

CHAPTER - III.

A) CAUSES OF INDUSTRIAL SICKNESS.

B) PREVENTION OF INDUSTRIAL
SICKNESS & STATE POLICY .

CAUSES OF INDUSTRIAL SICKNESS :-

Sickness is found to exist in some form or other even in a very healthy and highly developed economic structure. It is a painful reality of the very process of industrialisation. The reasons for sickness are manifold and complex. Even highly advanced market economies face industrial sickness, usually triggered off by technological obsolescence and market forces.

The factors causing sickness could be divided into two broad categories.

1. Internal
2. External

During the operational phase the following sources of important internal factors were found which have landed many sick industrial units in crisis.

1) FINANCIAL FACTOR :

In the financial field the most important reasons for the sickness are incorporation of heavy doses of debt, resulting in weak equity base, poor utilisation of assets, inefficient working capital management, absence of costing and pricing, absence of financial planning and budgeting and diversion of funds either from the business itself or by using short-term funds for long-term uses..

2) PRODUCTION FACTOR :

In the area of production wrong selection of sites for industrial units, lack of appropriate balance in plant and machinery, their inadequate maintenance (leading to inefficient operations), lack of proper materials control and quality consciousness and absence of research and development for commercial exploitation of future opportunities thrown up by the advances in national and international market may lead to erosion of efficiency competitiveness of the unit ultimately inviting sickness to set in.

3) MARKETING FACTOR

Any inappropriate or unremunerative product-mix; lack of demand, market forecast and market research; inadequate product planning; overdependence on a few selected buyers and an ineffective or absence of sales promotions may lead a unit into a stage of sickness.

4) PERSONNEL FACTOR :

Any malfunction in the area of personnel management, such as; inappropriate wage and salary administration, bad labour relations, lack of behavioural approach and absence of manpower planning can lead to problems which may jeopardise the overall functioning and future prospects of an industrial unit.

5) CORPORATE MANAGEMENT :

The causes in the field of corporate management include - improper functioning of the top management and inadequate corporate planning which may lead to lack of necessary co-ordination, supervision and control over the entire production and distribution mechanism in an industrial enterprise. Management unresponsive to changes, dispute among top management, wilful mismanagement and dishonesty are also some causes for industrial sickness.

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At times enterprises suffer due to external factors which are beyond the control and influence of the management. Such external factors are discussed herein.

- 1) GOVERNMENT POLICY : Over licensing, issue of many letters of intent, and stipulation uneconomic size of a plant cause industrial sickness. Pricing policies are never timely and prices of intermediates such as; coal and steel reduce the profit margins of user industries. Strikes, lockouts and ineffective labour laws add up to it. Imposition of power cut or distribution of canalised items in short supply to all units affects units which are doing not so good. An unfavourable import policy brings in competition from cheap imports to domestic industries and also to an extent a reason for sickness in India.

* R.M. Shrivastava. "Essentials of Finance" 1800 edition
Chapter - Industrial Sickness.



- 2) MONETARY POLICY : A sick unit finds it difficult to obtain additional credit facilities from a bank to step up production and sales. Delay in getting approval of financing schemes results in lower production, Power sales, higher cash losses and deepening of sickness. High cost of credit in the form of interest prevents generation of cash credits which a unit can utilise for improving its performance.
- 3) POLICY OF FINANCIAL INSTITUTIONS : Pursuance of credit restraint, inadequate timely finance, imposing of unrealistic conditions while sanctioning loans are some of the causes which adversely affect the liquidity of industrial units and may result in their sickness.
- 4) CHANGES IN INVESTMENT CLIMATE : "When the investment climate in the country is favourable, a unit can raise funds by cloating shares and debentures in the investment market or by way of public deposits. If it is unfavourable and industrial units find it difficult to raise funds from the market, the units may be in financial crisis which might cause their sickness.
- 5) NATIONAL AND INTERNATIONAL MARKETING SCENE : When recession sets in and demand for products declines, many units find it difficult to dispose off their

products. This would result in under-utilisation of the installed capacity and working below the 'break-even' point. An industry has also to keep pace with the changes in the international market or otherwise face problem of sickness.

- 6) STATE OF LABOUR MARKET : Existence of unfavourable conditions of labour market, such as, non-availability of skilled manpower, labour unrest and wage disparity in similar industries are also responsible for sickness.

Other than the above causes, factors like hyper-inflation, low business confidence and a low volume of industrial investment are also responsible for industrial sickness.

* According to a survey conducted by The Vidarbha Industries Association (VIA) out of 1500 SSI sick units in Vidarbha 75 per cent were sick due to non-cooperation by the banks, 10 per cent due to MSFC policy, 8 per cent due to changes in government policies and the remaining due to the various other factors like material shortage, non-availability of raw materials and marketing problems.

* Indian express, Feb.-21 (PTI news).

Actually no single factor is responsible for growing industrial sickness. The above general discussion on causes of Industrial sickness could be supplemented by statistics as reported by the "Tiwari Committee Report, 1984".^{**} The findings of the committee can be presented in a tabular form as given in table :

T A B L E * - No. 3.1

<u>CAUSES OF INDUSTRIAL SICKNESS IN LARGE & MEDIUM SCALE UNITS</u>		
Factors	<u>Position as on 31.12.79</u>	
	Numbers	% of total
1. Mismanagement/Management inefficiency	197	52
2. Market recession	86	23
3. Faulty initial planning and other technical drawbacks	52	14
4. Labour trouble	9	2
5. Other reasons	34	9
T o t a l	370	100.00

The factor mismanagement or management inefficiency includes, diversion of funds, infighting, lack of marketing agency, etc., The factor given as others includes power cuts,

** Business India, Nov. -82 - 1802 "Why do Industries turn sick"

* Business India, 1902 - 'Why do industries turn sick'.

shortage on raw materials, and such reasons. The committee also gives statistics by the importance of causes with reference to 341 sick units. The most important cause lies in the factor related to management, which affected 222 or 60 per cent of the total units. Marketing constraints/competitive markets comes second but distantly affecting 99 or 29 per cent of the total units. The other thirteen causes affected numbers varying from 01 or 24 percent of the units (shortage of working capital, liquidity constraints); to 11 or 3 percent of the units (lack of quality control, inferior quality, etc.)

The Committee has summed up the general thrust of its statistics as under :-

"Taking into account the findings of all the studies a broad generalisation regarding important causes of industrial sickness emerge. It is observed that the factor most responsible for industrial sickness can be identified as 'management'. This may take the form of poor production management, poor labour management, poor resource management, lack of professionalism, dissensions within the management or even dishonest management."

PREVENTION OF INDUSTRIAL SICKNESS AND STATE POLICY
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A survey of industrial sickness in India reveals that the State did not take preventive action before the enterprises closed down or became so seriously sick that they had to be admitted to the 'emergency ward'. But it must be clarified that but for reasons of accident, natural calamity or some other very powerful external factor, sickness does not develop all of a sudden. But the fact of the matter is that we do not pay any heed to the danger signals till the day comes when the enterprise collapses. It is in this context that we may understand the warning signals.

It would, therefore, be desirable to understand the process of industrial sickness,. For this purpose, a definition of industrial sickness would be helpful.

According to the Reserve Bank of India, "a unit is considered sick if it has incurred cash losses for one year and, in the judgment of the financing bank, is likely to incur cash losses for the current as well as following year and/or there is an imbalance in the unit's financial structure that is, when the ratio of current assets to current liabilities is less than 1:1 and debt-equity ratio (total liabilities as a ratio of net worth) is worsening^{*1} From

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Reserve Bank of India, Report on
 Trend and Progress of Banking in India (1977-78) p. 25

this, it follows that in the early stage of sickness, the unit is not able to meet its costs and depreciation. As a consequence, its net profits start declining. A stage comes when the losses mount further and the unit starts eating its capital and reserves. Mr. Sudarshan Lal in his definition of a sick unit has indicated two stages of sickness. According to him, "a unit can be considered as sick if it is operating at less than break-even point, that is, where it is unable to meet its costs and depreciation; the unit, which has eroded its capital and reserves, should be considered to have reached an advanced stage of sickness."²

It is, therefore, necessary that sickness should be detected at an early stage and preventive measures be taken immediately. If sickness is controlled in the beginning, it will involve much less social costs-both in terms of financial burden on the State exchequer and in terms of displacement of labour, loss of production and its effect on other industries. Sickness in one industry affects all those industries. Sickness in one industry affects all those industries which are connected with it on account of forward/backward linkages. Thus, the social cost of sickness in one or a few industries is not limited to them alone, but it retards the growth of other industries too. Thus from the point of view of the economy as a

*2 Sudarshan Lal, How to Prevent Industrial Sickness (1979)

whole, preventive measures are more desirable and economical.

WARNING SIGNALS OF INDUSTRIAL SICKNESS :

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The major warning signals of sickness are the following :

- i) Shortage of liquid funds to meet short-term financial obligations of creditors as also to meet statutory obligations. The first sign of sickness can be noticed when an enterprise can not pay for the purchase of raw materials, when it delays payment to its labour and when it is not in a position to meet the demand of short-term creditors for interest or repayment of loans. Besides this the industrial unit in all violation of legal provisions, stops meeting its statutory obligations, such as contributions to Employees Provident Fund, payment of excise and/or sales tax, etc. These signals foretell the development of a serious malady in future.
- ii) Growth of excessive inventories. Another warning signal is the growth of excessive inventories of raw materials, goods-in-process and finished goods. The failure of the firm to sell the finished goods at the pace it was doing earlier results in higher inventory accumulation.

- iii) Non-payment of interest on term loans or non-payment of instalments give another warning signal of impending sickness.
- iv) Under utilisation of capacity:- Every unit of production for its survival must cross the break-even point. It implies that the volume of production or sales of a firm is just adequate to cover the fixed costs, besides the variable costs which every production unit has to cover. If a firm operates below its break-even point, then it is incurring a loss and is bound to grow sick.
- v) Return on investment:- After meeting its costs, a production unit should be able to make an adequate provision for depreciation. Besides this, the unit after making payment of interest on borrowed capital from friends, relatives and other creditors, should be able to generate a reasonable figure of net profits (before tax) for the enterprise. For obtaining a rate of return on investment, net profit as a proportion of the total investment in the enterprise has to be taken. Total investment should include equity capital and reserve. A comparison of the rate of return with the prevailing rate of interest is indicative of the health of the enterprise.

vi) Maintenance of certain financial ratios. : An enterprise is considered according to the Reserve Bank of India, as sick if the ratio of current assets to current liabilities is less than 1 : 1. In other words, it indicates cash losses and declining liquidity of the firm.

Similarly, debt-equity ratio (total liabilities to net worth) is another indicator of the state of financial health of a firm. A declining debt-equity ratio indicates movement towards sickness.

However, the financial ratios can not be treated as true indicators of the state of health of a firm. The firms, more especially sickness-prone firms, in order to put up a better image do a lot of window dressing. The Report of the Pandon Group appointed by the Reserve Bank of India to frame guidelines for follow-up of bank credit states : " With a steady erosion of profitability, noticed by the banker, the borrower's liquidity declines and the first sign of difficulty is delayed payment to creditors, leading ultimately to default. With further deterioration in profitability, followed by losses, current liabilities exceed current assets or, in other words, a net working capital surplus becomes a net working capital deficit. At this stage, cases are not unknown where

a borrower may be tempted to furnish incorrect stock statements in the fear that disclosure of the true state of affairs would precipitate bank action."

GOVERNMENT POLICY ON INDUSTRIAL SICKNESS :

Mr. Geroge Fernandes, former Union Minister for Industry made a policy statement on industrial sickness on 15th May, '78 in the Parliament. The main elements of the policy were as under :

1. The government should make suitable arrangements for monitoring and detecting industrial sickness at an early stage.

2. The financial institutions should jointly set up a group of professional directors who would be full time employees of the institutions and who could be nominated on the board of directors of the companies with doubtful management competence or integrity and in which the institutions have a substantial stake. In case, the group finds that the management has acted in a patently incompetent manner or has indulged in malpractice the same management will not be extended financial assistance until the management is changed.

3. The government proposes to set up a screening committee to make recommendations relating to sick undertakings on the following lines :

a) It may recommend the take-over of the management of a sick undertaking with the clear understanding that the

units will not be handed back to the same management.

- b) In case, the financial institution or the State Govt. recommend that the unit should be taken over, or where the take-over of the unit is considered necessary in national interest, the management should be taken over.
- c) After take-over of the management, the unit could be sold as a running concern or alternatively, a reconstruction of the undertaking could also be done. Such reconstruction will include writing down the share values, conversion of loans to equity, acquisition of shares by the Government, constitution of new board of directors, etc.
- d) The merger of the unit with a public sector undertaking could also be considered.
- e) Sick units in the small sector will be given special attention. Three specific measures were suggested in this respect :
 - i) State Finance corporations and commercial banks will be asked to devise a scheme for rehabilitation of sick industries in the small-scale sector and assistance given by them for the revival of such units will be eligible for re-financing by the Industrial Reconstruction Corporation of India Ltd.

or the Industrial Development Bank of India at a concessional rate of interest.

- ii) The Government and other purchasers of the products of small-scale industry, will be directed to settle dues of small scale units on a priority basis and commercial banks will be asked to ensure that credit given to large-scale units for working capital is applied first towards meeting dues of small-scale suppliers.
- iii) In order to protect the investment of technical entrepreneurs in cases where small scale units promoted by them are forced to close down for reasons beyond the control of the entrepreneur, the possibility of evolving suitable scheme of risk insurance for safeguarding the interests of the entrepreneur will be examined.

The main thrust of the policy is to reduce the incidence of sickness in industry and dishonest management.

Following the announcement of the Government policy, a special cell on sick units in the RBI was formed to monitor the performance of sick units and to suggest corrective measures in regard to their rehabilitation.

Similarly, regional monitoring cells have been formed with experienced and qualified staff to give counselling assistance to agencies financing small-scale units.

From the foregoing analysis, it is clear that the problem of industrial sickness in large and medium scale enterprises is structurally different from the problem of sickness in small scale units. In the case of the large and medium-scale enterprises, the problem is basically one of enforcement of the Company Law to prevent contrived sickness.. It is also necessary that a careful review of the balance sheets should be made every year. This shall enable the State to understand whether a particular enterprise is healthy, sickness-prone, sick at an early stage or sick at the advanced level.

Since there is considerable scope for manipulation in the financial statements, it may be difficult to discover many of the manipulations from financial audit. It would, therefore, be appropriate to insist on cost audit which could reveal the malpractices in the manner of expenditure and thus indicate whether a particular unit was sound or not. The danger signals can be noted more easily in cost audit, rather than in financial audit. So far the vigilance of the government has not been adequate. Even the creation of a Cell in

the RBI for sick units does not imply that RBI will look into the affairs of all the companies. For this purpose, the enforcement of the Company Law is very necessary.

As per information contained in the progress report of the High Power Committee of the Reserve Bank on sick units for the quarter ended September 1979, there were 16,947 sick units in the small-scale sector, involving aggregate bank finance of Rs. 181 Crores. Out of these units, 4,142 units were considered by banks as potentially viable and 7,671 units as nonviable. The banks had still to decide on the viability of the remaining 5,134 units. In the medium and large sector, out of 345 units identified as sick, 155 units with outstanding bank credit of Rs. 605 crores were considered viable.

During 1979, the Government of India considered 18 new applications in addition to the pending applications for merger of sick units with healthy units under Section 72-A of the Income Tax Act, of which only 7 applications were approved. Under the new Industrial Policy (1980). Sick Units will be taken over in future only in exceptional circumstances and in appropriate cases.

Out of 463 large and medium sick units identified by banks by the end of June 1983, viability studies in respect of 409 units were completed; of these 345 units were considered viable and 248 units were put under nursing programme.

Out of 64,388 small scale units in June 1983, surveys by the banks of 53,367 units revealed that only 5,983 units (i.e. 11%) could be considered as potentially viable and 50,384 units (i.e. 89%) were non-viable, and Banks had put 2,257 (out of 5,983) viable units under nursing programme. The point to be noted is that the mortality rate in small-scale units was very high and this required more careful planning in the establishment and the nursing of small-scale units in infancy. The Government has established the Industrial Reconstruction Bank of India (IRBI) under the act of Parliament passed on August 7, 1984 by converting the Industrial Reconstruction Corporation of India (IRCI) - the principal agency for the revival of sick units. The IRBI would not only provide reconstruction assistance to sick units but also development assistance combined with merchant banking. It will also be empowered to take certain decisions in conformity with MRTP and FERA rules so as to permit large multinational houses to participate in reconstruction plans for sick units. Besides, it would be empowered to expedite cases of amalgamation. It shall also have the power to take over any sick unit under its assistance for the purpose of managing and running it. The entire approach of the Government to make the small-scale units as the underpinnings of the large multinational houses is faulty as it defeats the very purpose of promotion of small scale units. The multinationals will

only take advantage of the concessions available to such units and would not encourage the development of the small entrepreneurs as also the enlargement of employment.

As against it, though viability studies were completed for only 85 per cent of large and medium units, 73 per cent were considered viable and nearly 54 per cent were put under nursing programme.

In nutshell, it may be stated that no serious dent has been made into the problem of industrial sickness. Moreover, despite all talk of priority sector in which small units fall, the quantum of assistance to help large and medium units to rehabilitate them is far greater than that provided to small scale units, both in absolute and relative terms. Delayed provision of nursing programme, even among the viable industrial units, will push them into chronic sickness, thus falling a prey to mortality. The Government has failed to arrest industrial sickness during the last decade. It is really distressing that so far it has been able to create an infrastructure merely to detect sickness. How long shall it take to diagnose the causes of sickness and initiate measures to control and cure sickness? Unless the Government attacks this problem in right earnest, industrial sickness will not only damper entrepreneurial initiative, it will also bring

misery and suffering to the working classes. The problem of small scale sick units deserves priority attention to save lakhs of employees and small and young entrepreneurs dependent upon them.