs

ENVIRONMENT:

- Supply of raw material
- Availability of power, fuel and water
- Governmental policies with respect to excise duties, custom duties, export duties, reservations etc.
- Industrial Licensing Policy
- Lending policies of financial institutions and commercial banks
- General industrial relations situation
- Competitive developments

THE VIABILITY STUDY MAY SUGGEST ONE OF THE FOLLOWING:

(a) The unit can be revived by adopting one or more of the following measures: debt restructuring, infusion of funds, correction of functional deficiencies, granting of special reliefs and concessions by the government , replacement of existing management because of its incompetence and/or dishonesty.

(b) The unit is not potentially viable – this essentially implies that the benefits expected from remedial measures are less than the cost of such remedial measures.

REVIVAL PROGRAMME: The revival programme usually involves the following:

(i) settlement with creditors like rescheduling of principal and interest payment, waiver of interest, conversion of debt into equity, payment of arrears in instalments.

(ii)provision of additional capital: the additional capital may have to be provided on concessional terms, at least for the initial years, so that the financial burder on the unit is not high.

(iii) Divestment and disposal: divestment of unprofitable plants and operations and disposal of slow moving and obsolete stock to strengthen liquidity and facilitate reallocation of resources for enhancing the profitability of the unit.

(iv) Reformulation of Product-market strategy: Product mix strategy may have to be reformulated to improve the prospects of profitable recovery.

(v) Modernisation of Plant and Machinery: to improve manufacturing efficiency, plant and machinery may have to be modernised, renovated and repaired. This will result in attaining certain cost standards and quality norms for competing effectively in the market.

(vi) Reduction in manpower: the leaner the organisation the greater is the chances of survival. This may call for "golden handshake" offer by the firm to its employees to avoid redundant manpower on its payroll.

(vii) Strict control over costs: review of all the discretionary expenses may be undertaken to eliminate programmes and activities which are a drain on the finances of the firm

(viii) streamlining of operations: Value engineering, standardisation, simplification, cost-benefit analysis, and other approaches should be exploited fully to improve the efficiency of the operations.

(ix) Improvement in Managerial systems: The managerial systems in the unit must be strengthened. In this exercise, greater attention may have to be paid to the following:

- Environmental monitoring
- Organisational structure
- Responsibility accounting
- Management information system
- Budgetary control

(x) Workers' participation :During the revival phase, the dedication, commitment and support of the workers is all the more indispensable and meaningful workers' participation and

(xi) Change of management: A change in management may be necessary where the present management is dishonest and/or incompetent

DEBT RESTRUCTURING: In the case of sick or potentially sick companies, debt restructuring is done through a mix of reliefs and concessions. The common elements of such debt restructuring schemes are:

- Interest rate relief – the contracted interest rate may be reduced if the borrower is not in a position to achieve cash break even
- Deferment of past interest dues – arrears of interest upto the restructuring date are deferred and a repayment spread over a period of time is worked out
- Waiver of penalties- penalties levied in the form of compound interest and liquidated damages for non payment of dues on time are generally waived
- Reschedulement of loan repayment: reworked after assessing the future cash flow position.
- Reduction in the Loan amount – lenders may even write off a portion of the existing loan