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CHAPTER 1

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CHAPTER 1

FINANCIAL POLICIES - A PERSPECTIVE

1.1 INTRODUCTION

Policies are clear guidelines or criteria for managerial decision making on major or day-to-day matters. These are means to guide the thinking of managers in their decision making behaviour. Policies are derived from objectives and are designed to operationalise them. Hence, these are termed as operational objectives, which reflect the true character of the organisation. Policies are also called as standing plans in the sense that they are meant for repeated reference and ready guidance for recurring managerial decisions. They are valid for handling a range of same or similar problems and situations.

Policies are specific guidelines and constraints for managerial thinking on decision making and action. They provide the framework within which the decision makers are expected to operate while making organisational decisions. Policies become the basis for executive operations. They are the planned expressions of the company's official attitudes towards the range of behaviour within which it *will permit or desire its employees to act. Policies provide a means for carrying out the management process by making clear both the direction of the organisation and the way in which it is to achieve its goal. Thus, policies cover aspects of what is to be done and how it is to be done. In this sense, policies are means to operationalise organisational objectives serving as linking pins between organisational purpose and direction.*

Policy formulation is an important function of top management. Several major policies in the areas of finance production, personnel, marketing, purchasing and so on are to be formulated in a clear-cut manner for the guidance of the executives. Basic policies are also formulated by top management committees after due deliberations. Several derivative policies stem from basic policies.

1.2 MEANING

A policy is a guiding decision by the management which guides the organisation to deal with a particular situation in a particular area in future.

Policies may be defined on the mode of thought and the principles underlying the activities of an organisation.

Koontz et al.[1] defined policies as "the mode of thought and the principles underlying the activities of an organisation or an institution. Policies are plans in that they are general statements of principles which guide the thinking, decision making and action in an organisation".

Terry[2] says, "a business policy is an implied overall guide setting up boundaries that supply the general limits and direction in which managerial action will take place". Thus, according to this definition, policy reveals the management intentions for the future. They spell out clearly the sanctioned general direction and areas within which work has to be done.

Rodgers[3] state "a business policy is one which focuses attention on the strategic allocations of scarce resources, human, financial, physical or intangible. Conceptually speaking strategy is the direction of such resource allocation while planning is the timing of allocation".

Haner[4] has defined business policy as "a statement - verbal, written or implied or those principles and rules that are set by executive leadership as guidelines and constraints for the organisation's thought and action.

Their purpose is to enable the management to relate properly the organisation work to its objectives".

Newman and Logan[5] *observe that "a business policy is often used to cover both the objectives and the general rules of action for an enterprise. The purpose of such a policy is to resolve any conflict there may be between several objectives. The policy guides the action of the company along a path towards the objectives, it represents the best thinking of the company management as to how the objectives may be achieved in the prevailing economic and social conditions".*

According to Yoder[6] *"a management policy is a predetermined selected course established as a guide towards accepted goals and objectives. Policies establish the framework of guiding principles that facilitate delegation to lower levels and permit individual managers to select appropriate tactics or programmes. Such policies are developed by working organisations to keep them on course, headed and directed towards their organisational objectives. These define the intentions of the organisation and serve as guidelines to give consistency and continuity to total operations. They provide a base for management by principle* *as contrasted to management by expediency. In fact, they serve on-a-road map for the managers".*

In the opinion of Miller[7], "a policy is a statement or a commonly accepted understanding of decision making criteria or formulate, prepared or evolved, to achieve economy in operations by making decision relatively routine on frequently occuring problems and consequently facilitating the delegations of such decisions to lower managerial levels".

Thomas[8] states that "policy is the study of the nature and process of choice about the future of independent enterprises by those responsible for decisions and their implementation".

1.3 ESSENTIALS OF POLICY FORMULATION

According to Alford and Beatty[9], the essentials of policy formulation may be listed as under.

(a) A policy should be definite, positive and clear. It should be understood by everyone in the organisation.

(b) *A policy should be translatable into the practices and peculiarities of every department and division of the organisation.*

(c) *A policy should be flexible and at the same time have a high degree of permanency.*

(d) *A policy should be formulated to cover all reasonably anticipatable conditions.*

(e) *A policy should be founded upon facts and sound judgement.*

(f) *A policy should conform to economic principles statutes and regulations and should be a generally compatible with the public interest.*

(g) *A policy should be a general statement of the established rule to follow in recurring situations rather than one prescribing detailed procedure.*

1.4 POLICY MANUAL

When the policies are reduced to black and white and compiled into a book or manual that may be designated as a "policy manual". The organisation is considerably *strengthened by having a policy manual because the statement of policy then becomes readily available for reference and guidance. Some of the advantages of policy manual may be enumerated as follows.*

- i) *It lessens misinterpretation, misunderstanding and resulting friction because the policies are stated in writing.*
- ii) *It provides a checklist of current policies which can be used to determine whether or not they are being adhered to.*
- iii) *It constitutes useful instructional device for acquainting the personnel with the principles procedure required to make the policies effective in the operation of the enterprise.*

1.5 *IMPORTANCE OF BUSINESS POLICIES*

Policies flow from planning and are extremely useful connections between goals and actions. The policies are useful day-to-day guides. As a guide for making decisions, Policies provide the following advantages.

1) *They tend to serve as precedents and thus, reduce the repetitive rethinking of all the*

factors in individual decisions and save considerable time.

2) *Policies aid in coordination, if a number of individuals are guided by the same policies, they can predict more accurately the actions and decisions of others.*

3) *Policies provide stability in the organisation. A certainty of action is assured even though the top management may change. The policies continue and this continuity promotes stability in the organisation and thus, diminish frustrations of members.*

4) *Clear policies encourage definite individual decisions in as much as each manager has a clear understanding of the range with which he can make decision and thus, feels less uncertainty as to whether he can give answers to subordinates without "getting into trouble".*

5) *Because they specify routes towards selected goals, policies serve as a standard, or measuring yard for evaluating performance. The actual results can be compared with the policies to determine how well the members of*

an organisation have lived upto what extent goals have been achieved.

6) *Sound policies help build up employee enthusiasm and loyalty for the organisation. This is specially true when they reflect established principles of fair play and justice and when they help people to know within an organisation.*

7) *They set the pattern of behaviour and permit participants to play with a greater degree of confidence and lead to better co-operation.*

8) *Policies are control guides for delegated decision makings. They seek to ensure consistency and uniformity in decisions on problems that recur frequently and under similar but not identical circumstances.*

9) *Policies with clarity, relevance and reasonableness enable a firm to make the optimum utilisation of scarce available resources and thereby bring about an efficient level of operation because wastage is avoided.*

10) *Corporate policies buildup an image of the business in the eyes of the public and this brings in more reputation, goodwill, and*

profit, so that more acts of social responsibilities may be undertaken.

11) Proper administration and implementation of policies encourage initiative in the employees so that they act with full responsibility within the framework of the policies. This naturally improves the working environment with good labour-management relations.

Policies help the firm to clarify its objectives, guide planning for future operations, aid subordinates in reaching operating decisions, facilitate overall coordination and control and acts as yardsticks for evaluating the quality of executive decision making and action.

It is through policies that the organisations objectives are achieved, better use of resources is ensured, social responsibility is fulfilled in an increasing manner, personal satisfaction is obtained by the employees and the management is enabled to take useful decisions.

Since policies emanate from good plans and since the actual performance of duties and activities depend upon some means of directing future actions, planning and policies are *closely related in the management of an organisation.*

1.6 CLASSIFICATION OF POLICIES

Policies pertaining to working of an industry have been classified in various ways[9] as follows.

1) TOP MANAGEMENT POLICIES : These are derived from top management planning. They include policies concerned with long-range product selection, sales forecasting, sizing the enterprise, process selection, machine selection, determining plant needed and budgeting.

2) UPPER MIDDLE MANAGEMENT POLICIES : These are specific in nature pertaining to functions such as sales production, research, finance, accounting and are made by the Vice President or other executive responsible for these functions. They would be in harmony with the major policies of the enterprise.

3) MIDDLE MANAGEMENT POLICIES : These policies grow out of planning of junior executives, superintendents of departments or devisions and others in like positions. These men are functional, product or are specialists within *the sales, production, research, finance or accounting sub-divisions of the enterprise.*

4) FOREMEN POLICIES : Foremen policies are those directly related to the accomplishment of the tasks set for his small sub-division of the whole enterprise. They include the policies concerned with the assignment of the jobs to the best suited men, the provision for adequate tools by which to do the job and so forth.

5) OPERATING FORCE POLICIES : Operating force policies are those found in little notebooks in the possession of each worker. These state his rule or code for doing each job that he is called upon to do from it the worker knows how long each job should take, what tricks of the trade are required and what quality features are emphasised. He does not trust to his memory to complete a respective job satisfactorily for he has an established policy to follow for this recurring situation.

Policies can also be classified depending on the type of management functions. Various types of such policies include sales policies, production policies, research policies, financial policies, costing policies, marketing policies, accounting policies and promotion policies.

1) <u>SALES POLICIES</u> : The sales policies are concerned with determining location of markets, selecting channels of distribution, dividing the total market into branch or dealer areas, pricing the product, determining sales incentives, establishing advertising policies, setting up sales control policies and establishing sales volume and expense budgets.

2) <u>PRODUCTION POLICIES</u> : Production policies may be concerned with the making production budget, the selection of junior executives, the organisation and coordination of their activities, factory layout, inventory control, collective bargaining, and labour relations, selection of system for quality, cost, production control, and the like.

3) <u>RESEARCH POLICIES</u> : Research policies may be concerned with the selection of projects for investigation, the choice of personnel and mechanisms for carrying out these activities, the determination of research budgets, the measurement of results and similar matters.

4) <u>FINANCIAL POLICIES</u> : In the area of finance, a number of policies would be required such as, (a) the method of raising funds and the ratio between the various

types of sources of funds. How much risk that the company can undertake? What returns do it expect on the funds procured and how much of the control aspect management is willing to give? (b) Policy for the use of the funds and the ratio between different types of assets. (c) The credit policy and the distribution policy towards customers. (d) The dividend policy i.e. how much dividend is to be declared out of the profits earned. (e) Provision for working capital requirements and other matters of this type.

5) COSTING POLICY : The costing policy includes selecting the method of costing, the method of allocating, apportioning, re-apportioning and absorbing overheads, etc.

6) ACCOUNTING POLICY : The accounting policy includes the following :

i) The basis of valuation of stock of finished goods. It is a matter of policy whether the finished goods are valued at total cost or at direct cost or at works cost.

ii) The issue of raw materials whether to follow FIFO or LIFO or average cost or any other method of pricing.

iii) Deprecitation policy i.e. which method of depreciation be followed.

iv) Capitalisation of expenditure during the construction period.

v) The treatment of diferred revenue expenditure, intangible assets, fictitious assets and preliminary expenses.

vi) Policy for provision of doubtful debts, investment losses, etc.

7) <u>MARKETING POLICY</u> : The marketing policy consists of number policies in market analysis, business law, display and salesmanship, etc.

8) <u>PROMOTION POLICIES</u> : The objective of promotion policy may be (a) to utilise fully the managerial resources of the organisation, (b) to provide a fair opportunity to all for advancement and promotion, (c) to base the promotion on an objective assessment of merit and not merely seniority.

9) <u>PRODUCT POLICIES</u> : These may include the following :

i) The company will deal in the whole range of engineering products for construction projects.

ii) The products of the company will be meant only for Govt. and industrial customers.

iii) The company will purchase as many components as possible from small scale industrial units and will concentrate largely on assembling.

iv) The company will try to differentiate its products from those of the rival manufacturing units in terms of shape, design and other specifications.

v) The company will book bulk orders and make its products available according to the specifications provided by the clients.

Similarly, policies in various other areas of management may also be formulated.

1.7 TYPES OF FINANCIAL POLICIES

The basic important types of financial policies which have to be laid down to assure the success of the business operations on a continued basis are as follows.

I) <u>THE CAPITAL STRUCTURE POLICY</u> : Planning the capital structure of a company can take place in any one of the following situations in any business organisation.

i) When a new industry is started.

ii) When it is growing and it is in need of capital for development.

iii) When it is growing and is in need of additional funds for expansion.

iv) In case of merger or consolidation with existing business.

v) In case of re-organisation.

The points to be borne in mind in deciding a capital structure policy can be summerised as under.

(a) To provide capital at the lowest cost possible for the company.

(b) To have a conservative capital structure, which will enable future issues of capital or loans attract investors.

(c) Avoidance of rigid commitments or a safeguard against loan income periods.

(d) Simplicity of understanding by the investing public.

(e) Retention of control.

(f) Economy in the formalities of raising the capital.

II) <u>DEPRECIATION POLICY</u> : Depreciation provides for the loss in current use of assets on estimation of the deterioration in its life and above the repair and *maintenance to keep the asset in income producing level of efficiency. In effect, this is done by providing an annual rate, which is included in the cost of production with a corresponding credit to a depreciation reserve account. To that extent, it is earmarking of income for a specific purpose with the advantage that these funds remain with the business for further earning of income. If on the contrary, no depreciation is provided for, the capital would gradually become depleted with the increased dividends distributed during the course of the years.*

There are various methods available to calculate and charge depreciation. However, the provision of depreciation by any method, does not guarantee that cash will be available at the end of the useful life of an asset for its replacement. This can, however, be done by investing an appropriate amount every year which with the accr tion of interest earned would accumulate the required capital for replacement at the end of the estimated period. Normally, the cash retained in the business can be utilised as working capital and it would be a matter of policy assessment as to which of the methods would be ultimately advantageous from the point of view of the business.

Apart from the normal depletion in the usefulness of an asset over a period of time, there arise circumstances *under which it becomes essential to replace an asset in the interests of economy and competitive strength. This obsolescence cannot normally be provided by depreciation and in those industries where the incidence is greater, this can be taken care of specific reserve.*

III) <u>PLANT REPLACEMENT POLICY</u> : Apart from providing depreciation in the accounts, basic management policy should aim at replacement of assets to keep them in the most economic working conditions and efficiency. Towards this end, it may sometimes prove to be advantageous to relax the restrictions in regard to capital budget sanctioning by providing that departmental managers should have liberty to replace assets equivalent to a certain percentage of the annual depreciation charge for the experience of a large worldwide corporation, where this percentage is 90 percent of the annual depreciation, the measure has enabled the company to maintain its assets fully modernised and thereby reap the maximum operating economies.

However, when plant and machinery have to be replaced, the relative operating economies will have to be gauged by calculating not only the financial advantages to be gained but also the appropriateness to purpose, accuracy of performance, reliability of operation, output, performance in relation to anticipated production *requirements, servicing arrangements, availability of spares and requirements of specialised skill.*

IV) __STOCK EVALUATION POLICIES__ : Two aspects are involved in a stocks evaluation policy. The first aspect is in regard to charging to cost of production the value of materials consumed. The second is the valuation of the inventory at the close of an accounting period for the assessment of the profits. In regard to the charging to the cost of production the value of materials, several basic policies can be adopted. The common methods found used in the valuation of stocks are LIFO, FIFO and average method. The first two methods have economic reasoning behind them and in fact, affect considerably the valuation of the inventory for assessment of a true profit position. The method of ascertaining the actual cost has practical limitations in organisations of some size, while the average method has great practical utility behind it.

Many organisations follow conservative financial policies with a view to conservating capital from depletion revaluation reserves are created for stock items. The procedure in that case would be to arrive at group index figure for categories of materials and create reserves on the total stock held under each category. This can save a *certain amount of accounting labour which otherwise would be necessary if individual prices are to be adjusted.*

V) <u>RESERVES AND DIVIDEND POLICIES</u> : Creation of reserves is primarily guided by the need to conserve resources to ensure stability and financial strength to finance expansion and new developments. Specific reserves for dividend equalisation, obsolescence of stock, contingency reserves to offset fluctuations as occasioned by trade cycles are other general categories of revenue reserves. Revenue reserves as distinct from capital reserves are available for distribution as dividend on a future occasion if the Board of Directors so decide. Capital reserves are not available for distribution as dividend through the Profit and Loss Account either due to the regulations of the Companies Act or by virtue of the nature or purpose for which these have been created. Share premiums, capital redemption reserves and other categories of capital reserves specifically created e.g. realised capital profits from sale of assets, lease-hold redemption reserve funds, debenture redemption funds, etc., belong to the category of capital reserves. These can, however, be distributed in the form of capital by issue of shares credited as fully paid up on going through the prescribed formalities.

It is quite possible to build up secret reserves by excessive depreciation of assets, the general gains in goodwill and market acceptance, but the tendency however, through legislative enactment is to prohibit the building up of large secret reserves.

In formulating a policy, one must bear in mind almost the trusteeship function of the Board of Directors to preserve a balance between the claims of ownerships, employment of public welfare, payment of dividend out of capital is prohibited, but when money is required for capital project - extending to a period, if the Articles of Association permits, resort can be made to payment of an interest on share capital with the appropriate sanction and the limiting factors imposed by legislation.

VI) PRICING POLICY : One of the most important functions affecting financial policy is the pricing of manufactured products, and for that reason the decision is generally arrived at after consultation with several departments. Apart from the cost, the overriding considerations are the potential demand, the break-even point, the profit margin necessary in terms of the organisation as a whole to sustain its existence of growth and the stability of the market. Financial considerations will also determine the marketing policies whether the outlets should be through own distributing agencies or centres or normal trade channels, the promotional outlay and the priority in the matter of tapping e.g. nation-wise, region-wise, locally, etc.

Market research and other surveys provide the basic guidelines but to place absolute reliance on these may not prove to be a prudent procedure unless one applies one's own tests over the data. In those cases where selling prices are fixed by considerations other than cost plus profit margin, the most readily saleable items may in fact, bring the least amount of profit and to that extent to advice on a practicable product mix may require tact as well as knowledge. In the case of new product with a potentially increasing market in the following year, it would prove to be advantage in the long run to absorb a position of the promotional expenses during the subsequent period. To what extent deferred revenue expenditure would be regarded with favour in a published balance sheet is a matter which would require serious consideration and where limitations exist, the next best alternative may be a downright loss with explanations about hopeful anticipations.

Selling prices are to a great extent dependent on the credit allowed to distributors and dealers. The cost of *financing such extended terms of credit may in some cases prove more difficult than an .obvious price reduction but decision of the nature to a very great extent of competition. Leadership in an industry may enable one manufacturer to reduce prices all of a sudden beyond economic levels considered by smaller units but the question of survival would make it obligatory to fall in line and make subsequent readjustments or suffer partial or total eclipse.*

VII) <u>INSURANCE POLICY</u> : Good management is one of the best safeguards against business risks in general, but to leave uncovered risks which may at one time or other upset completely its running is inevitably bad management. Insurance against risks enables one to convert uncertain risks to a fixed annual charge, which by the very competitive nature of the insurance market is a negligible addition to overhead costs. It would be pennywise pound foolishness not to cover risks of fire, riot; workmen's compensation, loss of profit and third party liabilities, and in case of risks attendent on credits.

VIII) <u>EMPLOYEE RETIREMENT & PENSION SCHEMES</u> : The legislative enactment providesfor separate administration by trustees or through Govt. agencies or insurance companies of funds earmarked for provident fund or pension benefits.

Gratuity schemes are however, not covered by such enactments and consequently the provision of finances for retirement benefits is a matter of policy which requires consideration. Yearly calculated allocations to a separate fund is the obvious choice but it will be a matter for relative assessment as to whether the utility of funds for the purpose of working capital is of over-riding importance as against the possible element of risk involved in an unduly heavy commitment in one particular year. To the extent this is estimated, funds can be provided in advance but simplicity in administration would make it a reasonably worthwhile proposition to cover it under an insurance policy.

IX) <u>WORKING CAPITAL MANAGEMENT</u> : Working capital is the excess of current assets (inventories, bills receivables, cash, and other semi-finished assets) over current liabilities (accounts payable) during the accounting year. Working capital is the crucial requirement to all on-going business enterprises and is a measure of the ability of the enterprise to meet its current business obligations. Policies are to be laid down on the size and adequacy of working capital. Variations in working capital with seasonal swings in business activity, the quantum of inventory, amount to be held in cash and easily convertible *securities, the extent and duration of credit to be allowed to customers and to be sought from suppliers, terms of cash discount for prompt payment, cash credit management with banks and other institutions, etc.*

1.8 CONCLUSION .

In the case of a new enterprise, attempt at a broad financial policy is no doubt necessary, but practical considerations will make it necessary to let this grow out of the emerging circumstances. In the case of established and growing companies, the setting down of a policy is vitally important and in formulating one the considerations of continuity of operations, the need to set the pace for leadership and acceptance by the community of the social objectives of the enterprise will certainly provide guidelines.

The present study aims to understand and study various types of financial policies adopted by a selective co-operative dudha utpadak and purvatha sangh in Miraj Taluka of Sangli District.

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