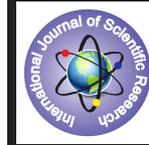


Financial Management of Indian Software Industry



Management

KEYWORDS :

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ABSTRACT

Computers were introduced in the early 1960s to help in the complex data processing work involved in formulating the country's Five Year Plans. This opened up a national debate on the ethics of computer use in a populous country with severe unemployment.

The fear that computers might displace workers held up their wider application until 1980 when the government decided in favour of economic and industrial liberalization and gave the green light to computer application in critical areas of production and research. Later the policy was extended to all areas in order to improve productivity and efficiency. Expectations are high that computer activity and exports will create more jobs, particularly for the educated unemployed. And even greater potential for absorbing this surplus labour is seen in the development of the software industry.

The software sector plays an important role in every modern economy because software is nearly omnipresent. In modern economies everybody uses software several times a day. The fields of application reach from a radio alarm clock to an automated production process. Today the software industry has become the backbone of companies around the world. With technology advancing in leaps and bounds, there is no stopping of IT professionals around the world to bridge the gap between huge untapped markets and its customers, as well as creating an opportunity for innovation.

Evolution of Indian Software Industry

Though the Indian software industry has risen to prominence in the last decade, it has a history of well over thirty years. The process of evolution has been chronicled from multiple perspectives. The common factors that are widely perceived to have been positive influences on the evolution and growth of this industry are availability of skilled, English speaking manpower; export orientation, policy initiatives of the government and the wide network of expatriate Indians in the global customer organizations. In addition to these factors, there are a few contextual conditions that appear to have accelerated the process. Rapid advances to information technology and its convergence with communication technologies gave rise to a few growth accelerators. Some of these accelerators were in the form of new opportunities (*Y2K and the Internet) and some were in the form of new business models (offshore development and remote services).

Software Technology Parks (STP)

The Software technology Parks (STP) scheme became operational in 1988. It comes under the Department of Electronics of the Government of India, but functions as an autonomous body. Its purpose is to encourage and support small software exporters, by giving 100 per cent export-oriented firms a tax-free status for five years within the first eight years of operation. In addition, it provides them with office space and computer equipment, access to high-speed satellite links and an uninterrupted supply of electricity. The STP scheme also provides services such as import certification, software evaluation, project approvals, market analysis, marketing support and training. Established firms that are 100 per cent export-oriented can also apply to become software technology parks to enjoy the benefits of the tax-free status and the duty free import of hardware, in addition to access to telecommunications infrastructure.

Further advantages of the scheme include "single window clearance" for projects. For the smaller projects, i.e. less than Rs.30 million only STP clearance is required. STPs are connected by an integrated network, soft NET, whereby subscribers can lease a point to point digital 64 kbps channel, and have access to the Internet with their own TCP/IP number, which would give them e-mail, remote log in, and file-transfer services as well as access to the World Wide Web.

The STP facilities also provide video-conferencing services between Bangalore and the rest of the world. the export obligation amounts to "1.5 times the CIF values of the hardware imported including software _ 1.5 times the annual wage bill. The obligation on the hardware part will be fulfilled over a period of four years". Approximately 400 software companies

around India are involved in this scheme. STPs are currently located in Bangalore, Bhubaneswar, Delhi/Noida, Gandhinagar, Hyderabad, Pune

Since its inception in 1988, NASSCOM has played an important and active role in pursuing the interests of its members in the policy arena. NASSCOM is "an industry association representing the interest of computer software and service companies in India". Its members include companies "which are incorporated and/or registered in India, which have made and will make positive contribution to the computer software industry and a good track, record in business operations, strong financial commitment and significant local value added component in the products and services offered".

Software Industry in Budget 2008

The Union Budget of India for the year 2008-2009 was announced on 29th February 2008. Information technology- the sunshine industry of India, has been registering tremendous growth over the years. New budgetary allocation and new policies for the development of the Indian software industries and its allied sectors was a major focus area of budget 2008. The Indian Rupee appreciation factor and the rising wage issue have been taken into account during the latest Union Budget of India.

The apex body- NASSCOM and the IT-BPO industry of India have responded positively to the Union Budget 2008-2009. The Department of Information Technology (DIT), under the Ministry of Information Technology, Government of India has been allocated Rs.1,680 crores in 2008-2009. Further, three new schemes have been announced for the development of IT in India. Two schemes for the establishment of one lakh broadband Internet enabled 'Common Service Centers' in rural areas and another scheme called 'State Wide Area Networks' (SWAN) have been announced. The former scheme is supposed to get assistance from the central Government. A third scheme for the 'State Data centers' has been announced with a budgetary allocation of Rs.275 billion. The IT and ITES sector of India is expected to benefit from increased spending on education as allocated in the Indian Union Budget 2008-2009, since this is expected to add to the present talent pool of India. The tax regime for the Indian information technology sector has been broadened in the Indian Union Budget 2008-2009, since this is expected to add to the present talent pool of India. The tax regime for the Indian information technology sector has been broadened in the Indian Union Budget 2008-2009. Customized Software will attract 12 per cent service tax from the financial year 2008-2009. Further, there has been an increment of Excise Duty from 8 per cent to 12 per cent for packaged software.

The success of a country and its economy to a large extent depend on the performance of its corporations. So it is imperative to evaluate the performance of the corporate sector. The performance of a company can be analyzed in many ways. It can be judged in respect to market place, technology, adoption, competitiveness, environmental protection and strategic positioning

Net Profit Margin

This ratio also indicates the firm’s capacity to withstand adverse economic conditions. This ratio is measured by

$$\text{Net Profit Margin} = \frac{\text{Profit after tax}}{\text{Sales}}$$

Return on Investment

As this ratio reveals how well the resources of a firm are being used. Higher the ratio, better are the results. It can be computed as

$$\text{Return on Investments} = \frac{\text{Earnings before interest and tax}}{\text{Total Assets}}$$

Current Ratio

Current ratio is the most common yardstick for measuring liquidity. It expresses the relationship between current assets and current liabilities. The basic point underlying the computation of this ratio is that it measures a firm’s short-term solvency. It can be calculated as

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

CAPITAL STRUCTURE

It is therefore necessary that correct estimate of the current and future need of capital be made to have an optimum capital structure, which shall help the organization to run its work smoothly and without any stress.

Factors Determining the Capital Structure

Every time the funds are method, the financial manager has to study the pros and cons of the various sources of finance so as to select the most advantageous capital structure. The factors influencing the capital structure are discussed as follows.

Cost of Capital

Every rupee invested in a firm has a cost. Cost of capital refers to the minimum return expected by its suppliers. The capital structure should provide for the minimum cost of capital. The main sources of finance for a firm are equity, preference share capital and debt capital.

Legal Requirements

The government has also issued certain guidelines for the issue of shares and debentures. The legal restrictions are very significant as they lay down a framework within which capital structure decision has to be made.

Corporate Tax

High rate of corporate taxes on profits compel the companies to prefer debt financing, because interest is allowed to be deducted while computing taxable profits. On the other hand, dividend on shares is not an allowable deduction for that purpose.

Government Policy

Government policy is also an important factor in planning the company’s capital structure. For example a change in the lending policy of financial institutions may mean a complete change in the financial pattern.

Debt Equity Ratio

The relationship between borrowed funds and owner’s funds is

a popular measure of the long-term financial strength of a firm. This relationship is shown by debt-equity ratio. There is no particular rule of thumb for this ratio. An acceptable norm for this ratio is considered to be 2:1.

A high ratio shows that the claims of creditors are greater than those of owners. A low debt equity ratio implies a greater claim of owners than creditors. From the point of view of creditors, it represents a satisfactory capital structure of the business since a high proportion of equity provides a larger margin of safety for them.

$$\text{Debt Equity Ratio} = \frac{\text{Total Debt}}{\text{Net Worth}}$$

Liability to Asset Ratio

This ratio indicates the relationship between the total liabilities to outsiders to total assets of a firm. The lower the ratio, more satisfactory or stable is the long term solvency position of a firm.

$$\text{Liability to Asset Ratio} = \frac{\text{Total Liabilities}}{\text{Total Assets}}$$

Interest Coverage Ratio

A higher ratio is desirable but if it is too high that indicates that the firm is very conservative in using debt. A lower ratio indicates excessive use of debt. The firm should make efforts to improve the operating efficiency, or to retire debt to have a comfortable coverage ratio.

$$\text{Interest Coverage} = \frac{\text{Profit before Interest and Tax}}{\text{Interest}}$$

COST OF CAPITAL

The cost of capital of a firm is the minimum rate of return expected by its investors. It is the weighted average cost of various sources of finance used by a firm. The capital used by a firm may be in the form of debt, preference share capital, retained earnings and equity shares. The concept of cost of capital is very important in financial management

Significance of Cost of Capital

The concept of cost of capital is very important in the financial management. It plays a crucial role in both capital budgeting as well as decisions relating to planning of capital structure.

As a Basis for Taking Other Financial Decisions

The cost of capital is also used in making other financial decisions such as dividend policy, capitalization of profits, making the rights issue and working capital.

Computation of Cost of Capital

Cost of Equity

It is the return required to be earned to retain the existing equity capital in the capital structure. Hence the cost of equity is calculated as

$$H_e = \frac{E}{P}$$

Where

H_e - Cost of equity

E - Earnings per share

P - Market price per share

Cost of Debt

The cost of debt is the rate at which the lenders would be satisfied. Payment of interest enjoys tax shelter, so it is the after tax cost which is more relevant. It is computed as follows

$$H_d = \frac{NP}{(1 - T)}$$

Where

H_d - Cost of debt after tax

I - Interest

NP - Net proceeds of long term debts

T - Tax rate

Here tax rate is assumed as 50%

GROWTH

The financial executives perceive growth as the end force that gears up the productivity of every organization. Growth is the increase in the size and activities of a firm in the long run indicating the level of efficiency of performance of any business.

Factors Influencing Growth

Corporate growth is influenced by both internal and external factors prevailing in an economy. The internal factors relate to operating performance levels of the company. The government policies and regulations, competition and changing demand trends, as well as other external factors are divergent and complex to the corporate to tackle the outcome.

Profit Margin

'P' in the model represents the net profit margin that defines the relative efficiency of the firm after taking into account all expenses and income taxes (except extraordinary charges). This ratio is particularly important to operating strategy and its ability to control operating costs. It indicates the firm's capacity to face adverse economic conditions such as price competition, low demand, cost cutting etc. Obviously higher the ratio the better is the profitability. While interpreting the ratio,

$$\text{Profit Margin} = \frac{\text{PAT}}{\text{Sales}}$$

Retention Ratio

In the model 'b' denotes the fraction of retained earnings in the business, which is expressed as one minus the dividend payment ratio (1 - d). Hence, higher the profits retained lower would be the dividend payout and vice versa. The retention Rate 'b' reflects the management's attitude towards of distribution of profits. It is a significant ratio as the profit ploughed back enables a company to grow and pay more dividends in future.

B = (1 - Dividend payout ratio)

Asset to Equity Ratio (Leverage Ratio)

A/E indicates the Leverage Ratio in the model. A company increases its financial leverage when it raises the proportion of debt relative to equity used to finance the business. The ratio indicates the proportionate claim of owners and the outsiders against the firm's assets. In addition, businesses, which have diversified portfolios of readily saleable liquid assets, can also safely use more financial leverage.

$$\text{Asset to equity ratio} = \frac{\text{Assets}}{\text{Equity}}$$

Asset Turnover Ratio

'A' in the model is the Asset Turnover ratio. This ratio measures the sales generated per rupee of assets. It measures asset intensity, with a low asset turnover signifying as asset intensive business and a high turnover the reverse.

$$\text{Asset turnover ratio} = \frac{\text{Sales}}{\text{Assets}}$$

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