# CHAPTER - III

## ANALYSIS AND INTERPRETATION OF LIQUIDITY & SOLVENCY

### 'A'

**III – 1. Introduction Liquidity ratio -**

Liquidity ratios measure the firm's ability to meet it's current obligations i.e. ability to pay it's obligations as and when they become due. Liquidity implies the ability to convert assets into cash or to obtain cash.

**III- 2. Meaning & Significance –**

Liquidity, however is a matter of degree Liquidity ratios establish a relationship between cash and other current assets to current obligations. 'Short Term' liquidity is very important for a firm.

A lack of liquidity may mean that the enterprise is unable to avail itself of favourable discounts and is unable to take advantage of profitable business opportunities as they arise. To the Owners, of an enterprise, a lack of liquidity, can mean reduced profitability and opportunity. It affects the customers and creditors of an enterprise in a big way.

A firm should also ensure, that it is not highly liquid too. A very high degree of liquidity is also bad because the funds are unnecessarily tied up in current assets, which earn nothing. A standing balance, therefore, is necessary.

Commonly used liquidity ratios are (a) Current ratio (b) Quick or Acid test ratio.

The short term liquidity of a firm or enterprise can be analysed or studied with the above two mentioned ratios as follows :

1) Current Ratio

(1.a) Meaning - Current ratio also called as Working capital ratio is the most widely used of all analytical devices based on the balance sheet. It expresses the relationship between Current Assets and Current liabilities.

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

(1.b) Components

A) Current Assets - It normally includes cash in hand, cash at Bank, marketable securities, other than short term and investments, Bills receivable, prepaid expenses, Sundry Debtors and inventories.

B) Current Liabilities - Current liabilities are composed of sundry creditors, outstanding, and accrued expenses, income tax payable, bills payable etc.

(1.c) Significance

The popularity of current ratio as a measure of liquidity and of short term financial health can be enumerated is following points

1) It measures the degree to which current assets cover current liabilities. The higher the amount of current assets to current liabilities, the more assurance exists that their liabilities can be paid out of such assets.

2) The excess of current assets over current liabilities provide a buffer against losses, which may be incurred in the liquidation of current assets other than cash.

3) It also measures the reserve of liquid funds in excess of current obligations, which is available as a margin of safety against uncertainties a firm may face.

4) Ina sound business, ratio of 2:1 is considered as a ideal one. If it is lower than 2:1, the short term solvency of a firm is considered doubtful .

5) Higher the ratio, higher the margin of safety to the creditors.

6) Cash in a concern, may not necessarily be immediately available to meet current liabilities appearing in a Balance sheet. But further there can be a likelihood of an adequate short term inflow, indicated by the same amount of sundry debtors, holding of easily realisable investments and inventories.

(1.d) Precautions - An analyst should use this ratio as a measure of firm short term liquidity, recognizing some of important points related to it.

1) Proper valuation of current assets and current liabilities is necessary. As if the values of current assets is not correctly estimated, the current ratio may be unduly inflated or unnecessarily reduced.

2) Only marketable investments value should be taken as current assets.

3) Current liabilities , by way of discount on bills receivable, should be given proper consideration.

4) Long term liabilities due for payment within a year as on the date of Balance sheet shall be treated as current liabilities.

5) Current assets, may sometimes fall in value, due to various market conditions or management faults in estimating the amount of debtors or inclusion of unsaleable stock into inventories. These cases should be properly analysed, by an analyst before blindly relying on available ratio figures.

6) More importantly : the quantity of current assets and nature of current liabilities which enter the determination of ratio, should be properly measured.

The liquidity position of 'Unique Industries' under study, can be analysed with the help of current ratio with the help of the information available from it's financial accounts or statements.

(1.e) Table below shows the current ratio computation of Unique Industries for the study period from 1997 to 2001.

**Table III ( 1.e) Current Ratio**

| | Year | | | | |
|---|---|---|---|---|---|
| | 1997 | 1998 | 1999 | 2000 | 2001 |
| **(A)** | | | | | |
| Current Assets | | | | | |
| Stock | 332639 | 273575 | 250950 | 457609 | 597960 |
| S. Debtors | 1070783 | 871942 | 1726878 | 2113213 | 1612076 |
| Cash in hand | 14124 | 19170 | 10129 | 11375 | 34946 |
| Cash at Bank | 125000 | 400500 | 783 | 10377 | 10377 |
| Tax deducted at source | -- | -- | -- | 2180 | 3880 |
| Total | 1542546 | 1565187 | 1988740 | 2594754 | 2259239 |
| **(B)** | | | | | |
| Current Liabilities | | | | | |
| Sundry Creditors | 581188 | 346774 | 844622 | 746196 | 409051 |
| Other Liabilities | 192475 | | | | |
| Out. expenses | 1719 | 1050 | -- | 7463 | 72769 |
| Total | 775382 | 347824 | 844622 | 753659 | 481820 |
| Current Ratio **A/B** | **1.9 : 1** | **4.4 :1** | **2.3 : 1** | **3.4 : 1** | **4.6 : 1** |
| Average | | | **3.3 : 1** | | |

(1.f) Analysis & Interpretation of current ratio of 'Unique Industries'

The current ratio measures the total rupees worth of current assets and total rupees worth of current liabilities.

From the table above showing the computation of current ratio for a period ranging from 1997 to 2001, following observations can be made –

1) The trend of current ratio represented by Unique Industries is fluctuating. The ratio for the year 1997 is 1.9 : 1, which increases to 4.4 : 1 in 98, which then further decreases to 2.3 : 1 in 99, which is

seen increased to 3.4 : 1 in 2000, with a continued increase to 4.6 : 1 in 2001.

2) The trend observed above is due to change in the current asset and current liability position of ' Unique Industries' for the years considered

a) Increase in ratio of 4.4 over the previous year's ratio is seen due to increase in current assets and decrease in current liabilities at the same time.

b) This ratio decreases in 1999, due to increase in current liabilities. The current assets are seen increased in this year, but the increase in current liabilities is more than the increase in current assets which reduces the ratio.

c) The ratio in 2000 is 3.4 which is improved over 1999 ratio i.e. 2.3. The reasons apparent from table are increase in current asset position and decrease in current liabilities figure.

d) Current assets are seen reduced in 2001. But the ratio is more as compared to the previous year ratio of 2000. 4.6 in 2001 and 3.4 in 2000. The reason is a big fall in current liabilities position in 2001 as compared o 2000.

3) As a conventional rule, a current ratio of 2:1 is considered satisfactory. This standard is based on a logic, that is worst situation, even if the value of current assets become half, the firm will be able to meet it's obligations. The average ratio of Unique Industries comes at 3.3 : 1, for 5 years period. Considering the standard, this ratio is above standard, which suggest that the current ratio position of Unique Industries is sound.

4) A proper current ratio is very significant for any concern. A very high and very low current ratio, considering the standard ratio is not favourable for any concern. The average current ratio of 3.3 of 'Unique Industries' suggests that Unique Industries current ratio is above

standard and that it enjoys a greater margin of safety as for it's ability to pay off current obligations is considered.

(1.g) **Conclusion** – Current ratio is an indicator of a concern's liquidity position. Current ratio of Unique Industries is good for all the five years considered. The average ratio of 3.3 depicts a sound liquidity position of Unique Industries. However, considering the quality of current assets, it can be seen that the firm's current assets compose more of stock and debtors, that are slow moving assets as compared to cash. This composition needs to be improved, so as to improve it capacity to meet current obligations quickly.

2) Analysis & Interpretation of Quick Ratio of Unique Industries.

(2.a) Introduction - While using the current ratio, the quality of current assets and the nature of current liabilities which enter the determination of ratio should be carefully taken into consideration. A firm which has a large amount of cash and account receivable is more liquid, than a firm with a high amount of inventory in its current assets, though both the firms may have the same ratio.

To overcome this a more stringent form of liquid ratio is referred to as quick ratio.

(2.b) Meaning - It is a more refined measure of the firms liquidity position. It establishes the relationship between quick assets and quick liabilities

(2.c) Formula - $\frac{\text{Quick Assets}}{\text{Quick liabilities}}$

(2.d) Components –

A) Quick assets – Liquid assets include cash and those assets, which can be converted into cash immediately, without loss of value such as temporary investments, Debtors & Bills receivable. Stock, inventories and prepaid expenses are not

included in quick assets, as their value is subject to fluctuation and also they may take time for realisation.

B) Quick Liabilities - Liquid or quick liabilities refer to current liabilities i.e. creditors, bills payable and statutory outstanding expenses less bank overdraft and cash credit and other short term borrowings.

C) Significance - Certain points related to quick ratio are significant which are as follows –

1) It is a more stringent form of liquidity measurement, because inventories are excluded from the ratio Inventories have to go through a two step process of first, bring, sold, and converted into receivable and secondly collected.

2) Generally a quick ratio of 1:1 is considered ideal as it represents a satisfactory financial position.

3) A low quick ratio may be an index of bad liquidity position and vice-a-versa.

4) The quick test is so named because it gives the ability of the firm to pay it's liabilities, without relying on the sales and recovery of it's inventories.

5) This ratio, when used in conjunction with current ratio, gives a better picture of the organisation, as it the ability to meet its short term debts out of short term assets.

(2.e) Precautions - Certain precautions are required to be observed in computation of quick ratio.

1) The analyst must take the qualitative view of quick assets as well.

2) Due allowances should be given to doubtful or non realisable book debts.

3) Interpretation of quick ratio, also like other ratios depend on certain circumstances like a seasonable business, seeking to stabilize production will tend to have a weak acid test ratio, during its period of slack.

4) It must be remembered that though inventories are not a part of liquid assets, they may be used to a measurable extent to meet current liabilities because of their normal conversion into cash and bills receivables.

5) Possibility of window dressing is not overruled and hence suitable precaution should be exercised in the analysis.

**2.f** Table showing the Quick ratio of Unique Industries from 1997 to 2001.

**Table III ( 2.f) Quick Ratio**

| | Year | | | | |
|---|---|---|---|---|---|
| | 1997 | 1998 | 1999 | 2000 | 2001 |
| Quick Assets | | | | | |
| Debtors | 1070783 | 871942 | 1726878 | 2113213 | 1612076 |
| Cash in hand | 14124 | 19170 | 10129 | 11375 | 34946 |
| Cash at Bank | 125000 | 400500 | 783 | 10377 | 10377 |
| Total | 1209907 | 1291612 | 1737790 | 2134965 | 1657398 |
| Quick Liabilities | | | | | |
| Sundry Creditors | 581188 | 346774 | 844622 | 746196 | 409051 |
| Other Liabilities | 192475 | | | | |
| Out. expenses | 1719 | 1050 | -- | 7463 | 72769 |
| Total | 775382 | 347824 | 844622 | 753659 | 481920 |
| Quick Ratio | **1.5 : 1** | **3.7 :1** | **2.05 : 1** | **2.8 : 1** | **3.4 : 1** |
| Average | | | **2.69 : 1** | | |

Source : Financial statement of Unique Industries.

(2.g) Analysis - Interpretation of Quick Ratio of Unique Industries –

An advantageous tool of analysis especially to credit grantors, depicts the resources available at a given time to meet the obligation at that given time of a business company.

Position of Quick ratio of Unique Industries.

1) Comparative analysis of quick ratio for 5 years period of study from 1997 to 2001, reveals a fluctuating trend like current ratio.

2) The ratio in 1997 is 1.5, which then increases to 3.7 in 1998, which further decreases to 2.05 in 1999 which again is seen improved to 2.8 in 2000 and a further improvement in ratio of 3.4 in 2001.

3) The reasons for the trend observed above can be analysed at

a) The ratio in 1997 is 1.5, which is seen increased to 3.7 in 1998, due to increase in the value of quick assets and decrease in the value of quick liabilities at the same time.

b) The ratio further decreases to 2.05 in 1999 from 3.7 in 1998, due to increase in quick liabilities, more than the increase in quick assets.

c) The ratio comes upto 2.8 in 2000 from 2.05 in 1999, due to increase in quick assets and decrease in quick liabilities.

d) Improvement in ratio is observed in 2001 at 3.4 over 2.8 in 2000 due to all in quick liabilities, which is more than the fall in quick assets.

4) Considering the standard ratio as 1:1 Unique Industries average ratio which comes to 2.69 shows a very sound liquidity position of Unique Industries.

(2.h) **Conclusion -** Unique Industries Quick ratio is good throughout the 5 years period of study, giving an average of 2.6; The difference in the current and quick ratio is mainly seen due to the stock exclusion from current assets while quick ratio calculation.

**III – 3) Conclusion -**

Current Ratio and Quick ratio are one of the important measures of Working capital analysis. Adequacy of working capital is the life blood and controlling nerve centre of business. Less or excess working is dangerous for the health of industry.

Considering the current and quick ratio of Unique Industries, we can say that it enjoys a good liquidity position. But too much of liquidity leads to less profitability. Both the ratios are above the standard ratios concerned, which may affect it's profitable position, due to idle cash and liquid assets, without being invested in a right purpose, so as to earn a proper return.

## III – B SOLVENCY RATIOS

**III- 4** Introduction - The financial strength and stability of a business entity, the profitability surrounding its ability to withstand random shock, and to maintain it's solvency in the face of adversity are some of the important measures of risk associated with it. The evaluation of risk is critical for the lenders, which require returns, which are commensurate with the level of risk they assume. Solvency ratio help the evaluation of financial strength and viability of enterprise.

**III-5** Meaning & Significance - Solvency of a firm refers to it's financial capacity to pay its debts. The process of evaluation of long term solvency of an enterprise differs markedly from that of assessment of short term liquidity. The measures used in the evaluation of long term solvency are less specific but more all – encompassing.

Generally bankers and other short term creditors are interested in the current debt paying ability of a business and the shareholders debenture holders and long term lenders are mainly concerned with the long term

prospects. A firm should have a strong financial position to meet its short term as well as long term obligations.

However, both the groups, short term lenders and long term tenders are concerned with current and non-current sections of Balance sheet as well as current and prospective earnings.

In this section of Chapter – 3 , we shall examine the tools and measures available for the analysis of long term solvency of stated small scale unit.

To judge the long term financial position of the firm following ratios are used .

1) Debt to Equity ratio
2) Proprietary ratio
3) Interest coverage ratio

1) Debt to Equity Ratio

(1.a) Meaning - These ratios indicate the funds provided by the long term creditors and owners. It relates all recorded creditors claim on assets to the owners recorded claiming in order to measure the firm's obligations to creditors in relation to funds provided by owners. It is also known as 'External – Internal Equity Ratio'

Debt financing is more risky from owners point of view due to the firm's obligation to pay interest irrespective of profits. Also a high debt burdened company has difficulty in raising funds from creditors and prospective shareholders in future. But equity shareholders also favour debt financed co. as if the cost of debt financing is less than profit ability rate, they get higher income by trading on equity.

Thus, the ratio is calculated to measure financial risk and the firms ability of using debt for the benefit of shareholders.

(1.b) Components -

A) External funds - It includes all long term debts, whether in the form of mortgages, bills or debentures.

B) Internal funds - It is composed of owners claims in the form of equity shares, preference shares, capital reserve, retained earnings and any reserves representing earmarked surplus e.g. reserves for contingencies or for plant expansion.

(1.c) Formula - $\frac{\text{Outsiders Funds}}{\text{Owners funds}}$

(1.d) Significance –

1) The purpose of Debt to Equity ratio is to derive an idea of the amount of capital supplied to the firm by the owners and the asset cushion available to creditors or liquidators.

2) On an average, debt to equity ratio of 1:1 is acceptable.

3) A high ratio shows the higher claims of creditors over assets of the firm than those of owners.

4) Average high ratio shows an unfavourable position as it is difficult in raising funds from creditors. A high indebted company has a greater charge on it's profits and profitability.

5) A low ratio on the other hand means greater claim of owners over the assets of the Company than those of creditors.

6) It provides greater margin of safety to creditors, so a low ratio is considered favourable from the point of view of creditors.

7) In concerns where owners funds are composed of equity shares, they have high prospects of earning more returns, if the profits of the concern are more than the cost of debt financing.

(1.e) Precautions –

1) There are different view on the inclusion of the short term or current liability in debt for the purpose of calculating debt equity ratio. But the more accepted view is the inclusion of current liabilities in total debts of the firm.

2) Additional analytical steps of importance include an examination of debt maturities, interest costs, and other factors which have a bearing on the risk. Also earning stability of the

enterprise and its industry are important factors of consideration.

3) Though on the average, debt to equity ratio of 1:1 is more acceptable, and it cannot be treated as a generalisation, as its interpretation depends on the financial and business policy of the enterprise.

I.f) Table below shows Unique Industries Debt- Equity ratio from 1997 to 2001 **(Table III B (1.f) Debt : Equity ratio.**

| | Year | | | | |
|---|---|---|---|---|---|
| | 1997 | 1998 | 1999 | 2000 | 2001 |
| **A** | | | | | |
| Debt | | | | | |
| H.P. Car loan | 145632 | 76499 | | | |
| Apple Ind. Ltd. | 276888 | 158222 | 39555 | | |
| Kotak Mahindra Premium Ltd. | -- | -- | 240605 | 146429 | 52253 |
| Tata Finance Ltd. | | | | | 193513 |
| Kop. Janata Sah. Bk C/C | 1019668 | 1834691 | 1910557 | 2801752 | 3101779 |
| Total | 1442188 | 2069412 | 2190716 | 2948181 | 3347545 |
| **B** | | | | | |
| Owners Fund | | | | | |
| Internal Funds or Owners contribution | 93025 | 20109 | 71269 | 98893 | 167026 |
| Profits/ Loss | 92395 | 105007 | 110338 | 126932 | - 120482 |
| Total | 185420 | 125116 | 181607 | 225826 | 46544 |
| Debt Equity Ratio **A/B** | **7.7 : 1** | **16.1 :1** | **12.06 : 1** | **13.05 : 1** | **1.9: 1** |
| Average | | | **2.4 : 1** | | |

Source : Financial Statement of Unique Industries.

1.g) Analysis and interpretation of Debt Equity ratio of Unique Industries for 5 years of 1997 to 2001.

Theoretically, higher the interest of proprietor as compared with that of creditors, sounder will be the financial structure.

1) From the table given above we can observe following trend of debt – equity ratio.

a) The ratio depicts a fluctuating trend, where ratio increases initially, then decreases, then again increases further.

b) The ratio of 7.7 is observed for the year 1997, which represents more of debt, then owners contribution this ratio is further increased to 16.1 in 1998, which is due to more of external use of funds, with less of owners contribution.

c) Ratio is further decreased to 12.06 in 1999, due to improvement in owners contribution toward concerns funds than the previous year.

d) 13.05 is an increased ratio in 2000 over the previous year of 1999 i.e. 12.06. The reason observed is more increase in and external funds towards concern's total funds, which is very large as compared to increase in owners contribution.

e) A very poor debt equity ratio is seen in the year 2001, with a very big increase in the ratio at 71.1 over the previous year's ratio of 13.5. There is a exceeding use of external fund in the year 2001, with a big fall in owners contribution, due to loss resulted in 2001.

2) Generally 1:1 is the standard ratio for debt – equity suggested. Comparing this standard the debt equity position of Unique Industries is very poor. There is a far more use of external funds than owners funds in business, throughout the period of study.

1.h) **Conclusion** – A suitable debt- equity policy is which, where the earning of owners increase. A very high ratio represents a greater risk to creditors and also to the shareholders under adverse conditions and

a low ratio indicates that the company is not making use of debt capital to the best advantage of owners. Considering the standard ratio of 1:1, Unique Industries ratio average for 5 years period comes to 24.1 which is very high. This high ratio threatens the concern's long term solvency position. This indebtedness of concern, creates a great charge on it's profit, creating higher claim of creditors over it's assets.

2) Proprietor's Fund ratio

(2.a) Meaning - This ratio shows the relationship between proprietor's funds and total assets. The difference between this ratio and 100 percent represents the ratio of total liabilities to total assets. So if this ratio is 80% it means the ratio of total liabilities to total assets is 20%. This ratio is a varient of debt- equity ratio, which establishes relationship between proprietors funds and total assets.

(2.b) Formula - $\frac{\text{Proprietor's Fund}}{\text{Total Assets}} \times 100$

(2.c) Composition – The two factors forming the above formula can be studied as follows –

a) Proprietors funds – It means owners funds in the form of equity or preference capital, reserves and surpluses minus losses.

b) Total assets - Total assets of the firm composes of fixed assets of depreciated value, current asset and other assets.

(2.d) Significance - The significance of the proprietor's fund ratio, can be jotted down in following words -

1) This ratio focuses attention on the general financial strength of a business enterprise.

2) This ratio is of particular importance to the creditors who can find out the proportion of shareholders funds in total assets employed in the business.

3) A high proprietary ratio indicates relatively little danger to creditors, in the event of forced reorganisation or winding up of a concern.

4) A low proprietary ratio indicated greater risk to the creditors because in the event of losses, a part of their money may be lost besides a loss to the proprietors as well.

5) Higher the ratio better it is. A ratio below 50 % may be alarming for the creditors since they may have to lose heavily.

(2.e) Table showing the proprietor's fund ratio for Unique Industries from 1997 to 2001.

**Table III B ( 2.e)**

| | Year | | | | |
|---|---|---|---|---|---|
| | 1997 | 1998 | 1999 | 2000 | 2001 |
| **A** | | | | | |
| Proprietor's Funds | | | | | |
| Capital | 93025 | 20109 | 71269 | 98893 | 167026 |
| Profit | 92395 | 105007 | 110338 | 126932 | -120482 |
| Total | 185420 | 125116 | 181607 | 225825 | 46544 |
| **B** | | | | | |
| Total Assets | | | | | |
| 1) Fixed Assets | 669698 | 663918 | 909959 | 909959 | 1051597 |
| 2) Current Assets | 1542546 | 1565187 | 1988740 | 2592574 | 2259239 |
| 3) Investments | 190747 | 313247 | 318247 | 42295 | 565069 |
| Total | 2402991 | 2542352 | 3216946 | 3927665 | 3875905 |
| Ratio **A/B x 100** | **7 %** | **4 %** | **5 %** | **5 %** | **1%** |
| Average | **4.4 %** | | | | |

Source : Financial Statements of Unique Industries.

(2.f) Analysis and Interpretation of Proprietor's funds ratio of Unique Industries for the period of 1997 to 2001.

This ratio focuses the attention on the general financial strength of the business enterprise.

1) Following trend is observed of proprietor's fund ratio of Unique Industries for the study period.

a) 7% ratio is seen in the year 1997, which has decreased to 4% in 1998. This change suggests that there is decrease of use of proprietors funds towards the assets of the concern.

b) Ratio is slightly improved to 5 % in 1999 from 1998, which can be seen through the increase in proprietor's funds in 1999.

c) A to same ratio is seen in 2000 as that of 1999 i.e. 5 %, which is reflected through increase in proprietor's funds application towards increased assets.

d) A very low ratio is seen in 2001 at 1 % only, due to loss in the year, resulting in decrease in use o proprietor's funds towards increased assets.

2) Generally a ratio below 50% may be alarming for the creditors since they may have to lose heavily, at concerns liquidations. The average ratio of 4.4 % is very low, suggesting a low percentage of proprietor's investment towards firm's assets.

(2.g) **Conclusion** - A high ratio may indicate firm's conservativeness in using debt and a low ratio indicates high risk to the creditors and proprietor and well. In case of Unique Industries the ratio is very low suggesting a risk to the concern's long terms solvency, which may result in losses to the concern in long run.

**3) Interest coverage ratio –**

(3.a) Meaning - This ratio is also known as Debt service ratio, which is determined by dividing fixed interest charges to Net Profit. It is a measure of a firm's ability to handle financial burdens. It is also

referred to as the times interest – coverage ratio. This ratio tells us how many times the firm can cover or meet the interest payments associated with debt.

(3.b) Formula - $\frac{\text{Net Profit before deduction of interest \& I.Tax}}{\text{Fixed Interest charges.}}$

(3.c) Components –

A) Net Profit = Net profit considered here has a controversy in it's usage. That is whether it is to be considered before charging income tax or after charging it. However Net Profit before income tax is considered more appropriate.

B) Fixed interest charges - Interest Obligations towards the external depths incurred by a concern.

(3.d) Significance:

1) The ratio gives an idea to the extent to which a firms earning may contract, before it is unable to meet interest payments out of current earnings.

2) The standard for this ratio, for an industrial company is that it's fixed interest charges should be covered 6 to 7 times.

3) A low debt service ratio, may make the financial manager experience difficulty in raising additional fund.

4) Similarly a relatively high debt service ratio is a sign of low burden of debt servicing and from the point of view of creditors, the larger the coverage of fixed charge liabilities.

(3.e) Precautions

1) The impact of income tax on the computation of earnings – coverage ratios should always be carefully assessed.

2) The assumption underlying this relationship is that the average historical performance of the firm under review will be

## Balance Sheet as on 31.3.99

| | | Rs. | Rs. |
|---|---|---|---|
| | Funds Employed | | |
| | I. Proprietary fund | | 181607 |
| | 1) Owner Contribution | 71269 | |
| | 2) Profit | 110338 | |
| | | 181607 | |
| | II. Long Term Loans | | 2190716 |
| | 1) Kop Janata Sah.Bank C.C. | 1910557 | |
| | 2) Apple Industries Ltd. | 39555 | |
| | 3) Kota Mahindra Premium Ltd. | 240605 | |
| | | 2190716 | |
| | Total | | 2372324 |
| | Application of funds | | ======= |
| | I. Fixed Assets | | 909959 |
| | 1) Land | 4400 | |
| | 2) Building | 175432 | |
| | 3) Machinery | 23890 | |
| | 4) Santro Car | 360263 | |
| | 5) Tata Tempo | 330390 | |
| | 6) Kinetic Honda | 15584 | |
| | II. Investment &Deposit | | 318247 |
| | 1) Kop. Jan. Sah. Bank Deposit | 216000 | |
| | 2) - " - | 50000 | |
| | 3) - " - | 47247 | |
| | 4) Bank of Maharashtra F.D. | 5000 | |
| | | 318247 | |
| | III. Working Capital | | 1144118 |
| | 1) Current Assets | | |
| | a) Stock | 250950 | |
| | b) Sundry Debtors | 1726878 | |
| | c) Kop. Janata Sah.Bank S/A | 783 | |
| | d) Cash in hand | 10129 | |
| | | 1988740 | |
| Less : | 2) Current Liabilities | | |
| | a) Sundry creditors | 844622 | |
| | Total | | 2372324 |
| | | | ======= |

it's average performance in future, which may or may not be true.

(3.f) Table showing interest coverage ratio of Unique Industries from 1997 to 2001.

**Table III-B (3.f) Interest Coverage Ratio**

| | Year | | | | |
|---|---|---|---|---|---|
| | 1997 | 1998 | 1999 | 2000 | 2001 |
| **A** Earning before int. and Tax | | | | | |
| Earnings | 92395 | 105007 | 110338 | 126932 | -120482 |
| Add : Interest | 215134 | 227718 | 383426 | 491989 | 579023 |
| Total (A) | 307529 | 332725 | 493764 | 618921 | - 458541 |
| **B** Total Interest | | | | | |
| Interest | 215134 | 227718 | 383426 | 491989 | 579023 |
| Total | 215134 | 227718 | 383426 | 491989 | 579023 |
| **Interest Coverage Ratio A/B** | **1.4 : 1** | **1.4 : 1** | **1.2 : 1** | **1.2 : 1** | **- 0.7 : 1** |
| Average | **0.9 : 1** | | | | |

Source : Financial Statements of Unique Industries.

(3.g) Analysis & Interpretation of Interest Coverage Ratio of Unique Industries from 1997 to 2001.

Interest coverage ratio shows how many times, the interest charges are covered by funds that are readily available to pay interest charges.

1) Above Table helps us to analyse the following information of Unique Industries interest coverage ratio.

a) To begin with the ratio in 1997 is 1.4. The ratio in 1998 is constant to that of previous year i.e. 1.4 There is improvement in

concern's earnings before interest, but there is also an increase in interest charges of that year, fairly at same rate, which maintains the ratio constant.

b) Increase in interest charges is seen in 1999, which pushes the ratio downwards to 1.2, in spite of improvement in profits in 1999.

c) Same trend is observed in the ratio during of the year 1999 to 2000, to that of 1997 to 1998. The ratio in 2000 is same at 1.2 as that of previous year.

d) A negative low ratio is observed in the year 2001, due to loss shown in the year concerned. Also interest charges are seen increased in 2001, which pushes down the ratio to -( 0.7)

2) The standard for this ratio for an industrial company is that interest charges should be covered 6 to 7 times. A low average ratio is seen in case of interest coverage of Unique Industries at 0.9. This low ratio indicates excessive use of debt to owners funds.

(3.h) **Conclusion** - Interest coverage ratio thus measures the capacity of the firm to cover up its interest payments, from the profits earned by it. Standard ratio suggested is 6 to 7 times, which as compared shows a weak interest coverage ratio of Unique Industries which is on an average only 0.9 times. The Unique Industries should improve it's profitability as well and try to bring down its big fixed interest obligations.

**III.6) Conclusion –**

Solvency ratios are concerned with a given firm's long terms financial strength. They measure the contribution of finance by owners compared with finance, provided to outsiders. There should be optimum mix of debt and owners contribution in financing firms assets. Unique Industries show a very weak solvency position. It shows increased use of external funds in the industry concerned, which

increases the cost of debt burden to the concern, which reduces the earning available to owner making it difficult in raising funds from creditors in future.