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FINANCIAL PERSPECTIVE OF MICRO FINANCE INSTITUTIONS: AN OVERVIEW

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ABSTRACT

To be successful in a financial point of view, how we see our shareholders? The financial perspective shown in the balanced scorecard or 360° analysis allows us to define and analyze our financial objectives, as well as breaking down the possible strategies and action plans necessary to achieve our financial targets. The parents of the Balanced Scorecard for 360° analysis, Kaplan and Norton, defined two types of strategies aimed to boosting financial results (i) Growth Strategy & (ii) Productivity Strategy. The growth financial strategy is based on increasing the income of the organization by increasing revenues via new sources (making franchise) or increases the number of customers. The productivity financial strategy is based on increase company profits by reducing costs throughout the organization and improves asset utilization. In this paper, Financial Perspective of Micro Finance Institutions is discussed critically.

KEYWORDS: *Micro Finance, Balanced Scorecard, Growth Strategy, Productivity Strategy.*

Introduction

The strategy of making franchise consists in obtaining new sources of revenue by selling the product in new markets, development and creation of new products or gaining new customers. The strategy to increase customers is based on keeping deep relations with existing customers, know company's clients allow to know their needs with the effect of offering highly specialized products and solutions for them, with the possibility of making sales cross, using the Customer Relationship Management (CRM) a company can define, monitor, manage and get this strategy based on customer relations. Revenue Growth and Mix: The most common revenue growth measure, both for growth and harvest stage business units, would be sales growth rates and market share for targeted regions, markets, and customers.

New Products Growth-stage businesses will usually emphasize expansions of existing product lines or offering entirely new products and services. A common measure for this objective is the percentage of revenue from new products and services introduced within a specified period, say two to three years. The preferred way is for the new product or new product extension to be a dramatic improvement on existing offerings so that, it captures new customers and markets, not just replaces sales of existing products. The cost reduction strategy improves the cost of the entire organization, both direct costs of products and services and indirect costs. Productivity depends on several factors such as the social condition, culture and location of the company, etc. The strategy to improve asset utilization consist in reduce working capital and fixed capital needed to support for the activity of the organization.

Concept of Financial Perspective

The financial perspective examines whether the company's strategy will contribute to the bottom-line improvement of the company. The financial perspective represents the long-term strategic objectives of the organization and thus, it incorporates the tangible outcomes of the strategy in traditional financial terms. The financial performance is a lag indicator and provides the ultimate definition of an organization's success and describes how to create growth in the shareholders' wealth. Depending on

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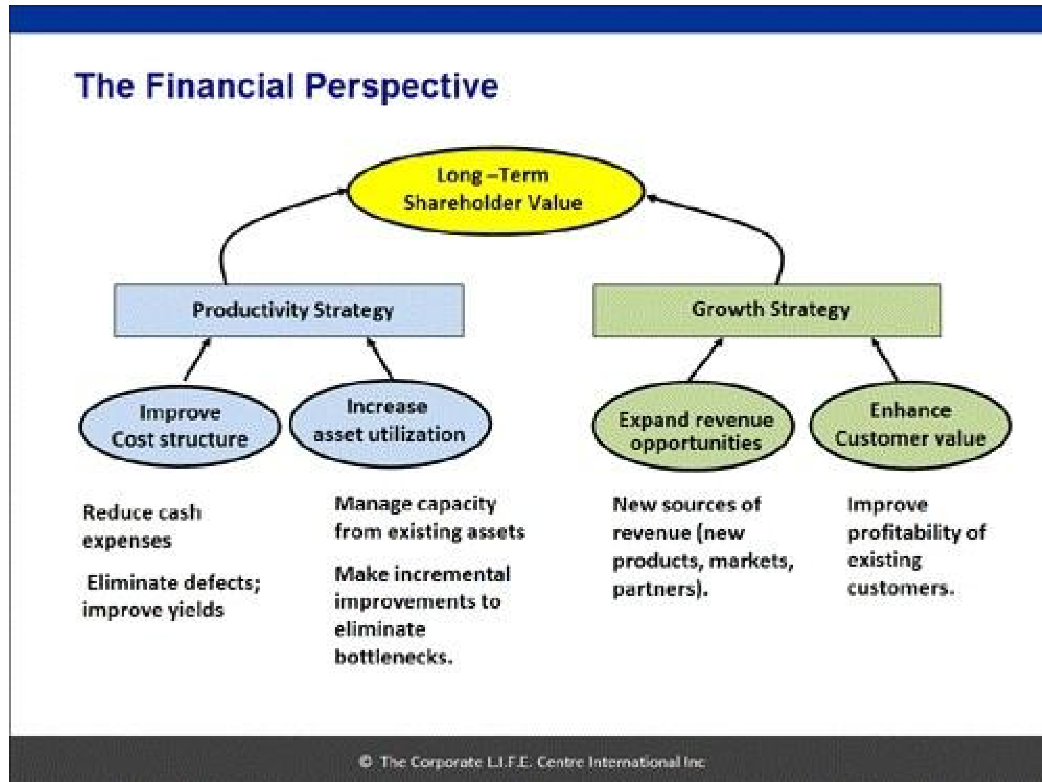
strategy, leaders of the organization follow a combination of growth strategy (i.e., to increase revenues) combined with varying emphasis on productivity strategy (i.e., to cut costs through efficiency). Some of the most common financial measures that are incorporated in the financial perspective are EVA, revenue growth, costs, profit margins, cash flow, net operating income, etc.



Probably the majority of business units in a company will be in the sustain stage, where they still attract investment and reinvestment, but are required to earn excellent returns on invested capital. These businesses are expected to maintain their existing market share and perhaps grow it somewhat from year to year. Investment projects will be directed more to relieving bottlenecks, expanding capacity, and enhancing continuous improvement, rather than the long payback and growth option investments that were made during the growth stage. Most business units in the sustain stage will use a financial objective related to profitability. These objectives can be expressed by using measures related to accounting income, such as operating income and gross margin. These measures take the capital invested in the business unit as given (or exogenous) and ask the managers to maximize the income that can be generated from the invested capital. Other, more autonomous business units are asked not only to manage income flows but also the level of invested capital in the business unit. The measures used for these business units relate accounting income earned to the level of capital invested in the business unit; measures such a return on-investment, return-on-capital employed, and economic value-added are representative of those used to evaluate the performance of such business units.

Some business units will have reached a mature phase of their life cycle, where the company wants to harvest the investments made in the two earlier stages. These business no longer warrant significant investment only enough to maintain equipment and capabilities, not to expand or build new capabilities. Any investment project must have very definite and payback periods. The main goal is to maximize cash flow back to the corporation. The overall financial objectives for harvest-stage businesses would be operating cash flow (before depreciation) and reductions in working capital requirements. The financial perspective addresses the question of how shareholders view the firm and which financial goals are desired from the shareholder's perspective. The specific goals depend on the company's stage in the business life cycle.

Capital Structure and Financial Structure

The terms 'capital structure' and 'financial structure' are often used interchangeably. However, there is a difference between these two terms. Capital structure is the permanent financing of the company representing long-term sources of capital i.e., owners' fund and long-term debt but excludes short-term credit. Financial structure refers to the way, the company's assets are financed. It is the entire left-band side of the balance sheet which represents all the long-term and short-term sources of capital. Thus, capital structure is only a part of financial structure. If short-term liabilities are added in capital structure, it becomes financial structure.

Factors Influencing Financial Structure

The factors affecting the financial structure of a company can be summed up under the following heads:

- **Leverage or Trading on Equity**

The use of fixed cost sources of finance, such as debt and preference share capital, to finance the assets of the company is known as financial leverage or trading on equity. If the assets financed with the use of debt yield a return greater than the cost of debt, the earning per share increases without an increase in the owner's investment. The earning per share also increases when the preference share capital is used to acquire assets. But the leverage impact is more pronounced in case of debt because (i) the cost of debt is usually lower than the cost of preference share capital and (ii) the interest paid on debt is tax deductible. Because of its effect on the earning per share, financial leverage is one of the important considerations in planning the financial structure of a company. The companies with high level of the earnings before interest and taxes (EBIT) may make profitable use of the high degree of leverage to increase return on equity capital. One common method of examining the impact of leverage is to analyse the relationship between EPS and various possible levels of EBIT under alternative methods of financing.

The EBIT-EPS analysis is one important tool in the hands of the financial manager to get an insight into the firm's financial structure management. If the probability of earning a rate of return on the firm's assets is less than the cost of debt, a large amount of debt can be used by the firm in its financial structure to increase the earning per share. This may have a favourable effect on the market value per share. On the other hand, if the probability of earning a rate of return on the firm's assets is less than the cost of debt, the firm should refrain from employing debt. Thus, the greater the level of EBIT and lower the probability of downward fluctuation, the more beneficial it is to employ debt in the financial structure of a company.

- **Cost of Capital**

The cost of a source of finance is the minimum return expected by its suppliers. The expected return depends on the degree of risk assumed by the investors. A high degree of risk is assumed by the shareholders than the debt-holders. In case of debt-holders, the rate of interest is fixed and the company is legally bound to pay interest whether it makes profit or not. For shareholders, the rate of dividend is not fixed and the board of directors has no legal obligation to pay dividend even if the company makes profit. The loan of debt-holders has to be returned within a prescribed period, while shareholders get back their capital only when the company is wound up. The debt, as such, is a cheaper source of funds than equity. This is generally the case even when taxes are not considered. The tax deductibility of interest charges further reduces the cost of debt. The preference share capital is also a cheaper source than equity capital, but is not as cheap as debt is. Thus using the component, or specific, cost of capital as a criterion for financing decisions, a firm would always like to employ debt since it is the cheapest source of funds. The specific cost of capital criterion does not consider the entire issue. It ignores risk and the impact on equity value and cost. The impact of financing decision on the overall cost of capital should be evaluated and the criterion should be to minimize the overall cost of capital, or to maximize the value of the firm. It should, however, be realized that a company cannot continuously minimize its overall cost of capital by employing debt. A point or range is reached beyond which debt becomes more expensive because of the increased risk of excessive debt to creditors as well as to shareholders.

- **Market Conditions**

The magnitude of capital to be invested is also influenced by the prevailing market conditions. Readiness of investors to purchase a particular type of security in a given period of time, stage of business cycle, tax consideration, prevailing interest rates, risk and uncertainty regarding investment in

the market, etc. combines to form market conditions. Marketability does not influence the initial financial structure, but it is an important consideration while deciding about the appropriate timing of security issues. The financial markets are changing continuously. At one time, the market favours debenture issues, and at another time, it may readily accept common shares issue. Due to changing market conditions, the company has to decide whether to raise funds with common shares issues or with a debt issue. The alternative methods of financing should, therefore, be evaluated in the light of prevailing market conditions and the internal conditions of the company. If the share market is depressed, the company should not issue common stock, but issue debt and wait to issue common stock till the share market revives. During boom period in the share market, it may not be possible for the company to issue debentures successfully. Therefore, it should keep its debt capacity unutilized and issue common shares to raise fund. The internal conditions of a company may also dictate the marketability of its securities.

- **Size and Nature of Capital Requirements**

If the organizers of a concern own all the funds required to start a business there will be no need of issuing a variety of securities. Issue of only one kind of shares will be sufficient and other types of securities may be issued in future as and when funds are required. On the other hand, if the organizers own no funds or less funds and large funds are required to start a business, different classes of securities may be required to attract the investors. In case of rapid expansion there will be need to seek all possible sources of capital. Ploughing back of earnings will be sufficient in case of moderate growth of a concern.

- **Growth and Size of a Concern**

Different financial structures may be there at the various stages of development of a concern. During early period of rapid development, equity capital and short-term loans are the main sources used to finance the activities of the concern. As it grows in size, other sources of financing i.e., preference shares and debt capital etc, are also being utilised. Companies during early stages of their development face tremendous problems in assembling funds from variety of sources due to their poor credit worthiness. Investors feel afraid because of the great uncertainty involved in such companies. No one easily becomes ready to take risk. Lenders of funds prescribe highly restrictive terms and conditions in lending. On the other hand, well-established concerns with good performance are always in a position to acquire funds from whichever source they like.

- **Stability and Adequacy of Earnings**

Stability, adequacy and predictability of earnings are the important factors which affect the financial structure. The firms with stable earnings will have stable earnings per share and thus are in position to employ a high degree of leverage as they will meet their fixed commitments easily. The likely fluctuations in earnings increase the business risk. As a result, the shareholders of the firm perceive a high degree of financial risk if debt is employed by such firms. The expected growth in earnings also affects the degree of leverage. The greater the expectation of growth in earnings, the greater will be the amount of external financing needed. Debt is the cheapest and most advantageous source of external financing. Therefore, grown firms usually employ a high degree of leverage. Firms with declining earnings should not employ debt or preference share capital in their financial structure as they may face difficulties in meeting their fixed contractual obligations. Even firm may be forced into liquidation due to non-payment of fixed charges.

- **Government Regulations**

Government controls and regulations play vital role while planning financial structure. The controller of capital issues has prescribed debt-equity ratio norm of 2:1. Higher debt-equity ratios of around 3:1 or higher have been permitted for large capital-intensive projects. On the other hand, for small industrial projects the debt-equity norms have been liberalized through a number of aids and concessions which have made possible very high levels of debt relatively to equity.

- **Policy of Term Financing Institutions**

The attitude of financial institutions as regards providing the funds is an important factor to be considered while designing financial structure as, the availability of debt capital depends on the willingness of lenders to provide the same. If the financial institutions prescribe highly restrictive terms and conditions of lending, management has to move towards other sources of financing and refrain itself from borrowing from these institutions. However, if adequate funds can be obtained on easy terms, it would be beneficial to obtain funds from the institution that provides cheaper funds.

Nature, Value and Cost of the Assets: The nature of the assets owned by a company also has impact on financial plan of the same. In case of Public utilities and heavy industries like railways, water supply and other basic industries etc. the assets acquired are of permanent nature, which is an important factor in vindicating a high ratio of fixed charge security. In the companies having monopolies of a semi-permanent nature, a higher debt-equity ratio may be used than in the companies running on purely competitive basis. The proportion of funds that should be borrowed and the amount of funds needed are fixed by the values of fixed assets. J. Batty has rightly observed that, "borrowed capital should not exceed a reasonable percentage of fixed assets. It may be either 1/3 or 1/2 so that sufficient margin of safety may be maintained and may also permit future borrowings in emergency."

- **Interest Rate Level**

The prevailing interest rate plays a very important role in determining the size of capital and its kind. It affects the choice of securities to be offered to investors. When high interest rates are there, all financing may be costly. When interest rates are relatively lower, many alternatives may be available for choice of type of security to be used.

- **Flotation Costs**

Flotation costs are incurred when the funds are raised. Generally, the cost of floating a debt is less than the cost of floating an equity issue. The firms may be inspired by this to use debt than to issue common shares. If the owner's capital is increased due to increase in retained earnings no flotation costs exist. Flotation cost as a percentage of funds raised will decline as the amount of issue increases. If securities are issued at a large scale to raise the funds, the firm will save in terms of flotation costs. But the firm's financial flexibility will be concise due to such large issue. Therefore, flotation cost can be a significant consideration in deciding the size of a security issue. Also, only that much funds should be raised by company which it can employ profitably.

- **Taxation**

Debt interest is a charge against profit, as such, it is an allowable expenditure from Income Tax point of view where as dividend on shares, whether it is equity dividend or preference dividend, is appropriation of profit and thus is not an allowable expenditure from Income Tax point of view. As such issuing debt capital is more advantageous as compared to share capital. Hence, the higher the rate of tax, the greater will be the motive to employ debt capital to raise funds.

- **Attitude of Management**

The attitude of the persons who are responsible for the affairs of the organization should also be analyzed carefully while assigning weight to different factors affecting the capitalization pattern. Management's attitude regarding the control of the concern and risk has to be noted minutely. Where management has strong will for exclusive control, preference shares and borrowings will have to be used for raising funds. Further, if the main aim of management is to stay in office, they would insist more on leverage principle and would be reluctant in issuing preferred shares, which might endanger the position of the concern due to the high degree of risk involved in it.

- **Cash Position**

One of the features of a sound financial structure is conservatism. Conservatism does not mean employing no debt or small amount of debt. Conservatism is related to the fixed charges created by the use of debt or preference capital in the financial structure and the firm's ability to generate cash to meet these fixed charges. Whenever a company raises funds through borrowed capital, it becomes mandatory to pay interest on that. Failure of which may cause condition of financial insolvency for the firm. The companies expecting larger and stable cash inflows in the future can employ a large amount of debt in their financial structure. It is quite risky to employ fixed charges source of finance by those companies whose cash inflows are unstable and unpredictable. Van Horne has commented as, "the analysis of debt to equity ratios alone can be deceiving and an analysis of the magnitude and stability of cash-flows relative to fixed charges is extremely important in determining the appropriate financial structure for the firm. To the extent that creditors and investors analyse a firm's cash-flow ability to service debt, and management's risk preferences correspond to those of investors, financial structure decisions made on this basis should tend to maximize share price."

- **Flexibility**

Flexibility is one of the most serious considerations in setting up the financial structure. Flexibility means the firm's ability to adapt its financial structure to the needs of the changing conditions.

The company should be able to raise funds, without undue delay and cost, whenever needed to finance the profitable investments. It should also be in a position to redeem its preference capital or debt whenever warranted by the future conditions. The financial plan of the company should be flexible enough to change the composition of the financial structure as warranted by the company's operating strategy and needs. It should also be able to substitute one form of financing for another to economise the use of funds.

Conclusion and Recommendations

- The debt-equity ratio was highest for SML which is quite unsatisfactory hence, it is suggested that the microfinance company should try to reduce this ratio.
- An inter-firm comparison of the microfinance companies under study reveals that average of capital gearing ratio was highest for SML at 2.25 times followed by 2.16 times of IDFCBL, 1.45 times of SSFL and 0.81 times of BFIL. As a rule of accounting the capital gearing ratio should be less than one and only average capital gearing ratio of BFIL was below one, it is suggested that other companies should try to reduce their capital gearing ratio.
- An inter firm comparison of proprietary ratio reveals that only BFIL has satisfactory average ratio hence, it is suggested that remaining microfinance companies under study should try to improve their proprietary ratio in future.
- For BFIL, the solvency ratio can be regarded favourable as the ratio was within the norm and denotes a proper financing policy which should be maintained in future and it is suggested for remaining companies under study that they should maintain their respective solvency ratio.
- It is suggested that the management of SML should try to reduce the fixed assets to net worth ratio by increasing net worth while the management of other companies should try to follow the same policy in future.
- The inter-firm comparison of fixed assets to long term funds ratio of the microfinance companies under study reveals that this ratio has been more than one for all the companies which signifies that the fixed assets were financed thoroughly from long term funds as well as from short term funds. It denotes mismanagement of the funds as a part of long term funds should be used towards the working capital.
- The gross profit ratio of BFIL and SSFL cannot be regarded satisfactory and it is suggested that these microfinance companies should improve the ratio while remaining companies having satisfactory gross profit ratio should maintain it in future.
- As the average of the net profit ratio was satisfactory for SSFL and BFIL that should be maintained and for IDFCBL and SML, this ratio is not satisfactory and should be improved.
- To increase the operating profit ratio, it is suggested that the management of the IDFCBL and SML should try to have an effective control over the operating cost of business and the management of SSFL and BFIL should try to maintain the same trend in future.
- The return on net worth ratio showed a decreasing trend in SSFL and SML which shows an inefficient management and denotes an under utilization of the available funds. It is therefore, suggested that the management of SSFL and SML should try to make an optimum use of the available resources while the management of BFIL and IDFCBL should still try to increase the profitability by making an optimum use of shareholders' funds to the fullest extent.
- An overall comparison of return on capital employed ratio shows that the ratio was highest for BFIL followed by SSFL, IDFCBL and lowest for SML. It is therefore, suggested that BFIL and SSFL should try to maintain the same trend whereas IDFCBL and SML should improve the ratio in future.
- The overall comparison of return on total assets among all the companies under study reveals that the average of the return on total assets ratio was highest for SSFL followed by BFIL which shows that the management of these companies have properly utilized the total assets available but it is suggested that the management of these companies should try to control the decreasing trend of the ratio by increasing the profit after tax and before interest.
- The average of return on total assets for SML and IDFCBL cannot be regarded satisfactory and it is suggested that the management of these companies should try to make an optimum use of their assets to increase the return on total assets.

- It is suggested that southern microfinance companies under study should reduce their operating costs to improve their profitability.
- It is recommended that these companies should increase their turnover which will give them more liquidity and financial strength.
- It is suggested that southern microfinance companies under study should expand their market sectors and find out new markets to get more business and better profitability.
- It is suggested that these companies should give more new products and services to strengthen their customer belt.
- It is recommended that these companies should give proper attention on management team, its efficiency and ability to manage changes of every kind in favour of the company.
- The microfinance companies under study can find some expenses to reduce, it's suggested that they should not to cut costs at the expense of the quality of their products and services.
- It is suggested that in ever-changing and competitive market, microfinance companies' management should analyse these questions regularly: Do you need to review your finance facilities?, Are they at the most competitive terms available?, Are you using any loans and overdrafts effectively?
- For microfinance companies, it is suggested that, focusing on their most profitable customers - even if it means letting the less profitable ones go - could boost their profitability, so long as it is handled carefully.

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