CHAPTER I

INTRODUCTION

1.1 Background:

Nepal is a developing country. Agriculture plays a dominant role. More than 70 % of the people are engaged in the agriculture. It contributes about 40 % to the total GDP. Realizing the importance of industrial development, government initiated the economic reforms during last decade. The extent of development of any country is reflected by the development of financial sector of that country. The financial sector is a vast field, which comprises of banks, co-operative societies, insurance companies, financial companies, stock exchange, foreign exchange market, and mutual fund etc. or in other word: financial institutions. Financial institutions refer to organizations that act as agents, brokers, and intermediaries in financial transactions. These institutions facilitate and improve the distribution of funds, money, and capital by providing services like payment mechanism, security trading, transmutations, risk diversification and portfolio management. Further, these institutions mobilize saving and make investment in different enterprises of the national economy that consequently help in reducing poverty, raising employment opportunities and thereby developing the society and country as a whole.

In spite of growing role and importance of financial institutions, the development and growth of financial institutions in Nepal were not encouraging till mid eighties. Only two commercial banks and six special purpose financial institutions represented the whole institutional base of financial sector in Nepal. The situation was not expected in that period when the government had a policy of absolute prohibitions of free banking and financial institutions.

The situation however changed since mid eighties when the government embarked on financial liberalization program with liberal attitude towards free entry of financial institutions in Nepal. In a period of about decade, a number of commercial banks, finance companies, insurance companies have come into existence.

The concept of finance company is recent emergence in the context of Nepal. Finance companies are the effective instruments for mobilizing public, private and external financial resources and channelizing them in to productive areas as short-term loan and long-term loan in different commercial business activities. Being financial intermediaries, they accept deposit and allocate them in different sectors in the economy. In this sense, they are similar to commercial banks. In the context of Nepal, scope for opening finance companies emerge as only the commercial banks are not getting able to supply credit timely to Nepalese entrepreneurs and they pay less attention towards small projects. Finance companies have established not only to serve with less complicate procedures but also to carry out capital market activities. However, they differ in some other aspects. Unlike commercial banks, finance companies are not allowed to operate checking accounts and hence not involved in payment mechanism. The exact scope of operation of finance companies differs from country to country. In developed countries like the United States, for example, the scope of operation of finance companies is limited to sales finance, consumer finance and business finance activities. Even in India, finance companies are differentiated as hire purchase companies, leasing finance company and housing finance company etc. for regulatory purposes. In Nepal, there is no such function-based classification of finance companies. “Any public limited company established with the objective of carrying out financial transaction is known as finance company.” (Finance Company Act; 1985)

Financial transaction includes hire purchase or installments, housing finance, leasing finance, term lending, deposit mobilization, merchant banking, underwriting and syndication and trading on securities. In this sense, any public limited company licensed under finance company act 1985 to carry out any one or all of the above financial transaction is able to accommodate varieties of financial institutions as finance companies. Such broader definition is helpful to bring different types of financial institutions under one regulatory umbrella.

Finance companies help to strengthen the economy. It helps to collect the scattered small deposits and utilize them in productive areas. Hence, it helps to link between the small savers and the capital seekers. Finance companies work as an intermediary between them. When the options finance company act 1985 and democratic movement 1989 has come, his majesty government has formally adopted economic liberalization policy. This policy has given more emphasis to the private sectors and international investors to invest in Nepal as encouraging factor of sustainable economic growth. The new policy has already resulted that the establishment of finance companies is an encouraging trend. The main objective of Finance companies is to collect deposits and provide loans and also mobilizing scattered savings through various schemes and deploy them in different sectors of economy for economic development of the country.

Finance companies are the limited liability companies engaged in money lending activities mainly to support the purchase of consumer durables such as vehicles, television, refrigerator etc on hire purchase credit and also provide short to medium term business finances and even to perform merchant banking activities like share issue management, bank guarantee, merger, acquisition etc. The aim of Finance company act 1985 is to guide the economy in right direction as giving services where commercial banks and other financial institutions mentioned above are not available.

Economic liberalization policy of the government has encouraged the establishment and growth of finance companies in the country within a short span of time. In a situation when the existing financial institutions especially commercial banks are unable to supply credit timely and carry capital market activities, finance companies have come timely to meet the individual credit needs, undertake merchant banking functions also to curtail the operations of Upahaar and Dhukuti program. However, Finance companies are not free from problems. Most investors have not developed full confidence of putting money in fixed time deposit certificate of various maturity and sizes. Moreover, the liquid funds maintained by these financial companies vary from each other. The loan loss provision as required to be maintained as per NRB guidelines by most of the finance companies still seem to be not adequate.

At the same time, the financial performance of finance companies varies from each other in terms of their profitability, dividend payment and market prices.

At the end of FY 2008/2009, there are altogether 78 listed finance companies in NEPSE. Among them, there are 58 finance companies are in operation. Finance companies can be registered only as a public limited company as per the rule of Finance Company Act, 1985. The company should be registered with HMG/Nepal and license for operation is granted by central bank i.e. NRB. All the finance companies should follow directives and policies of NRB. In fact, NRB is to protect and regulate the finance companies.

Statement of the problem:

For the economic growth of a nation, proper utilization of available resources in efficient manner is highly necessary. The major problem of developing country like Nepal is the problem of economic growth with stability. Due to various factors, the economic activities have been highly fluctuating. The frequent change in growth rate had made the economic activities unpredictable.

When government introduced the liberalization policy many banks, financial institution and other institution are established rapidly. These days many commercial banks, developments banks and financial institutions are operating their work to assist in the process of economic development in the country. Due to the high competition between the financial institutions, the collected huge amount from public is comparatively lower than fund mobilization and investment practice of collected funds. So, it raised the problems of investment and proper mobilization of collected funds. Strong fund mobilization activities play a vital role in utilization of collected funds and overall development of economy of the nation.

Sustainability and growth of any business highly depend on its market demand. With the economy having recessionary phase with negative gross domestic product and liquidity with public is quite low, the performance of the finance company too showed slump during recent years. The decline in business activities, lack of proper investment opportunities, poor financial performance, high competition, lack of capital resources,

lack of skilled manpower, political instability, lack of security, lack of proper regulation and supervision by the central bank and very low rate of loan recovery has affected the business of the finance companies, which gradually leads the trend of decreasing their investment and the ongoing economic downturn is affecting their sustainability. The impact of the declining performance of the finance company is visible in Nepal Stock exchange index (Nepse index). This is a serious matter and may turn to be disastrous for financial sector and thus for whole country. In practical term, criticism on the growth of finance companies is an inescapable reality. Such criticism, largely, is the direct outcome of events following experience and lessons learned from past mistakes. There are frequent hot news about the ways followed and impacts predicted regarding the uncontrollable growth in number of finance companies within a short span of time. In this context, there raise the important questions regarding demand of finance company in future, which is a vital issue concerning prospect of such companies. Since the individual credit needs are expanding, finance companies are expected to have good opportunity as the industry is gaining more and more experience and public confidence. Mobilization of deposits by the old and newly emerging finance companies are coming up with positive signals of growth both in terms of volume and speed of deposits. Nevertheless, there is no denying the fact that finance companies have to gain the confidence of depositors further with better performance and funds utilization to generate adequate cash flows from investment and lending function to ensure timely repayment of obligations.

1.2 Objectives of the study:

A financial market in Nepal is gradually developing and hence it is challenging. Rapid changing technology and increasing globalization are dramatically transforming financial policies for the markets. As a result, numbers of new finance companies are emerging. History of finance company in Nepal reaches to a decade. So it is a right time to reevaluate their performance and think about their prospect.

The main objective of the study is to find out and analyze the problems and prospects of finance companies in Nepal. The objective can be stated as follows:

a) To study and compare the annual deposits collected, annual investment and annual loans and advances those are being practiced by the finance companies in Nepal.
b) To forecast the total deposits, total loans and advances, total investment and profitability of finance companies in Nepal that is determining factor for the prospects of the finance companies in Nepal.
c) To compare and contrast the financial performance of selected finance companies with the industry performance.
d) To study on problems and prospects of finance companies on the basis of financial performance of the companies.
e) To suggest and recommend measures for better prospects of finance companies on the basis of analysis of data.

1.3 Significance of the study:

It is undisputable fact that the development of finance companies plays a vital role in economic development of the nation. If this sector is promoted on efficient line, it can held out prospects of higher purchasing power, increase employment, full utilization of resources and finally increase efficiency and modernization in the country.

Nepal is one of the least developed countries in the world. Economic liberalization policy of the government has encouraged the establishment and growth of finance companies in the country within a short span of time. There is considerable heterogeneity in the size of operations and the performance of finance companies. There exists large and small, profitable and loss making, fast growing and sluggish finance companies. In this context, finance company cannot be apart from providing supportive role in economic development activities.

So for the promotion of the finance companies, their problems should be identified. After the identification of the problems, these problems can be eliminated by the application of proper mechanism and the prospects of the finance companies can be increased.

Proper research is needed in this sector to acquire answers for the various questions like those raised in the statement of problems regarding the prospect of finance companies in Nepal. It is believed that the study may prove itself to be one of the helping papers for concerned parties like government, policy makers, existing companies and new comers, Nepal Rastra Bank etc. Moreover this study will assist to the further researcher and interested persons to acquire knowledge about finance company in Nepal.

1.4 Limitation of the study:

a) Listed finance companies have many problems and prospects but this study is focused on major problems and prospects of listed finance companies on the basis of financial performance.
b) Data of only past 5 years have been collected and analyzed.
c) Presentation and analysis of data is fully dependent on the accuracy of the data provided by the respected organizations and respondents.
d) Future prospects of finance company of Nepal does not only depend on intra company factors but also factors like Global, Asian and neighboring countries economic conditions. The influences of these factors are not considered during the analysis.
e) The study mainly focuses on the past and present state of finance companies, so the study may not provide hard and fast conclusion about the future prospect of finance companies in Nepal.
f) Comparison of selected companies with the industry is done on only some of the financial ratios due to lack of availability of aggregate data.

1.5 Organization of the study:

This section deals on how the whole thesis has been structured. This consists of

Chapter 1: This chapter contains the background of the study, statement of the problems, objectives of the study, significance of the study and limitation of the study.

Chapter 2: This chapter presented review of literature where some past related research works, articles, discussion papers are reviewed.

Chapter 3: This chapter explains the research methodology used in this research to find the result for meeting the objectives set in the chapter one.

Chapter 4: Chapter four deals with the analysis of collected data i.e. primary as well as secondary data. First part of this chapter deals with analysis of secondary data and second part includes the analysis of primary data collected from the respondents.

Chapter 5: Finally, in chapter five, whole study is summarized and the findings and conclusions are drawn. Recommendations based on analysis of data are made to solve the research problem.

CHAPTER II

REVIEW OF LITERATURE

2.1 Theoretical framework:

The theoretical framework is the foundation on which the entire thesis is based. It is a logically developed, described and elaborated network of associations among variables that have been identified through such process as interviews, observation and literature survey; these variables are deemed relevant to the problem situation.

2.2 Conceptual framework:

The term finance is not a new topic in today's world. Finance is a very important and essential in everybody's life. Certainly it deals with money matters. Finance is a science of money. It has far reaching impact on other sectors as well.

Many people in many ways have defined the term finance. According to Howard, "Finance may be defined as that administrative area or set of administrative functions in an organization which relate with the arrangement of cash and credit so that the organization may have the means to carry out its objective as satisfactorily as possible." This definition is only concerned with the collection and proper arrangement of fund, which is necessary in the business activities.

The finance company is defined by the dictionary of modern economics as "A financial intermediary not a bank which may obtain fund from its own capital resources by accepting deposit (usually for fixed periods) or even by borrowing from other institutions which it then lends for variety of purpose, especially to finance hire purchase contracts but also leasing."

Finance companies are financial institutions, which plays a significant role in the development of the country. It has been subjective of growing importance and facilitates to provide employment as well as consume funds and helps to increase purchasing power, which develops standard of living. Finance is one of the leading sectors for economic

development. The world economic activities trends are affected by open market policy and liberalization policies of the government. Economic liberalizations policy has to create the environment for the establishment, growth and development of financial institution in the world.

Financial institutions can be broadly classified into two types namely: Banking and Non-banking. Bank is an organization normally a corporation charted by the state or federal government. Non-banking financial institution is defined as any institution other than bank that provides financial services and makes loans to business or individuals. Finance companies perform banking activities that collect deposits and invest such deposits into productive sectors by means of loans and advances. "Financial institution facilitates the savings and borrowings process and doing so maximizes the wealth of the institution owners. Unlike non-financial business that enter the money and capital markets to satisfy only their own needs, institutions deal in the financial markets to satisfy the needs of other business. Money is regarded as a commodity that is borrowed and lent to facilitate the timely employment of real economic resources. Money is brokered, refined and accounted for by financial institution just as wheat; oil and ores are processed and traded by non-financial business." (Edmister, et al; op cit.: 4)

2.2.1 Financial Markets

Financial markets play an important role in capitalist economy by facilitating intermediation between savers and investors. The better they perform that service, the more likely it is that savers will be motivated to supply capital, thereby reducing its cost to investors, who themselves will be motivated to seek capital. By facilitating intermediation, well functioning financial market increase investment or saving rates, which translate into higher rates of economic growth.

For that reasons, it is important that financial markets be well organized and regulated. In economics, where markets have not developed, capital shortages inhibit development. Economists realize the importance of financial market and hence separate field of specialization have emerged in order to study these markets.

The financial system facilitates lending payments and trade in risks. It does so in two distinct ways, through financial intermediaries and through organized mechanism. The most effective use of idle and surplus resources can be brought into practice only by means of organized market mechanism. Resources mobilization is assumed to be vital and challenging work in the present day's world economy. In this era of financial, economic and political liberalization, the task is more complicated than before. The developed countries have a long history of industrialization and simultaneously development of other field. But developing countries like ours have no long history of industrialization and thus we are just tackling our steps towards free market economy. In this regard development of financial markets was new emerged in our context.

"The Nepalese financial sector is composed of banking sector and non-banking sector. Banking sector comprises of Nepal Rastra Bank and commercial banks. The non-banking sector includes development banks, micro-credit development banks, finance companies, co-operative financial institutions; non-government organizations performing limited banking activities. Other financial institutions comprise of insurance companies, employee's providend fund, citizen investment trust, postal saving offices and Nepal stock exchange." (Banking and financial statistics; 2008)

2.2.2 History of Finance Company in Global Context:

Financial activities play the vital role for the development of the nation as well as the world economy. Increasing trend of open market policy, liberalization policies of the government and rapid development of information technology has narrowed down the world. Economic liberalization policy has created the environment for an open international market and overwhelming growth of banking and non-banking financial institution

Initial step to organized financial services originated from the establishment of the *First Investment Bank* began in Philadelphia, USA in 1764. The first commercial bank," The Bank of North America", opened in the same city in 1781. Then the first investment company, "The Massachusetts Hospital Life Insurance Company", was founded in 1816

in Boston that is usually designated as the first *Saving Bank Insurance Company* that is an old as the country itself. Mutual Life Insurance companies first began operation on the 1940s. The Postal Saving System, Credit Unions and funding systems are all products of the 20th century. (Kenneth; 1992:63)

"Finance company is recent innovation in South Asia and it was established, grew and developed from the Mid 1950s. The first group of finance companies was established in Philippines and Singapore but they are suffering from so many difficulties. Out of 58 finance companies established in Thailand, 56 collapsed in the decade of 1990AD leaving 15-20 thousands of their employees jobless. The companies had invested huge fund (borrowed from out of the country as well) in long term relatively, unproductive sectors like housing, real estate etc. but as Bhat devaluated against US dollar disastrously, they could go towards however else than to liquidation. But the companies those established in Hong Kong, Thailand and Malaysia have developed efficiently to accomplish their objectives and goals." (Idem; 1994:26)

"Most governments in South Asian countries have enacted legislation to protect both depositors and investors in this invested industry. In India these types of company used to operate without taking prior permission from central bank and thus there was question mark regarding guarantee of deposits made by the public. But nowadays the companies in India have to get license from Reserve Bank of India before starting their operation. Singapore and Malaysia have enacted protective legislation regulating all finance companies. The Hong Kong requires a banking license whereas in Philippines, they also allowed depositing general public as a result of the passage in 1963 of a 'Truth-in-lending act'." (Gold; 1994:42)

2.2.3 Establishment, Growth & Development of Finance Companies in Nepal

"There is a tremendous growth in the number of financial institution in Nepal in the last two decades. At the beginning of the 1980s when financial sector was not liberalized, there were only two commercial banks, and two development banks performing banking activities in Nepal. There were no micro-credit development banks, finance companies,

cooperatives and NGOs with limited banking transactions. After the liberalization of the financial sector, financial sector has made a hallmark progress both in terms of the number of financial institutions and beneficiaries of financial services." (Banking and Financial Statistics; 2008) "History of finance company in the global context is considerably longer in comparison to that in Nepal. Finance companies are a new type of institution in the Nepalese context. Need of Finance Company Act was felt because unorganized sector was collecting savings from general public in the name of Upahaar and Dhukuti programs. People showed great interest and enthusiasm in these programs but they were cheated by most of the organizers of the programs. Considering peoples' interest in such programs, benefit of mobilizing such savings in productive sector, inability of the banking sectors and to carry out capital market and merchant banking activities and to meet the consumers' need for credit, the government introduced Finance Company Act 2042. With the adaptation of a policy of gradual liberalization by the government following the restoration of democracy in 1990 and subsequent assumption of the political power by the democratic government in1991, a number of reforms have been pursued in the financial sector. However, no finance company was set up till 2049 B.S because the Act came into being only in 2049 with some amendments. Finance company in Nepal is governed by the Finance Company Act 2042 B.S (1985A.D). Finance companies have to be registered with the company registrar office and an application has to be made with NRB for obtaining license to operate in the kingdom of Nepal.

After the first amendments of Finance Company Act, 1985 in 1991 (2049 BS), in the month of Shrawan on that year, the first company, Nepal Housing and Development Finance Company, was established in government sector. The second came in Poush of the same year, Nepal Finance and Saving Company, putting its name as the first finance company to be operated from private sector. Within a period of four years 1991-1995, there had been 56 finance companies of various capital sizes registered in HMG company register office." (Shrestha; 1995:7)

"Till the end of fiscal year 2064/65 BS, there were all total 78 finance companies listed in Nepal Stock Exchange. Out of total, Nepal Share Markets Ltd, Nepal Merchant

Banking and Finance Ltd and Capital Merchant Banking and Finance Ltd were from finance side. Starting from the early 1990s, finance companies have been growing rapidly. However, majority of the finance companies are rendering their services in Kathmandu valley. Of the total finance companies, 47 are being operated in Kathmandu and the rest are being operated outside the Kathmandu. (Quarterly Economic Bulletin; 2008: Vol. 42) " In view of the growing number of finance companies registered and applying for license with NRB, a high level technical committee has been constituted for more detailed study and analysis of feasibility report submitted by finance companies under the leadership of NRB's deputy governor to accomplish the objective creating a more competitive environment in the financial sector. Based on the recommendations of this high level committee, policy framework and guideline will be published to help and direct the establishment of finance companies in the country, The recommendations of this committee will also help to determine basic eligibility criteria to be applied while issuing license to new finance companies and also in monitoring those already established and have started operations.

"Moreover, in Bhadra 2052 BS, with a view to protect the common interest of the members and to encourage collection and mobilization of scattered saving and its utilization in productive sectors by creating favorable investment environment to help the support in growth of the members within the country, *Nepal Finance Companies Association (NFCA)* a purely non-profit voluntary organization of the finance companies was legally established. The association has been providing common platform to the members for raising various relevant issues like development of credits norms to determine quality grading of finance companies, undertaking complementary approach to growth among the companies through mutual interest, improving the credibility of the companies and also taking the public matter seriously that the companies have to be profitable for rewarding the shareholders according to their expectations."

2.2.4 Types of Finance Companies

There are different views about finance companies in different countries. Most of the countries don't have clear cuts directions to the finance companies in terms of their

functions and area of coverage. However, finance act has mentioned certain areas of operations such as receiving time deposits of different maturity dates, providing loans for hire purchase, house construction, business and also undertaking merchant banking function such as share issue, management portfolio, management mutual fund, project counseling merger etc.

Generally, finance companies are categorized in two types according to their financial activities performed in different shape and structure, which are given below.

a) Sales Finance Companies
b) Consumer Finance Companies

a) Sales Finance Companies

"Sales finance companies are different from other consumer credit institutions by virtue of their indirect extension of credit. Sales finance companies typically purchase the installment contract the notes signed by purchases of consumer durable goods from the dealers involved. The other consumer credit sources deal directly with the borrower. Thus we can say that sales finance company acted as go between obtaining credit from commercial goods" (Ranlett; 1997:211)

b) Consumer Finance Companies

" The consumer finance companies are much more specialized than commercial banks and sales finance companies. In the early 1960's however some of the larger companies began to diversify their operation in USA. For example, Household Finance Corporation acquired a major interest on City Products Corporation, a large retail chain. Household earlier had acquired coast-to-coast store and bader paint and hardware stores. The largest consumer finance companies obtained more of their funds from banks than that do sales finance companies of similar size." (Ibid; 1985 214)

2.2.5 Contribution of Finance Companies towards National Economy:

Finance companies are a comparatively new scenario in the country, and they have to compete with other very well accepted financial institutions, including commercial bank and are practically made to fight against the prevailing public psychology that works

against finance companies. Finance companies are potential institutional tools of collecting and mobilizing funds for investment in the country. They are highly applicable to attract scattered saving, which provide investment opportunities to the small and medium savers. As intermediaries the finance companies help the process of resource mobilization. The government in turn is required to regulate their activities so that the financial policies are implemented as per the requirements of the country. Policies such as lending to the priority sectors, lending to generate self-employment, creation of entrepreneurship in the society are certain examples, which the government tries to implement with the help of financial institutions. With the rapid increase in the numbers of finance companies and the expansion of the financing business undertaken by them, the institutions are making hard efforts to leave no stone unturned to mobilize maximum capital resources.

"In Nepal, the growth rate of saving is very low and there is growing resources gap in Nepalese economy. Nepal has been obtaining foreign capital (in long term loan) to bridge this resource gap. Moreover, the country cannot depend on foreign loans forever. Therefore, financial development is indispensable to meet the growing demand for capital in the country." (Neupane; 1996:32-34). Finance companies are the effective scientific instruments for mobilizing public, private and external financial resources and channelise them into productive areas as short-term loans and long-term loans on different commercial business activities. The main objectives of finance companies is mobilization of small and large resources from urban as well as rural areas and their channelisation into prospective, structured and high priority areas to assist in the economic development of the nation. Moreover, the finance companies have to channelise funds by gradually shifting priorities from hire purchase and trading to productive industrial sector.

Finance companies help in expansion and growth of both small and medium scale industries that in turn helps in industrialization process, creating the market for industrial products within the country. They can help consumers to consume domestic products and at the same time help industries both in financing and creation of market for their products.

"The finance companies support industries for production and to consumers credit for consumption. The relationship between production and consumption's function is important to make credit worthwhile to have a meaningful contribution to the development of national economy. As industry grows on, the support and funding of finance companies and other economic indicators such as creation of employment, income generation and saving to recycle for further collection of deposits again for finance companies and credit to industries also gear-up. The process should repeat to have significant relationship between growth of finance companies and overall economic development on the other hand."

2.2.6 Sources and uses of Funds of Finance Companies

Finance companies obtain funds from their own capital resources, i.e., equity shares, preference shares, convertible debentures etc or from debt, i.e., accepting deposit from public, borrowing from other institutions etc. Beside these, a part of retained profit is also used in business.

In this context, NRB give permission to finance companies to raise funds equal to ten times of their net worth has come in handy. The sources of funds of finance companies are generally as follows;

a) Borrowings (from NRB, Commercial banks and Others)
b) Deposits
c) Capital fund (paid up capital, General Reserves, Other Reserves and Loan loss provision)
d) Transferred of Profit from Profit and Loss Account
e) Others.

Similarly, the uses of funds of finance companies are generally as follows;

a) Liquid funds (Cash in hand, Balance with NRB and Balance with Domestic Banks)
b) Investments (Government securities and other)
c) Loans and Advances (Hire purchase loan, Housing loan, Term loan, Lease finance, Fixed Deposit Receipts and others)
d) Others

Worldwide, the main source of funds for finance companies is commercial banks, especially leasing companies. In Nepal debenture issue of tradable instruments and money market sources are largely untapped and carry immense potential as source of funds.

Banking institution and finance company are competing for the same source of funds. Finance companies are a new scenario and only traditional sources of fund exit for both finance companies as well as commercial banks and new source are yet to be developed. Thus, finance companies have to aware about various avenues for sources of funds.

2.2.7 Objectives and Services of Finance Companies

“Finance companies exist with meaningful purpose. The main objectives of finance companies are

a) To design for customer and help to execute the appropriate investment portfolio.
b) To design for the investors business or venture the optimal capital structure and help them raise the capital i.e. the adequate capital formation for overall national development.

Beside these, finance companies should redirect thinking in the line in developing industry by financing the expansion and growth to both small and medium scale industries. Then by creating the market for industrial products within the country. They can finance consumers to consume domestic products and at the same time creating market for their products.

Finance companies provide different types of services to people and institutions as demanded by the market. However, there are certain specific functions, which are mentioned below.

1) Financial services

a) Resource Mobilization
b) Fixed deposit Scheme
c) Real State Financing

d) Asset Financing
e) Inter company deposits
f) Term loan

2) Investment Banking Services
a) Stock brooking
b) Trading and market marketing
c) Fund management scheme
d) Equity research
e) Portfolio management
f) Structural income schemes

3) Banking Merchant Services
a) Issue management
b) Underwriting issues
c) Bridge finance
d) Equally placements
e) Co-operative advisory services
f) Project counseling

4) Leasing
a) Finance lease
b) Operating lease

Other general services performed by finance companies are as follows.
a) They explore and innovate new business opportunities such as venture financing, managing investment plans etc.
b) They collect and mobilize small and large-scale deposits that are institutionally spread.
c) They prepare investment and credit strategy to the productive industrial sector.
d) They finance firm and industry by using the deposit in the form of loan.

e) They provide different alternatives to depositors enabling them to deposit according to their needs and preferences."

'One important thing to be considered by finance company is that they have to generate income from free based activities rather than always depending upon fund based activities. Those include broad range of merchant banking functions, such as project planning, corporate counseling, loan syndication through underwriting and bridge financing, issue management, individual investment portfolio management, mutual fund, venture financial leasing, merger and acquisitions, brokerage and management consultancy services etc.'(Shrestha; 2052 B.S: 1)

2.2.8 Difference between finance companies and Commercial banks (including other financial institutions)

Prof. Dr. Manohar Krishna Shrestha argued that the line of demarcation between finance companies and commercial banks including other financial institutions exist given the functional declinations in various respects such as these:

a) Size Versus Potentiality:

In terms of size and resource base, finance companies are very small compared to commercial banks and other financial institutions. But in terms of potentiality and financial services, finance companies are faster in delivery of financial services.

b) Debt versus Equity related activities:

Because of differences in approaches and attitudes, commercial banks and other financial institutions basically deal with debt and debt related finance as their activities are arrayed towards credit proposals, credit appraisals and loan sanctions. But in contrast,

Finance companies have sphere of activities dealing with equity and equity related finance since their power lies in raising funds from capital market but with backing of credit line from commercial banks.

c) Slow versus quick delivery of financial services:

Moreover, the differences between finance companies and commercial banks including other financial institution lie in the delivery of financial services in market because the activities of finance companies have decisive impact on growth, stability and liquidity of capital and money market both in secondary and primary markets as they manage underwrite and support public issues with willingness to task risk compared to commercial banks that consider these function secondary and undertake only in case there are no inherent risk involved.

d) Assets versus Management orientation:

Commercial banks and other financial institutions is asset oriented and their lending decisions are guided by detailed credit analysis, as they are generally risk avoiders. But finance companies are generally management oriented and are willing to accept risk of business by placing greater emphasis on the growth, management and cash flows from the prospective clients that they finance.

e) Borrowing versus Deposits collections:

Commercial banks and other thrift institutions obtain most of their funds by issuing time, saving and demand deposits while finance companies tap majority of their funds in large amount by borrowing directly from commercial banks and other financial institutions or by selling securities in capital and money markets.

f) **Small deposits, large loans versus large borrowing small loans:**

Commercial banks and other financial institutions pool relatively small deposits and make relatively large loans. But in contrast, finance companies secure of borrowing large amount and provide loans of widely varying sizes. Even the consumer loans would be relatively for small amount.

g) Risk- Avoiding versus Risk Taking:

Commercial banks and financial institutions do not venture to take risks unless adequately covered by securities and return while finance companies venture to manage

risks by mobilizing funds from non-risk taking banks and financial institutions. In fact, finance companies tend to enter such fields or potential areas while commercial banks and other financial institutions hesitate to enter.

h) Less versus more regulations:

Finance companies are not very much strictly regulated like that of commercial banks and other financial institutions although they do suffer from policy inconsistencies, procedure lapses and inadequacy of guidelines.

i) Low versus high net worth:

Finance companies have low net worth base compared to commercial banks and other financial institutions.

j) Consumptions versus production linkage:

Finance companies are basically targeted to meet a wide variety of consumption loan by creating demand for industrial products although loan also goes for business and industries but commercial banks and other financial institutions provide loan for produce means of production to encourage capital formations in the country.

k) Dynamic versus Traditional lending:

Finance companies management have come under increased pressure from gradual changes in the regulatory and institutional structure to have a dynamic and considerable shift in their assets portfolio from consumer lending to business lending compared to commercial banks and other financial institutions. Moreover, finance companies due to rising costs may come under regulatory restrictions coupled with binding interest rate ceilings and reduce their profitability.

l) Financiers versus financial Architects or engineers:

Commercial banks and other financial institutions simply acts as financiers but finance companies are more than that to act as financial engineers and architects. It is because every time commercial banks and other financial institutions strive on financial muscles

while finance companies depend much on the strengths of the ability to anticipate, innovate and discovery of new ideas.

2.3 Review of related studies:

2.3.1 Review of Policy Documents:

Directives of Nepal Rastra Bank (www.nrb.org.np)

i) Legal Framework:

Prior to the promulgation of *Bank and Financial Institutions Ordinance* (Popularly known as Umbrella Act), the operations of Bank and Financial Institutions were governed by different Acts. For example:

Institutions	***Act:***
Commercial Banks	Commercial Banking Act
Finance Companies	Finance Companies Act
Development Banks	Development Banking Act
Agriculture Development Bank	Agriculture Development Bank Act
Nepal Industrial Development Bank	Nepal Industrial Development Bank Act

With the promulgation of the new ordinance, all these Acts has now been repealed. Now all the operations of these institutions are governed by the ordinance. However, the existing institutions has been given a maximum period of two years to bring themselves within the confinement of the new ordinance.

The main features of the new ordinance are as follows:

1. All the institutions have been grouped under 4 categories. They have been given the names of Class A, B, C and D.
2. All institutions, before they start operations, are required to take license from Nepal Rastra Bank.
3. Although it has not been spelt out clearly, however, looking at the permissible functions for each category of classes, one can presume that the existing commercial banks will be given the class A license. Similarly, the existing development banks

will be provided class B license. *Finance Companies* and Micro Credit Providing Institutions will be provided with *class C* and class D respectively.

4. Institutions, which have been given the license of Class A, only can use the word Bank in the name. All other license holder i.e. Class B+C+D will have to use the word Financial Institutions in their names.

5. Provisions have been made under which, license holder can move upward (like from D to C, C to B and B to A). However, before they apply for such promotion, they will have to comply with the regulation/ guideline/ directives/ conditions specified by Rastra Bank for this purpose. These are:
   (a) In case it possesses the capital prescribed by the Rastra Bank for a licensed institution of a higher class.

   (b) In case it has been able to earn profits continuously for the past five years.

   (c) In case its total non-performing loan is within the limit prescribed by the Rastra Bank.

   (d) In case it has met all the conditions prescribed by the Rastra Bank.

6. Similarly, institutions could be demoted also, if they fail to comply with the regulation/ guideline/ directives/ conditions specified by Rastra Bank. These are:
   (a) In case it has failed to raise the capital as prescribed within the period prescribed by the Rastra Bank.

   (b) In case it has been continuously incurring losses for the past five years.

   (c) In case it has been subjected to action for having repeatedly violated the directives issued by the Rastra Bank.

   (d) In case it has failed to maintain a risk-bearing fund as prescribed by the Rastra Bank.

However, there is no provision for demotion from Class C to Class D. It is mainly because, Class D has been established for delivering Micro Credit. So it will not make any sense in demotion from Class C to Class D. Once Class C license holder fails to comply with the stipulated condition, their license will be revoked.

7. What are the functions that each category of classes can perform has now been spelt out clearly in the law itself. So the confusion/duplicity, which was there in earlier laws, has now been avoided.
8. How much capital is required for each category of institutions however has not been spelt out in the Law. It has been left to Rastra Bank for specifying. So the required capital amount will be as per the directives issued by Rastra Bank from time to time.

9. The number of Directors Financial Institutions can vary between minimum 5 and maximum 7. However one Director will have to be chosen from the list of professional specialists. This list will be prepared and made public by Rastra Bank.

10. Provision has been made in the ordinance for voluntary merger between two license holders. However, it requires Rastra Bank approval before becoming effective.

11. All the Banks and Financial Institutions have to comply with the Directives/ Guidelines/ issued by Rastra Bank from time to time. Otherwise, they will be subject to Rastra Bank actions. The areas of such actions could range from monetary penalty to suspension of the Board of Directors to the repeal of the license.

ii) CAPITAL ADEQUACY NORMS

1. MAINTENANCE OF MINIMUM CAPITAL FUND

Effective from F.Y. 2063/64 (2006/07) the licensed institutions shall maintain minimum capital fund on the basis of their risk-weighted assets, as follows:

Institutions	Required Capital Fund on the basis of weighted risk assets (in percentage)	
	Core Capital	Capital Fund
"A","B" and "C" Class	5.5%	11.0%
"D" Class	4.0%	8.0%

2. ACTIONS FOR NOT COMPLYING THE DIRECTIVES RELATING TO CAPITAL FUND

Where any finance company does not maintain minimum Capital Fund, any of the following actions may be initiated:

(a) Suspension of opening new branch.

(b) Suspension of access to refinancing facilities of Nepal Rastra Bank.

(c) Restriction on lending activities of the licensed institution.

(d) Restriction on acceptance of new deposits.

(e) Any actions may also be initiated under Section 100 of Nepal Rastra Bank Act -2058.

iii) MAINTENANCE OF LIQUIDITY

(i) Finance companies shall maintain 2 percent of their Total Deposit liabilities.

(ii) Penalty shall be imposed in case the balance to be maintained as above falls short, as follows:

(a) For first time shortfall in maintaining the mandatory balance, at the rate percentage of existing bank rate on such shortfall amount.

(b) For second time shortfall in maintaining the mandatory balance, at double the rate percentage of the existing bank rate on such shortfall amount.

c) For third time and successive shortfalls in maintaining the mandatory balance, at triple the rate of the existing bank rate on such shortfall amount.

iv) LOAN CLASSIFICATION AND PROVISIONING.

Finance companies shall classify the loan and advances in following rules:

CLASSIFICATION OF LOAN AND ADVANCES

(a) PASS

All Loans and Advances the principal of which are not past due or past due for a period up to 3 (three) months shall be included in this category.

(b) SUBSTANDARD

All loans and advances the principal of which are past due for a period of more than 3 months and up to 6 months shall be included in this category.

(c) DOUBTFUL

All loans and advances the principal of which are past due for a period of more than 6 months or up to 1 (one) year shall be included in this category.

(d) LOSS

All loans and advances the principal of which are past due for a period of more than 1 (one) year shall be included in this category.

LOAN LOSS PROVISIONING

(1) The loan loss provisioning on the outstanding loans and advances and bills purchases shall be provided on the basis of classification made as per this Directives, as follows:

Classification of Loan	Loan Loss Provision
Pass	1 Percent
Substandard	25 Percent
Doubtful	50 Percent
Loss	100 Percent

v) SINGLE BORROWER OBLIGOR LIMIT

1. FIXATION OF LIMIT ON CREDIT AND FACILITIES

Finance companies may extend to a single borrower or group of related borrowers the amount of FUND BASED loans and advances up to 25 percent of the Core Capital Fund and NON FUND BASED off-balance sheet facilities like letters of credit, guarantees, acceptances, commitments up to 50 percent of its Core Capital Fund. Fixation of limit on credit and facilities to single borrower shall be made on the basis of Core Capital Fund as per the latest quarterly balance sheet certified by the Internal Auditor of concerned institution. The Fund-Based loan and Non-Fund Based facilities are separate and accordingly the single borrower limit shall not be calculated by aggregating the both. For this purpose, the definition of "Core capital" shall be as defined in the directive of Nepal Rastra Bank relating to capital fund

vi) FIXATION OF INTEREST RATES

a) Finance companies will be free to fix interest rates for both deposits and lending, including fixation of types of interest and procedures.

b) Finance companies cannot fix flat interest rates on loan and advance.

c) Finance companies shall implement the Interest rates for deposits and lending, procedures for calculation of interest, penal interest, commission and service charges only after approval. The institutions cannot vary (upward or down ward) the interest rate for deposits in excess of 0.5 percent over the published rates.

CHAPTER III

RESEARCH METHODOLOGY

This chapter describes the methodology employed in this study. Research is essentially a systematic enquiry seeking facts through objectives verifiable methods in order to discover the relationship among them and to deduce from them broad principles or laws. Research methodology is a way to systematically solve the research problem. This chapter describes research designs, population and sample, sources of data, data collection technique and data processing procedures and analysis tools.

3.1 Research design:

A research design is a plan for the collection and analysis of data. It presents a series of guideposts to enable the researcher to progress in the right direction on order to achieve the goal.

A research design is the specification of methods and procedures for acquiring the information needed. It is the overall operational pattern of the framework, of the project that stipulates what information is to be collected from which sources and by what procedures. If it is a good design it will ensure that the information obtained is relevant to the research questions and that it was collected by objective and economic procedures.

This research is descriptive as well as analytical. The research identifies problems and justifies current conditions and practices to make comparisons and evaluations in making future plans and decisions.

3.2 Populations and Sample

The population of this study consists of all the finance companies in Nepal. Among them only 6 finance companies are selected as sample for the purpose of this study. A Stratified sampling procedure has been applied in this research.

3.3 Sources of data:

Secondary data has been widely used. Those data has been collected through Internet, published report, annual report, seminar papers etc.

3.4 Data processing procedures and analysis tools:

For processing the data, financial statements of various finance companies is reviewed. The collected data is processed and arranged in the form of tables for simplicity. Arranged data is analyzed with the help of chart and diagrams and different statistical tools and financial measures.

3.4.1 FINANCIAL TOOLS:

Financial tools are used to examine the financial performance i.e. strength and weaknesses of finance companies. In this study financial tools like ratio analysis have been used.

Ratio Analysis:

Ratio analysis is one of the most commonly used techniques in the analysis of financial statement and evaluation of managerial performance. It helps analysts to make quantitative judgment about the financial problems and prospects of the firm. Ratio analysis used financial report and data and summarizes the key relationships in order to appraise financial performance. The effectiveness will be greatly improved when trends are identified, comparative ratios are available and inter-related ratios are prepared.

Financial ratios are calculated and tested to examine different aspect of business operation. There are various types of ratios that are used by different parties for different purposes and can be calculated from the information given in the financial statements. Generally, ratios are calculated from the financial statements by the parties such as creditors, investors, financial institutions and management of the firm to know their field of interest. The various aspects of the firm are examined by testing the following sets of financial ratios:

a) **Liquidity ratio**
b) **Activity turnover ratio**
c) **Leverage ratio**
d) **Profitability ratio**
e) **Valuation ratio**

Although there are various ratios only selected ratios have been chosen which are related to the assets and capital structure of the finance companies. The study covers following ratios:

a) Liquidity Ratio:

These are the ratios grouped as liquidity ratios that measure the liquidity position and short-term solvency indicating the company's ability to meet short-term obligation. So. It is the ability of finance company's ability to convert its assets into cash to meet daily deposit withdrawal and other commercial obligations.

i) Current Ratio:

It is a test of liquidity. This ratio establishes a relationship between current assets and current liabilities. It measures short-run debt paying ability of the firm. In other words, it measures the availability of current assets for meeting current liabilities. This ratio is called working capital ratio. It is calculated by dividing current assets by current liabilities and 2:1 is regarded as standard. Current assets are those assets that are expected to convert into cash or consumed in the production of goods and services in normal course of time. Current assets include cash in hand, cash at bank balance, loan and advances, money at call, investment in government securities, bills receivable, discounted overdraft and other miscellaneous current assets. Current liabilities are those liabilities that fall due for payment in the relatively short period of time. Current liabilities include deposits, short-term borrowings, bills payable, staff bonus, dividend payable and other miscellaneous current liabilities.

The ratio is expressed as a ratio of current assets and current liabilities:

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

Higher current ratio indicates that the firm is in liquid and has ability to pay its current obligations in time as and when they become due. And on the other hand, lower current ratio represents that the liquidity position of the firm is not good and the firm will face difficulty in payment of current obligations in time.

ii) Liquid Assets to Total Deposit ratio:

It is the liquid current assets. This ratio measures the proportion of liquid assets i.e. cash and bank balance, government securities, NRB bonds, marketable securities among the total deposit of the finance company. Higher ratio shows ability to meet its demand for daily cash requirements to customers' deposit.

This ratio is expressed as a ratio of liquid assets and total deposit:

$$\text{Liquid Asset to Total Deposit} = \frac{\text{Liquid assets}}{\text{Total deposits}} \times 100$$

b) Activity turnover ratio:

This ratio measures how efficiently the finance company manager utilizes the resources at its command. The following ratios are taken to find out the utilization of finance companies' assets in a productive area.

i) Cash and Bank balance to Total Deposit ratio:

This ratio measures the ability of finance companies to meet their daily requirements for their daily customers. Cash and bank balance includes cash in hand, cash in bank, cheques and other cash items. Total deposit includes current deposits, saving deposits, fixed deposits, money at call, short notice and other deposits. This ratio is measured whether bank and cash balance is sufficient to cover unexpected demand made by depositors. This ratio shows the percentage of most liquid fund with the finance company to make immediate payment to the deposit.

The ratio is expressed as a ratio of cash and bank balance and total deposit:

$$\text{Cash and Bank balance to Total Deposit ratio} = \frac{\text{Cash \& bank balance}}{\text{Total deposits}}$$

This ratio shows the percentage of most liquid fund with the finance company to make immediate payment to the deposit.

ii) Loans and Advance to Total Deposit ratio:

This ratio measures how total deposit is utilizing as a loan and advances for generating more profit. Higher the ratio higher the utilizing the deposit and higher the chance to make more profit.

This ratio is expressed as a ratio of total loan and advances and total deposit.

$$\text{Loan and Advances to Total Deposit ratio} = \frac{\text{Loans \& advances}}{\text{Total deposits}}$$

iii) Investment to total deposit ratio:

This ratio indicates the proportion of the amount invested out of total deposits. Higher ratio indicates higher portion of investment and vice-versa. This ratio is expressed as a ratio of total investment divided by the total deposits.

$$\text{Investment to total deposit ratio} = \frac{\text{Investment}}{\text{Total deposits}}$$

iv) Capital Adequacy ratio:

The capital adequacy ratio is one of the most significant ratios, used specially to assess the firms' strength of the capital structure of the adequacy of the capital. Adequate capital is required to the efficient operation and functioning of the firm in the modern competitive environment, is always the matter of controversial debate. In one hand, holding excess capital keeps the firm in low profit position while on the other hand; inadequate capital limits the firm to meet the public demand of loan and low earning capacity. However, extremely high or low capital adequacy ratio is undesirable in terms of lower return and lower solvency respectively.

Capital refers to the paid up capital, general reserve and undistributed profits. So, capital adequacy is determined as

$$\text{Capital Adequacy Ratio} = \frac{\text{Net worth}}{\text{Total deposits}}$$

c) Leverage ratio:

A firm should have a strong short term as well as long-term financial position. This ratio is concerned with the long-term solvency of the company. It is used to measure the financial risk and the firms' ability of using debt or the benefit of the shareholders. It determines the amount of return available to the equity holders. Long-term creditors like debenture holders, financial institution etc are more interested to the firm's long-term financial strength. The ratio measures the proportion of outsiders' fund and owners' capital used in the company. Those ratios are calculated to measure the leverage structure.

i) Total Debt to Equity ratio:

Total assets are financed by pool of funds supplied by creditors and owners. This ratio measures relative claim of creditors and residual to shareholders against the company's assets. It is a test of long-term solvency of the firm. Debt-equity ratio measures the relative claims of creditors and owners against the assets of the firm. This ratio indicates the relationship between the debt and equity i.e. outsiders funds and shareholders fund which are sometime called as external and internal equities.

The ratio is expressed as a ratio of total liabilities and shareholders' equity.

$$\text{Total Debt to Equity ratio} = \frac{\text{Total liabilities}}{\text{Shareholders equity}}$$

d) Profitability ratio:

The ratio is related to profit of the business. Profit is essential for the survival of the business, so it is regarded as the engine that drives the business and indicates economic progress. Profitability ratios are calculated to measure the overall efficiency of the business. Following ratios are examined to find out the profitable performance of the finance companies.

i) Total interest earned to Credit disbursed:

This ratio measures the interest earning capacity of the finance company through the efficient utilization of outside assets. Higher the ratio, higher the utilization of assets and higher the profit.

This ratio is expressed as a ratio of total interest earned and total loan.

$$\text{Total interest earned to Total Loans and Advances ratio} = \frac{\text{Interest income}}{\text{Loans \& advances}}$$

The denominator includes loan and advances, bills purchased and discounted and all types of investments. Similarly, the numerator includes total interest earned from loans, advances, credit and overdraft, government securities, inter finance companying and from other investments.

ii) Total interest paid to total deposit ratio:

This ratio is computed to find out the percentage of interest paid on liabilities with respect to total deposits fund. A company collects deposits of different maturity periods and pays different interest rate for different groups. Hence, this ratio is helpful to find the cost of deposit fund to finance company.

This ratio is expressed as a ratio of total interest paid to total deposits.

$$\text{Total interest paid to Total Deposit Ratio} = \frac{\text{Interest expenses}}{\text{Total deposit}}$$

The numerator includes the interest paid on deposits, loans and other deposits.

iii) Total interest earned to Total working fund ratio:

To depict the earning capacity of the finance company on it's total assets/working fund, total interest earned to working fund ratio is very helpful and significant. In other words, this ratio reflects the extent on which the finance companies are capable to mobilize their total assets to generate high income as interest. Here, interest comprises total interest income from loans, advances, cash credit and overdrafts, government securities, inter finance company and other investment. A high ratio is an indicator of high earning power

and better performance of the finance companies on it's working funds and vice versa. This ratio is expressed as a ratio of total interest earned and total assets.

$$\text{Total interest earned to total assets ratio} = \frac{\text{Interest income}}{\text{Total assets}}$$

iv) Total interest paid to Total working fund ratio:

This ratio measures the percentage of total interest paid on liabilities with respect to total working fund. The interest paid comprises of total interest expenses on total deposits, loans and advances, borrowings and other deposits. A high ratio indicates high interest expenses on total working fund and vice versa. The ratio is expressed as a ratio of total interest paid and total assets.

$$\text{Total interest paid to total working fund ratio} = \frac{\text{Interest expenses}}{\text{Total assets}}$$

v) Interest income to total income ratio:

This ratio is calculated to find out the proportion of total interest income in relation to the total income of that company. It shows the magnitude of the interest income out of total income. It also denotes how the investment and loans and advances have been utilized. This ratio is expressed as a ratio of total interest income to the total income.

$$\text{Interest income to total income ratio} = \frac{\text{Interest income}}{\text{Total income}}$$

vi) Interest expenses to total expenses ratio:

This ratio is expressed to find out the proportion of total interest expenses out of total expenses. Interest is paid on total liabilities of the company like deposits, borrowings etc. This ratio is expressed as a ratio of total interest expenses to the total expenses ratio.

$$\text{Interest expenses to total expenses ratio} = \frac{\text{Interest expenses}}{\text{Total expenses}}$$

vii) Interest income to interest expenses ratio:

This ratio compares the total interest income with respect to total interest expenses. It shows the operating efficiency of the company.

The ratio is expressed as a ratio of total interest income to total interest expenses.

$$\text{Interest income to interest expenses ratio} = \frac{\text{Interest income}}{\text{Interest expenses}}$$

viii) Return on Total Assets ratio:

It measures the productivity of the assets. It is measured in terms of relationship between net profit and assets. This ratio judges the effectiveness in using the total fund supplied by the owners and creditors. Higher ratio shows the higher return on the assets used in the business thereby indicating effective use of the resources available and vice versa.

This ratio is expressed as a ratio of Net profit and Total assets.

$$\text{Return on Total Assets ratio} = \frac{\text{Net profit after tax}}{\text{Total assets}} \times 100$$

The numerator indicates the position of profit left after all expenses, cost, tax and bonus have been deducted.

ix) Return on Total Deposit ratio:

Net profit to total deposit ratio measures the relationship between net profits towards finance company's total deposit.

This ratio is expressed as a ratio of net income to total deposits.

$$\text{Net profit to Total Deposits ratio} = \frac{\text{Net profit after tax}}{\text{Total deposit}} \times 100$$

x) Return on Loans and Advances:

This ratio measures how efficiently the finance company has employed its loan and advances. This is the most important ratio in which every finance company has to be concentrate because higher the ratio, higher the finance company can generate more profit.

This ratio is expressed as a ratio of net profit and total loan and advances.

$$\text{Return on Loans and Advances} = \frac{\text{Net profit after tax}}{\text{Loans \& advances}} \times 100$$

xi) Return on net worth or total shareholders equity:

The ratio is computed to find out the percentage of net profit after tax with respect to the total net worth of the company. This ratio indicates the profitableness of the owner's investments. This is the most commonly used ratio for measuring the return on owner's investment. This ratio reveals how profitably the firm has utilized the owners' funds. Higher ratio or percent shows the efficient use of owner's investment and vice-versa.

The ratio is expressed as a ratio of net profit after tax and net worth.

$$\text{Return on net worth} = \frac{\text{Net profit after tax}}{\text{Net worth}} \times 100$$

xii) Return on total investment:

The ratio is calculated to find out the percentage of net profit after tax with respect to the total investment on that company.

The ratio is expressed as a ratio of net profit after tax and total investment.

$$\text{Return on total investment} = \frac{\text{Net profit after tax}}{\text{Total investment}} \times 100$$

e) Valuation ratio:

The valuation ratio indicates the market value of the firm as compared to the book value and measures the stock price relative to earnings. These ratio results the overall performance of the firm measuring the combined effect of risk and return. The following ratios are calculated under this group.

i) Market Value to Book value ratio:

Market value to book value ratio is an important valuation ratio. It is a relative measure of how the growth option for a company is being valued vis-à-vis its physical assets. Greater ratio indicates greater expected growth and value placed on such. A company with a strong management and an organization that has learned to function efficiently should have a market value in excess of its costs of physical assets. Lower ratio (even less than one) generally indicates that the company is earning less that what the financial markets required through industry attractiveness.

$$\text{Market value to} = \frac{\text{Market price of a share}}{\text{Book value of a share}}$$

Book value ratio

Where,

$$\text{Book value per share} = \frac{\text{Net worth}}{\text{No. of shares outstanding}}$$

ii) Earning per share

Apart from the rate of return, the profitability of a firm from the point of view of the ordinary shareholders is the Earning Per Share (EPS). It measures the profit available to the equity shareholders on per share basis, i.e. the amount that they can get on each share held. In other words, this ratio measures the earnings available to equity shareholders on a per share basis. The objective of computing this ratio is to measure the profitability of the firm on per equity share basis. EPS is calculated as:

$$\text{Earning per share} = \frac{\text{Earning available to equiry shareholders}}{\text{No. of shares outstanding}}$$

iii) Price earning ratio:

Price earning ratio is widely used by the security analyst to value the firms' performance as expected by investors. Price earning ratio reflects the investors expectation about the firm's growth in the firms earning. " It shows how much investors are willing to pay per rupee of reported profits. This ratio is calculated as,

$$\text{Price earning ratio} = \frac{\text{Market price of a share}}{\text{Earning per share}}$$

Where earning per share is calculated by dividing profit after tax by total number of common shares outstanding.

3.4.2 STATISTICAL TOOLS:

The relationship between different variables related to study topics will be drawn out using statistical tools. The tools to be used are as follows:

a) Mean or Average:

The averages are the measures, which condense a huge unwieldy set of numerical data into single numerical values, which are representative of the entire distribution. Averages provide us the gist and give a bird's eye view of the huge mass of unwieldy numerical data. They are the values, which lie between the two extreme observations, (i.e. the smallest and the largest observations), of the distribution and give us an idea about the concentration of the values in the central part of the distribution. Accordingly they are sometimes referred to as the " Measures of Central Tendency". The following are the five measures of central tendency, which are commonly used in practice.

1) Arithmetic Mean or simply mean.
2) Median.
3) Mode.
4) Geometric Mean.
5) Harmonic Mean.

Among them, we take arithmetic mean for measuring average. Arithmetic mean of a given set of observations is their sum divided by the number of observations. The formula is given below:

$$\overline{X} = \frac{X}{n}$$

Where,

$\overline{X}$ = expected return (mean)

= summation

n = number of observation

b) Standard Deviation:

Standard deviation is by far the most important and widely used measures of dispersion. It is rigidly defined and based on all the observations. It is known as root mean square deviation for the reason that the square root of the mean of the square deviations from the arithmetic mean. It is also denoted by the small Greek letter (read as sigma). The standard deviation measured the absolute dispersion/or variability of a distribution. A small standard deviation series, a large degree of uniformity of the dispersion as well as homogeneity of a series a large standard deviation means just the opposite. Hence, a standard deviation is extremely useful for judging the representatives of the mean.

Symbolically,

$$= \sqrt{\frac{d^2}{N - 1}}$$

Where,

= standard deviation

d^2 = sum of the squares of the deviations measured from the arithmetic mean

N = number of observation

c) Coefficient of Variation:

Coefficient of variation is the percentage variation in mean, standard deviation being considered as the total variation in the mean. Standard deviation is only an absolute measure of dispersion, depending upon the units of measurement. The relative measure of dispersion based on standard deviation is called the coefficient of variation and is given by:

$$\text{Coefficient of variation (CV)} = \frac{}{\overline{X}}$$

Where,

= standard deviation

$\overline{X}$ = mean

This is a pure number independent of the units of measurement and thus, is suitable for comparing the variability, homogeneity or uniformity of two or more distributions. For comparing the variability of two distributions we compute the coefficient of variation for

each distribution. A distribution with smaller C.V. is said to be more homogeneous or uniform or less variable than the other and the series with greater C.V. is said to be more heterogeneous or more variable than the other.

d) Method of Least Square

Straight line trend is represented by the equation y_t= a + bx

Where,

Y_t= trend values

a= Y-intercept or computed trend figure of y- variable when x= 0

b= slope of trend line or amount of change in y- variable that is associated with a change on one unit in x- variable

x- variable represents time and y is the variable, which is to be best fit in the line of best fit.

Values of a and b are calculated by solving following normal equation

$\sum y = Na + b\sum x$…………… i

$\sum xy = a\sum x + b\sum x^2$………… ii

e) Coefficient Of Correlation

The correlation is a statistical tool, which studies the relationship between two variables, and correlation analysis involves various techniques used for studying and measuring the extent of the relationship between the two variables. Correlation is an analysis of the covariance between two or more variables. The effect of correlation is to reduce the range of uncertainty of our prediction. Two variables are said to be correlated if the change in one variable results in a corresponding change in the other variable. Correlation coefficient can be either positive or negative. If the values of the two variables deviate in the same direction i.e. if the increase in the values of one variable results, on an average, in a corresponding increase in the values of the other variable or if a decrease in the values of one variable results, on an average, in a corresponding decrease in the values of the other variable, correlation is said be positive or direct. On the other hand, correlation is said to be negative or inverse if the variable deviate in the opposite direction i.e. if the

increase (decrease) in the values of one variable results, on the average, in a corresponding decrease (increase) in the values of the other variable. It is also likely that there may be no relationship between the variations of the two series in which case there is said to be no correlation between them.

The formula for the correlation of coefficient of correlation is given below:

$$r = \frac{N \; xy - \; x \times \; y}{\sqrt{[N \; x^2 - (\; x)^2] \, [N \; y^2 - (\; y)^2]}}$$

Where,

R = co-efficient of correlation

xy = the total of the product of items in the two series

x & y = the total of x and y series respectively

x^2 & y^2 = the total of square of items in x and y series.

N = the number of items paired.

The coefficient of correlation always varies between the two limits of +1 and –1, when there is perfect positive correlation, its value is +1 and when there is effect negative correlation its value is –1. Its mid point is 0, which indicates absence of correlation. Lastly, the value of the coefficient of correlation is always between +1 and –1. It cannot exceed unity.

f) Coefficient of determination

The coefficient of determination is a measure of the degree of linear association or correlation between two variables, one of which happens to be independent and other being dependent. In other words, coefficient of determination measures the percentage of total variation independent variable explained by independent variable. The coefficient of determination can have value ranging from zero to one. The coefficient of correlation has been grossly overrated and is used entirely too much. Its square, the coefficient of determination is a much more useful measure of the linear co variation of two variables. The reader should develop the habit of squaring every correlation coefficient he finds stated before coming to any conclusion about the extent of the linear relationship between

the two correlated variables. For example, if the value of $r = 0.8$, we cannot conclude that 80 percent of variation in the relative series (dependent variable) is due to the variation in the subject series (independent variable). But the coefficient of determination in this case is $r^2 = 0.64$ which implies that only 64 percent of the variation in the relative series has been explained by the subject series and the remaining 36 percent of the variation is due to other factors.

Coefficient of determination is the square of the coefficient of correlation.

Symbolically,

$$R^2 = r^2$$

Where,

R^2 = Coefficient of determination

r = coefficient of correlation

g) Probable error

After computing the value of the correlation coefficient the next step is to find the extent to which it is dependent. Probable error of correlation coefficient, usually denoted by PE(r) is an old measure of testing the reliability of an observed value of correlation coefficient in so far as it depends upon the conditions of random sampling.

Symbolically,

$$PE(r) = 0.6745 \times \frac{1-r^2}{\sqrt{N}}$$

a) If $r < PE(r)$ i.e. if the observed value of r is less than its PE, then correlation is not at all significant.

b) If $r > 6PE(r)$ i.e. if the observed value of r is greater than 6 times its PE then r is definitely significant.

CHAPTER IV

Data Presentation And Analysis

In this chapter, collected data are presented with various tools to achieve the objective of study mentioned in chapter one. On the whole, this chapter is related to quantify analysis of various ratios as well as some quality oriented analysis has also been done to make the result realistic and complete to the possible extent. This chapter is also called the central nervous system, which helps to provide conclusion after detailed analysis, so that the proper recommendation can be given at the end of the study. The gist of the research work presents in the form of major findings, vital issues and recommendations in the fifth chapter. In this way this chapter makes proper linkage and associates with every chapter.

4.1 Analysis Of Selected Finance Companies

1) **Financial Tools**

a) Liquidity ratio:

It measures the short-term solvency of the firm. It emphasizes the instant debt paying capacity of the firm. Liquidity refers to the ability of a concern to meet its current obligations as and when these become due. The short-term obligations are met by realizing amount from current assets.

i) Current ratio:

It is a test of liquidity. It measures short-run debt paying ability of the firm. In other words, it measures the availability of current assets for meeting current liabilities. The trend of data of the selected companies are given below:

CHAPTER V

Summary, Conclusion and Recommendations

This chapter contains summary and conclusions, major findings of the research and lastly some reasonable recommendations for minimizing shortcoming and better sustains of finance companies in Nepal. This chapter aims to sum up every analytical part that would be important and meaningful to the management of the finance company to sign up the actions as per the company's present situation and demand.

5.1 Summary

Nepal is an under developed country. There is a need for additional capital investment to earn higher rate of economic growth. As domestic savings and foreign capital (grants and loans) are two principal sources of capital available for investment, domestic savings is the most important and stable source of capital. After the adaptation of economic liberalization policy by the government, different financial institutes are establishing and finance company is one of them. Finance companies are registered with the registrar of company registration office and HMG license for operations is granted by Nepal Rastra Bank. Until the year 2064/65, there are 58 finance companies in operation. Among them 38 finance companies are within the Kathmandu and remaining are out of Kathmandu. The main objective of these finance companies is to collect deposits from public and institutions and invest them on different sectors. To protect these public funds, these companies should operate properly and there has to be a study to analyze them.

The scope of the study is limited to the selected finance companies namely Nepal Finance & Saving Co. Ltd, Nepal Finance Co. Ltd, Nepal Share Markets Co. Ltd, Annapurna Finance Co. Ltd. In this regard five-year trend from the year 2060/61 to 2064/65 and the data have been analyzed through descriptive approach. The study has been carried on the basis of the data mainly published by NRB and individual company's annual reports. The major findings are summarized below:

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APPENDIXES

Note:

- The entire figure presented here are RS in million unless otherwise mentioned.
- The data presented herein are based on the amount mentioned in the annual report of respective years of concerned banks and a journal of NRB, if not otherwise mentioned.

Appendix (I)

Table-a

Current Assets

Year	NFSCL	NFCL	NSM	AFC
2060/61	64.51	49.26	78.45	22.38
2061/62	44.05	47.76	61.03	25.36
2062/63	27.6	177.5	211.76	104.4
2063/64	30.94	94.18	56.33	59.44
2064/65	67.9	80.7	192.9	83.9

Table-b

Current Liabilities

Year	NFSCL	NFCL	NSM	AFC
2060/61	36.39	49.48	57.07	34.12
2061/62	48.42	64.11	80.71	42.26
2062/63	150.58	122.6	161.6	104.4
2063/64	97.21	114	150.8	47.3
2064/65	39.9	142.2	165.4	113.2

Table-c

Cash and Bank Balances

Year	NFSCL	NFCL	NSM	AFC
2060/61	46.07	119.35	182.77	59.93
2061/62	36.16	107.15	235.17	63.98
2062/63	67.7	129.0	281.6	212.0
2063/64	30.39	94.18	56.33	59.44
2064/65	67.9	80.7	192.9	83.9