

# Growing Pains

## MANAGEMENT CHALLENGES IN AN EMERGING FINANCIAL MARKET<sup>1</sup>

### *Kathmandu, Nepal*

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#### January 1995

One could feel the tension in the air at the daily hour-long Management Committee meeting of World Finance and Savings Co., Ltd. (WFS), a three-year-old Nepalese finance company and the first private financial institution of the country. The topic of today's customary monologue from the Executive Director, Sanjay Shrestha, was whether or not to show accrued interest expense in the company's financial statements. He did not want it included.

"I only have the best interests of the company in mind," he said. "But we cannot go to the Annual General Meeting (AGM) without showing a profit, no matter how small."

Sushim Sherpa, the Marketing Officer, did not want to outwardly contradict the Executive Director, his superior, or to appear to confront him directly, but he felt that adjusting the figures to make the business look profitable was the wrong thing to do. Diplomatically, he queried, "But aren't there other views to consider in this situation? We must not only think of today, but also plan for tomorrow."

It was as if the Executive Director had not heard Sushim's words. "How will the company survive if two years in a row we have a loss? All the other finance companies are showing generous profits." His voice grew shrill. "I cannot face the AGM with a loss!" He soon ended the meeting pounding his fist on the table and proclaiming: "I will resign if the Board does not agree to 'show' a profit! It is all up to them!"

#### Five Months Earlier

During the past year, WFS had engaged two consultants to help the bank solicit deposits and raise profitability. The results were disappointing: not one additional Nepali rupee (NRs) had been deposited through their efforts. It was after these two unsuccessful attempts that the Board finally decided to create a full-time marketing position. Sushim Sherpa, hired directly by the Chairman for his independent thinking, was brought in to lead the firm out of the red. His main assignment was to devise a plan to resolve the problems of deposit mobilization.<sup>2</sup> This project led him step by step into issues of raising capital, then loan recovery, and ultimately, financial reporting (including what to include on the balance sheet). In addition, he was assigned the onerous task of organizing the AGM.

Sushim had little time to assess the slow deposit situation before he was called away to solve a pressing cash flow problem. The loan department had closed for two weeks because there were insufficient funds available from deposits to continue lending. The low level of deposits was due to the upcoming Nepali holidays of Dashain and Tihar, when most people returned to their family villages in the countryside and spend money on food and presents. The processing of loan applications was delayed in hopes that deposits would flow in after the holidays.<sup>3</sup> The Executive Director, Sanjay Shrestha, told Sushim to drop everything and focus his efforts on a deposit mobilization campaign aimed at increasing fixed deposits, currently at NRs.340 lac (\$680,000), by an additional eight lac (\$16,000)<sup>4</sup> to meet monthly

expenses. Sushim thought to himself, "This is the biggest holiday season of the year. Why wasn't this taken into consideration when estimating deposits?" In Sushim's opinion, the crisis could have been avoided with proper planning. This oversight was just a small sign of things to come.

## WFS History

In January 1992 WFS was one of the first finance companies established in Nepal. WFS started operations with 40 lac (\$80,000) in capital (50% of the capital was initially collected, and the remaining 50% was to be called at a later time). The shareholders included 11 "promoters" (major stockholders) who owned 51% of

### Exhibit 1 FINANCE INDUSTRY IN NEPAL

Groups A, D were established after the 1984 deregulation of the financial sector (except for A1, A2).

Groups B, C, E were formed after 1992.

Formed after 1984:

#### A. COMMERCIAL & RURAL DEVELOPMENT BANKS

1. Nepal Bank Ltd.
2. Rastriya Bannijya Bank
3. Nepal Arab Bank, Ltd.
4. Nepal Grindlays Bank
5. Nepal Indo Suez Bank
6. Himalayan Bank, Ltd.
7. Nepal SBI Bank, Ltd.
8. Nepal Bangladesh Bank
9. Everest Bank
10. Bank of Kathmandu
11. International Finance Investment & Commercial Bank Ltd.

*the country's 2 original  
state-owned banks*

#### D. INSURANCE COMPANIES

1. Rastriya Beema Sansthan (National Insurance Co.)
2. Himalayan General Insurance Co., Ltd.
3. Life Insurance & General Co.
4. National Life & General Insurance Co., Ltd.
5. United Insurance Co. (Nepal)
6. Everest Insurance
7. Premier Insurance

Formed after 1992:

#### B. FINANCE COMPANIES

1. Annapurna Finance Co.
2. Himalaya Finance & Savings Co.
3. Himalayan Securities & Finance Co.
4. Kathmandu Finance Co., Ltd.
5. Mercantile Finance Co.
6. National Finance Co., Ltd.
7. Nepal Finance & Savings, Ltd.
8. Nepal Housing Development Finance Co., Ltd.
9. Nepal Share Markets Co.
10. People's Finance Co.
11. Union Finance Co.
12. United Finance & Leasing Co., Ltd.

#### C. COOPERATIVES

1. Nav Jeevan Cooperatives
2. Nav Kshitiz Cooperatives
3. Nepal Cooperative and Finance Co.
4. Sagun Cooperatives
5. Nirdhan
6. Self Development Centre

#### E. CREDIT GUARANTEE CORPORATION, SECURITY BOARD, STOCK EXCHANGE

1. Citizen Investment Trust
2. NIDC Capital Markets Ltd.

Source: "Booming Business," *Spotlight*, 11 November 1994, p. 10.

the company. The motivation behind the establishment of the firm was not only monetary gain but also altruism. The original intent was to provide opportunities for the Nepalese people to improve their economic situation by saving, borrowing and investing.

The first two and a half years of existence were difficult for WFS. During the first year, the Board of Directors divided into two factions, with one side supporting the Chairman and the other side favoring another candidate. The sides disagreed over their preferred direction for the company. In the end, threats were made against the staff and Directors' families in an attempt to sway votes. During this period, a Central Rastra Bank<sup>5</sup> representative was brought in to monitor operations and settle the conflict. The first AGM was held without a Board of Directors and a loss was declared. Six months later, the Central Rastra Bank representative left after a resolution had been reached with the second faction agreeing to sell their interest to the first. WFS was reborn with a new Chairman, a new Board and new offices. By then, however, the initial advantage of being the first finance company in the nation was lost, and the competition had grown significantly. During those two years, 15 new finance companies had opened up, as well as commercial banks and savings cooperatives offering a wide range of services. These new institutions were founded with much more capital—up to four crore<sup>6</sup> or ten times that of WFS. As expected, WFS's operations were greatly affected by the conflict and during this period its deposits dwindled to almost nothing.

## The Banking Industry

With only two commercial banks and one development bank as of 1984, Nepal's banking sector was quite small. Financial liberalization started in 1984 with the establishment of the first joint venture bank, Nepal Arab Bank Ltd., after which a number of venture banks were launched. In 1985, the Finance Company Act was enacted allowing incorporation of finance companies to conduct nonbanking business as public limited companies.<sup>7</sup> Even with this legislation, however, significant change did not take place until the democratic election in 1991.

With the new democratically-elected government in Nepal in 1991 and the regional shift towards economic liberalization in India, a new attitude towards development grew within the Kingdom of Nepal. Until 1992 the financial sector was dominated by two state-owned banks, which controlled 70% of all banking deposits. These two banks proved to be a considerable drain on the financial community and were restructured in 1991 due to millions in outstanding loans. Official reported figures showed that as of the end of January 1994, overdue loans at the two banks amounted to some NRs.2.8

billion (\$56 million) and were increasing.

The establishment of WFS in 1992 started a new phase in the financial sector. So far, 18 finance companies accepting public deposits had started operations. Numerous other petitions still awaited approval at Central Rastra Bank. Since inception of deregulation in 1993, the total volume of net domestic credit had increased by 15%. The expansion of credit to the private sector accounted for most of the increase in domestic credit. Another significant development in the banking sector was the interest rate policy, which was earlier controlled and regulated by Nepal Central Rastra Bank but was deregulated in 1989. Commercial banks and finance companies were free to fix their own interest rates on deposits and loans, with a maximum six percent spread.<sup>8</sup> However, a local economist, Dr. Kishort K. Gurugharana, noted that "the development of financial sector per se is not bad, but it owes more to global factors than the liberalization policy of the government."<sup>9</sup>

## Nepal Stock Exchange (NEPSE)

The Finance Company Act changed the shape of the finance industry by opening up many opportunities including the development of a stock exchange. NEPSE opened its trading door on January 13, 1994. After one year in business, the infant capital market was trying to speed up its pace with limited success. With 74 companies listed, share prices went higher in the beginning but then started to come down when the government changed hands following the Communist party's election victory. The new government's alleged indifference towards the growth of the capital market was criticized by investors and brokers.<sup>10</sup> "The government has not introduced its policy regarding the capital market, which has made its future uncertain," complained H.P. Dev, an investor.<sup>11</sup>

Lack of a systematic information flow, inadequate knowledge of market procedures and excessive risk-taking left the common investor vulnerable. With the opening of the floor, most of the companies' values rose regardless of performance. NEPSE officials held the view that the market was beginning to reflect real values. NEPSE had 74 companies listed for trading purposes with only 45 attracting regular transactions. Most of the companies still did not make their financial positions transparent to the public even though this information was required for share trading.

## Deposit Shortage

Anxious to have a recommendation prepared for the upcoming Board meeting, Sushim called the first Management Committee meeting<sup>12</sup> to brainstorm ways to solve the immediate problem. After reviewing several options, including the possible use of TV commercials

## Exhibit 2 WFS PROFILE

**Purpose:** WFS was established to perform nonbanking functions through institutionalized investment of capital to promote the economic interests of Nepalese people by providing loans for hire purchase, housing, trade and industry finance, merchant banking, trust management, leasing and other financial resource mobilization plans, as prescribed by the Finance Company Act, 1985.

**Mission:** WFS's mission is to provide total customer satisfaction by constantly striving to meet the changing financial needs, wants and expectations of its customers, both explicit and implied. WFS strives to contribute to the betterment of the country's economy by creating job opportunities and promoting development of an entrepreneurial spirit both nationally and globally.

WFS is the first financial institution in the private sector in the Kingdom of Nepal. Established under the Financial Company Act 2042 (First Amendment 2049), WFS was founded in Shrawan 2049 BS (July 1992).

### WFS's Distinctive Features:

- Higher interest rates on deposits compared to banks and many other financial institutions.
- A team of highly motivated, professional, trained staff.
- Customer-friendly environment.
- A hassle-free computerized system.
- Greater flexibility on hire purchase loan schemes.
- Convenient industrial loans.
- Personalized, efficient, prompt and courteous services.
- Market-driven company.

### WFS's Main Areas of Service

#### DEPOSITS

(1) <u>Fixed Deposit</u>	Period	Interest Rate (per annum)
	6 months	9.00
	1 year	11.00
	2 years	12.00
	3-5 years	12.50

- Features:
- Minimum deposit amount NRs.10,000.00
  - Interest given every three months
  - Interest deposited at the bank of client's choice

Interest rate on deposits is negotiable depending upon the deposit amount and deposit period.

#### (2) Recurring Savings Scheme

Under this scheme, an account can be opened with a monthly deposit amount divisible by NRs.100 (Maximum NRs.5,000). After 42 months, a lump sum amount will be paid out. Minimum deposit amount is NRs.500.

#### (3) Pre-Interest-Marked Deposit Scheme

- Features:
- Minimum deposit amount NRs.10,000.00
  - After 5 years, double the deposited amount will be paid out
  - A guaranteed letter of deposit amount will be issued to the depositor

Under this scheme, account cannot be opened without approval of the company.

#### INVESTMENTS<sup>13</sup>

##### (1) Hire Purchase Loan

With minimum cash down payment of 20%, loan can be sanctioned (applicable interest rate on loan-3% flat) for the hire purchase of the following items:

- Transportation vehicles
- Agriculture, engineering and medical equipment
- Household appliances
- Office equipment
- Furniture and fixtures

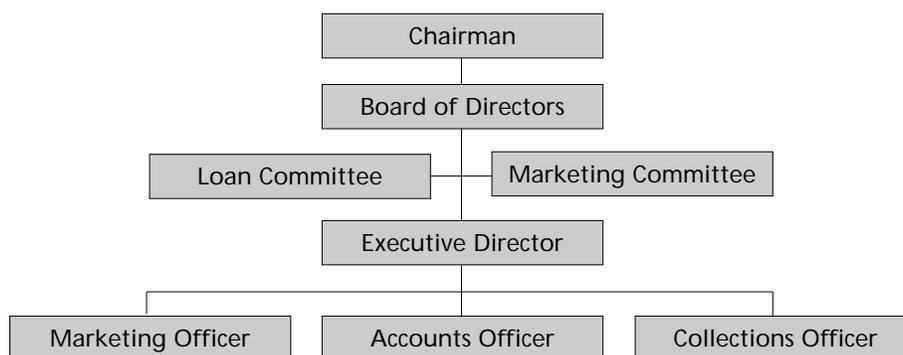
Hire purchase loan period: one to five years

##### (2) Industrial Loan

With minimum cash down payment of 20%, loan can be sanctioned (applicable interest rate 18.5% simple) for small- to medium-sized industries.

- |                    |                    |
|--------------------|--------------------|
| • Housing finance  | • Trade finance    |
| • Merchant banking | • Bill discounting |
| • Leasing finance  | • Trust management |

**Exhibit 3  
ORGANIZATION CHART<sup>1</sup>**



<sup>1</sup> WFS had a Board consisting of nine directors; five were promoters and four were minority shareholders elected at the AGM. There were 12 employees, consisting of an Executive Director, three Officers, four assistant supervisors and four messengers.

**Exhibit 4  
MAIN PLAYERS**

**Chairman**

Mr. Santos Sherpa was a well respected economist and intellectual, with vast international experience developing policy for large development organizations. Unfortunately, he had little experience running a small business and has hired numerous consultants over the last six months to improve the firm's operations. He was eager to implement western ideas, such as Management by Objectives and Total Quality Management at WFS.

**Executive Director**

Mr. Sanjay Shrestha was a seasoned bank executive with 20 years experience in state-owned banks. He had strong connections in the banking sector, but it was unclear if he was able to meet the challenges facing a market-driven institution. He was of Newar decent, the predominant tribe in the Kathmandu valley, an asset in the eyes of the Directors. He was brought in to implement control systems previously missing in day to day operations.

**Marketing Officer**

Mr. Sushim Sharma recently returned from five years working and studying in the United States, where he received his MBA. A member of the Braham caste,\* Sushim was on his third job after returning from abroad. He was full of energy and enthusiasm to implement the new theories he had learned in the West but appeared to have difficulties readjusting to the Nepalese way.

**Company Secretary**

Mr. Rajesh Singh was heavily involved with WFS as the Company Secretary, Promoter and Director. The feelings of dislike between the Executive Director and Mr. Singh disrupted every meeting the two attended. It was unclear each time who was right or wrong, and no one could control them at meetings. A lawyer and the youngest Promoter and Board Member, Mr. Singh had most of his money invested in WFS. He was trying to move the firm in the right direction but this was always in direct confrontation with the Executive Director.

\*The caste system, though illegal, still plays a strong role in society, with Braham and Chetri being the top two classes. One's caste is identifiable by one's last name.

and the raising of interest rates, it was agreed to investigate providing health insurance for depositors as an avenue to increase deposits.<sup>14</sup>

Sushim was satisfied with the outcome of the meeting, but felt the others were reluctant to proceed with the plan. He overheard the Accounts Officer whispering, "WFS needs deposits now, but soon we won't be able to accept any more money."

Confused, Sushim shook his head and asked the Accounts Officer to repeat himself. Did he hear correctly? "You mean our target is only to raise the eight lac needed for this month's expenses? What's going on?"

The Accounts Officer explained that WFS was approaching the deposit saturation point as prescribed by Nepal's Central Rastra Bank Law. According to his calculations, in three months or less the firm would not be able to accept any more deposits.

WFS would reach deposit saturation, the maximum leverage point allowed by law. The deposit limit was constrained by the amount of capital.<sup>15</sup> With 40 lac in paid-in capital, WFS's maximum deposit level was 400

**Exhibit 5  
WFS CAPITAL STRUCTURE  
(NRs.)**

September 1994	
Authorized capital*	2,00,00,000
Issued capital	1,00,00,000
Paid up capital**	50,00,000
Reserved right share	20,00,000
Current total shares	40,00,000

\* Nepal and India use the same units of measure:

100,000 = 1,00,000 (1 lac)  
10,000,000 = 1,00,00,000 (1 crore)

\*\* During initial offering, only 50% of share price was collected.

lac (\$800,000).

“OK, so the real constraint here is capital. Fair enough. So why don’t we raise the capital?” Sushim asked excitedly. Finally, he felt the real problem had been identified, and he set to work to propose raising new capital.

## Mid-September 1994

After working a solid week on the proposal to the Board, Sushim was ready to present his findings. By that time, WFS had received NRs.1.2 million (12 lac) in

<b>Exhibit 6</b>			
<b>DEPOSIT MAXIMUM FORECAST</b>			
<b>(lac)</b>			
	<b>October/ November</b>	<b>December/ January</b>	<b>May</b>
Total deposit estimate* (in lacs)	360	400	500
Deposit maximum**	400	400	500
Paid up capital	40	40 + 10	50
* Based on adding monthly increments of 20 lac (based on monthly average).			
** Legally mandated deposit maximum = 10 x paid capital.			

deposits, eliminating the cash crisis. However, the deposit saturation problem still loomed.

As a new member of staff, Sushim was formally introduced at the September Board Meeting. However, no one informed him that the meeting had started an hour earlier and that the messenger had not yet returned with his report from the photocopy store down the street. On the surface it appeared the Board knew of the deposit problem, but they were alarmingly unaware that it was a constraint to growth. Everyone was interested in growth and profit, but the Board did not understand how the deposit limitation impacted the bottom line. Sushim was beginning to realize that while the Board members were well respected professionals, few had hands-on experience operating a business. The Executive Director assured him that he would be given a chance to speak later in the meeting. Later never came, and after waiting three and a half hours, the Executive Director informed Sushim he could go home and the proposal would be discussed another day (which also never came). The deposit saturation problem was never discussed. This would not be the last time agenda items were overlooked at a WFS Board Meeting.

Slightly frustrated by not having had the opportunity to

discuss his ideas with the Board, Sushim discussed his concerns with the other Officers. He also took advantage of the opportunity to clear up a few loose ends. “Why does WFS only provide two investment channels (hire purchase and industrial) when our competition is offering a greater variety of services?” he asked.

He was told that the types of investments WFS could make were limited by the amount of paid up capital, as well as by the deposit ceiling. Nepal’s Central Rastra Bank Law states that until or unless a firm has 1 crore (\$200,000) paid up capital, it was sanctioned to make only two types of investments, hire purchase and industrial loans. Hire purchase loans were for 5 lac (\$10,000) or less, while industrial loans charged 18.5% interest.

Sushim thought to himself, “This provides an even more compelling reason to increase capital quickly.”

## Raising Capital

Sushim, eager to share his discovery, quickly moved to lobby the Directors individually to take prompt action on this issue. To his alarm, Sushim discovered that four months prior the Board had already agreed to collect the outstanding 50% unpaid capital and issue another 20 lac (\$40,000) of Right Shares, but nothing had been done since then. Increasing capital had been agreed upon in principle, but nothing would move forward until full consensus was reached by all Directors.<sup>16</sup> It seemed the Company Secretary was the key opponent of this plan. It took four months to persuade him and several other Directors that the additional capital was vital. Without any further delays, the earliest possible date for issuing Right Shares or collecting paid up capital was January, five months away.

In addition to the internal problems, Sushim discovered an external constraint affecting the capital issue. Clear lines of division between the Nepal Stock Exchange (NEPSE) and the Securities Board were not in place. The NEPSE claimed a new prospectus was not needed to issue the 20 lac Right Share. Meanwhile, the Securities Board said it was needed. The Chairman requested the Company Secretary and Executive Director collaborate to resolve the matter. On his own, the Company Secretary sent a letter asking for clarification. Quietly, the Executive Director boasted that he could resolve the whole problem more effectively than the Company Secretary by making a single phone call. It was on that occasion that Sushim first noticed the animosity between the two men.

## January 1995

As predicted, WFS was close to deposit saturation by the end of January, pressuring the Board to reach consensus. It was decided first to call for the 50% paid up capital

from existing shareholders and then sell the new right shares. Luckily, the Chairman deposited his portion of the capital before leaving on a month-long holiday, giving the WFS some breathing room to issue loans. The next task was sending a collection notice to the 1,500 shareholders. Sushim assumed the stockholders mailing list was computerized and that it would be just a matter of affixing labels to envelopes. He later learned that, while there was a database, it had not been updated for a year. Four staff members worked four hours overtime everyday for three weeks to send out handwritten notices. During this time, the Executive Director threatened to fire half the staff when they asked for an increase in overtime pay. Several days without electricity (the line had been cut while placing a telephone line) left the office at a standstill which allowed the entire staff to pitch in and finish the project.

Shortly after sending out the requests, the market tumbled.

“The Kathmandu Stock Market witnessed a downward trend last week sending shock waves across the investor community. But looking at the sensitive nature of the market, it is not clear whether it is the political change or other facts that caused the panic.”<sup>17</sup>

NEPSE had been bearish for the prior few weeks. The average daily turnover dropped from NRs.2.3 million to 1.46 million in the first two weeks of the newly elected Communist government. However, WFS experienced an even more severe drop in share value. Its stock fell from NRs.350 to 110 during this time. The Chairman, puzzled by this turn for the worse, asked Sushim his view. Hardly an expert of the stock market, Sushim answered, “It looks like a scare. Somehow the shareholders are misinterpreting the reason for our request for capital.”

Sure enough, after talking with the head of the NEPSE, it was revealed that even the stockbrokers thought WFS was short of cash. The share price balanced out after the Central Bank restrictions and regulations were explained to the public and stockbrokers: WFS was simply growing and it needed to increase paid up capital to expand. This was the first time that the year-old stock market had experienced a call for capital, as all other firms listed had 100% initial paid up capital.

## Loan Recovery Dilemma

The drop in share price refocused Sushim’s effort on ensuring a fair return on investment to shareholders. WFS’s image could not afford another year in the red given the Central Rastra Bank intervention and the first year’s loss. The Chairman was concerned about the lack of profitability as the AGM was scheduled to be held soon. Other finance companies were rumored to be giving large dividends. He turned to Sushim for advice: “I just don’t understand. Where is all their profit?”

### Exhibit 7

#### WFS LOAN RECOVERY PROCEDURES

Prepared and translated by WFS Staff and Directors

- (1) Statement to the client three days or more prior to installment due date.
- (2) Three days grace period for payment of the installment.
- (3) Phone call to the client after seven days.
- (4) Initial letter to the client after eight to sixteen days.
- (5) Will accept written explanations between 15 days and a month to establish cause of delinquency. Rescheduling of payments considered in certain cases.
- (6) Second letter after 45 days stating, “If payment is not received in \_\_\_days then WFS will begin procedures to repossess the goods (vehicle, equipment).” Personal visit to defaulters will take place during this time.
- (7) If WFS has received no response from the defaulter, then assistance from the police will be requested in capturing the goods.
- (8) Third letter after 60 days stating, “WFS will publish your name in the Gorkha Patra (local newspaper) for the recovery of all payments.” At 75 days, WFS will publish the notice in the paper.
- (9) If WFS has received no response after 90 days, then after consulting with the police and other concerned parties the company will take the case to court.
- (10) One copy of these regulations will be posted in the WFS office and given to each client.

Sushim suggested that WFS’s woes might lie in its high default rate. The Chairman asked Sushim to investigate and prepare a plan of action in coordination with the Loan Officer. What were the reasons behind WFS’s consistently high default rate? The target default rate was three percent, but rates had risen to 6.5% in the last few months. Sushim began his research with a review of the current loan recovery procedures (Exhibit 7).

After comparing the written procedure with the actual process, Sushim concluded that the majority of the problems stemmed from (a) inconsistent client contact, and (b) legal difficulties in collecting the collateral or guarantee.

## Legal Constraints

Nepal's weak legal and judicial systems prevented efficient collection of outstanding debt. In addition, the lack of a Bankruptcy Act inhibited the financial sector and other creditors from pursuing and collecting from nonpaying large, small and micro-enterprise clients. These restrictions limited expansion and risk-taking activities of financial firms.<sup>18</sup> Large state-owned banks were not alone in encountering difficulties with debt collection. Over 60 percent of WFS's clients used land as collateral. Legal collection was very costly and lengthy, taking anywhere from one to five years to settle a case in court. Another constraint was that the land could only be claimed when the land was up for sale. In Nepal, family land is rarely sold as extended families live together for generations at the same location.

There was a real need for Nepal's authorities to implement financial guidelines suggested by the Bank of International Settlements (BIS) for loan and capital requirements. The lack of standards forced private banking and finance firms to introduce their own standards, causing greater confusion. The bureaucracy supporting this system effectively resisted the collection of outstanding loans. Limited manpower was available to perform the detailed procedures involved in recovering collateral. Even after consulting with officials at Central Rastra Bank regarding the procedures for recovering collateral, the proper steps remained unclear to the Loan Recovery Officer of WFS.

With long-term defaulters, police involvement was necessary to repossess goods or collateral. The problem lay in identifying individuals in the police force who were willing to take responsibility. Unofficial sources quoted the standard rate for this assistance at NRs.1,500 per client. No collection agencies existed, so paying a fee for these services appeared practical. Even if the police reclaimed the collateral, typically a motorcycle, WFS would then be in the business of reselling the used bikes. With no storage facilities or manpower to manage such an operation, repossession made little sense. From Sushim's point of view, police payments constituted bribery, and they were not the most suitable option. To date, WFS had not pursued this course of action against any defaulting borrower, for two reasons: concern about retribution and the desire to maintain "good" relations with the client. Direct confrontation was generally not preferred in Hindu society. Sushim was concerned that cultural norms and not profitability were driving WFS's loan recovery policy.

## Logistical Constraints

While the Loan Officer was explaining the recovery procedure, Sushim realized that he had grown accustomed to Western business standards during his five years in

the United States, and he was now overlooking basic logistical problems. For example, the first step in loan recovery was to call the client within one week after default. However, only 65% of the customers actually had access to telephone service. In addition, the office phone frequently was out of order for several weeks at a time. When the phone did operate, Radio Nepal was heard over the line, making communication difficult. An additional phone line had been requested a year ago, but it was not expected anytime soon.

Sushim and the Loan Officer believed the sooner the defaulters were contacted, the better the chance of recovery. Instead of calling defaulters during the first week following a missed payment, on average 50% of defaulters were called after a month.

The second step in the process was to contact the client by mail. The government was behind in assigning street addresses to homes and only 30% of the defaulters had mailing addresses.

The third step was to visit the client, but without a house address, the supervisor would spend hours locating a client. Contrary to loan recovery policy, personal visits targeting 75% of defaulters occurred approximately four months after the default date. In the end, half of the customers were eventually contacted, but only 20% made partial payments.

Before Sushim's arrival, the Loan Officer had sent a proposal to revise the loan recovery policy, but no action had yet been taken. The Board's Loan Recovery Subcommittee responsible for these issues had not met for the last two months to discuss the issue. Between the winter hours<sup>19</sup> and scheduled brownouts,<sup>20</sup> it was difficult to organize a meeting.

## Annual General Meeting Preparations

There was another urgent matter for the Board to consider: the upcoming AGM. The annual meeting had already been postponed several times, and as the date approached several stockbrokers lodged complaints and threatened trouble if WFS delayed the AGM again. Legally, WFS had another month, six months after the fiscal year ended, to hold the AGM. Sushim was responsible for organizing the event, and he was becoming concerned that the true facts about the firm's financial position would not be presented. After reviewing the balance sheet with the Accounts Officer, Sushim learned that the report included accrued income but not accrued expenses. The Accounts Officer agreed the current balance sheet was not an accurate statement. Even one of the Directors had requested information on the accrued interest expense, but to no avail. The Executive Director would not allow accrued interest expense to be includ-

**Exhibit 8**  
**AUDITOR'S COMMENTS ON THE BALANCE SHEET\***

\* Author's note: This statement was translated from Nepali into English by a Kathmandu translator. Inaccuracies in grammar and word usage reflect his limited command of English.

Account Comments

1. Income last year was on a cash basis but this year on an accrual basis.
2. Equal interest in every month by calculating interest in initial loan amount.
3. Loan provision is not adequate with only 1% held for bad debts and no debt is written off.

Classification and Provision for Loan:

Classification and provision for outstanding loan has been done according to this:

<u>Loan Classification</u>	<u>Loan Outstanding</u>	<u>Bad Debt Provision</u>
Good	NRs.2,64,05,142	NRs.2,69,667

According to Rastra Bank direction and my own opinion, above classification and provision for bad debt should be like this:

Loan Classification	Loan Amount Outstanding	Percent	Bad Debt Provision
Good	2,30,89,541	1	2,30,895
Less Good	32,89,611	10	3,28,961
Doubtful	13,740	50	6,870
Bad	12,250	100	12,250
<b>Total</b>	2,64,05,142		5,78,976

We request an additional NRs.3,09,309 be set aside for Bad Debt Provision.

Fixed Assets

4. a) Depreciation in vehicle is according to the income tax act.  
b) No depreciation in those assets added in this fiscal year.
5. According to the decision of the first AGM, NRs.2,27,142.90 is transferred to due account from pre-operational cost and the rest pre-operational cost.
6. 20% of deposits are held in 5 year "double your money" account. None of the accrued interest expense is being included.

Deposit

At the end of the fiscal year 1993-94, the company had the following deposits:

Fixed deposit	NRs.	2,08,22,331
Pre-interest posting deposit		54,46,001
Recurring deposit		<u>10,37,323</u>
	NRs.	2,73,05,654

Out of the above deposit schemes there is no interest expense listed for recurring and pre-interest deposit schemes. We request the firm to provide\_\_\_\_\_. Without listing the amount of accrued interest expense, the Profit and Loss statement will not reflect the company's actual position.

**END OF AUDITOR'S REPORT**

ed on any balance sheet given to the Board. As a result, profit was always overestimated, placing the Executive Director in a better position.

The Executive Director wanted his form of accounting to be used for the Annual Report. At this time the internal and external auditors discovered the miscalculation and a debate ensued. Several items stirred controversy between the Executive Director, the auditors and the Officers. The biggest concern was the 54 lac interest expense due in three years.<sup>21</sup> The Executive Director argued not to include the expense in his version of the balance sheet, implying a meager profit on the income statement. The auditors and Officers believed these costs must be included. The auditor's comments are detailed in Exhibit 8.

## NOTES

1. This case was written by Catherine Rothenberger of the American Graduate School of International Management (Thunderbird). It is intended as a basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

2. Deposit mobilization means soliciting individuals and firms to deposit their surplus money in fixed deposits.

3. Nepali Holidays: *Dashain* and *Tihar*, which generally fall in October and November, are the biggest holidays in Nepal. During this time, employees are given a month's wages in bonus and most people return to their family village to celebrate. For many this journey takes several days each way and offices and businesses are closed for up to two weeks.

*Dashain* is the truly national festival of Nepal. It symbolizes the victory of Lord Rama over Ravan. The whole festival lasts ten days. The first nine days are devoted to worship of Goddess Durga Bhanvani, and during this period buffaloes, goats and chickens are offered in sacrifice. On the last day, the elders give *tika*—a blessing to their junior family members. Thousands of people line up to receive *tika* from the King and Queen.

*Tihar* comes just two weeks after *Dashain*. The festival lasts five days and is marked by worship of the crow, dog and cow. During the five days, homes are lit by tiny lamps and electric lights. On the last day, sisters show their affection towards their brothers by performing a *puja* and feeding them food while praying for their long life.

4. There are approximately 50 Nepal rupees (NRs.) per US\$1. One lac equals 100,000 rupees or about \$2,000, so 340 lac = \$680,000 and 8 lac = \$16,000.

5. Nepal's Central Rastra Bank is the equivalent of the U.S. Federal Reserve Bank.

6. 1 crore equals 100 lac (written as 1,00,00,000), worth approximately \$200,000.

7. Mathema, Vijaya Ram, "Nepal's Banking Industry," *Rising Nepal*, 5 May 1995, p.4.

8. World Bank Report, "Nepal: Fiscal Restructuring and Public Resource Management in the Nineties." Manila, Philippines: Asian Development Bank, 1994.

9. Yogi, Bhaarigrath, "Booming Business," *Spotlight*, 11-17 November 1994, p.10.

10. On November 15, 1995, Nepal held national elections. The United Marxist Leninist (UML) party received the majority of

votes. After a month, a coalition government was finally formed. Though Communist in name, UML claimed to support continued private sector efforts to develop Nepal. "The Communists have promised to be good and protect democracy and capitalism while emphasizing social programs." ("Not Very Royal," *Economist*, 19-25 November 1994, pp. 31-32.)

11. Yogi, Bharigrath, "Taking Stock," *Spotlight*, 17-23 February 1995, p.12.

12. The seven member Management Committee comprised of all Officers and Assistant Supervisors. The Accounts Officer was the Convener and Secretary.

13. WFS was eligible to offer two types of loans: hire purchase and industrial. The Board decided against industrial loans because they reckoned the profit margin was not high enough, a decision that would later be changed. They only offered hire purchase loans, of which over 50% was to individuals purchasing motorcycles. Motorcycle firms in Kathmandu were unable to offer financing and they looked to the new finance companies to supply credit to customers.

14. Although there is socialized medicine in Nepal, the quality and availability is far below Western standards. Private medical facilities were preferred over public hospitals.

15. According to the Finance Company Act of 1985, Nepal Rajapaa, Vol. 35, No. 30A (E), Chapter 4, "Arrangements relating to Shares and Capital," #21 (7) Aswin 23, 2042: "The paid-up capital of the Company must be at least 10 percent of the total amount to be received through deposits, debentures, loans, and mobilization of other resources."

16. In traditional Nepali culture, even though a decision may have general approval, no concrete action can be taken until *all* participants unanimously support the decision. Voting is not a favorable alternative because the dissenting voters and the Chairman would lose face.

17. Yogi, Bhagirath, "Struggling to Recover," *Spotlight*, 16 December 1994, pp. 9-10.

18. Devres, "Mid-term Evaluation of the Economic Liberalization Project (ELP)," 5 August 1994, p. 40.

19. From mid-November to mid-February, government and most businesses close early by an hour or two due to short days and cold weather. Many homes and offices do not have heat in temperatures that drop to freezing. In addition, transportation was severely limited at night.

20. During peak evening hours, electricity was on a load sharing basis. Twice a week, every neighborhood would be without electricity for two to three hours.

21. To attract deposits, WFS initially offered a five-year deposit which would "double your money." The campaign was successful and 54 lac was deposited. These deposits represented approximately 20% of WFS's total deposits.

22. WFS was eligible to offer two types of loans: hire purchase and industrial. The Board decided against industrial loans because they reckoned the profit margin was not high enough, a decision that would later be changed. They only offered hire purchase loans, of which over 50% was to individuals purchasing motorcycles. Motorcycle firms in Kathmandu were unable offer financing and they looked to the new finance companies to supply credit to customers.