C H A P T E R 5

FINANCIAL STRENGTH OF THE BANHATTI CO-OPERATIVE SPINNING MILL LIMITED, BANHATTI

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C H A P T E R 5

FINANCIAL STRENGTH OF THE MILL

5.1 INTRODUCTION

The modern financial management covers various functional areas. Due to limitations of time, the present study is confined mainly to analysis of financial statements to judge the financial strength of the Banhatti Co-operative Spinning Mill. Analysis of financial statement is one of the functional areas of financial management. This chapter is divided into two parts namely,

(1) Short-term financial strength, and

(2) Long-term financial strength

The ratio analysis technique is used to judge the financial strength of spinning mill. The period of five years is taken for this period from 30th June, 1986 to 30th June 1990.

5.2 FINANCIAL STRENGTH

Financial strength indicates the financial position of the enterprise. An enterprise is deemed to be financially sound if it is in a position to carry on its

business smoothly and meet all its obligations both long-term as well as short-term without strain. According to Kennedy and Momullen, "the term financial strength has reference to the ability of the business enterprise to

i. meet the claims of the creditors not only under current economic and business conditions but also under unfavourable situations that may occur in the future.

ii. take advantage of business dealings or expansion which requires presently owned resource, additional funds obtained and capital stock or a favourable credit rating, and,

iii. To continue interest and dividend payment without interruption[1]".

There are two aspects of the financial strength of any business enterprise - the short-term and the long-term. The short-term financial strength relates to the technical solvency of the enterprise in the near future. The long term financial strength depends on the structure that has been imposed on the business in financing more permanent assets requirements. Thus, the financial strength includes the overall financial health of an enterprise i.e. whether the enterprise is able to meet all its obligations like, short-term as well as long-term, when they fall due for

payment. To quote Sehattke, Jensen and Bean, "the financial strength of the company refers to the company's ability to pay expenses and to meet debt obligations, when they become due and paybale[2]".

The evaluation of financial strength of an enterprise is useful for all the parties interested in the enterprise directly or indirectly, as shareholders, financial institutions, Government, economists, trade union, employees, public and researchers, etc. While banks and other short-term creditors are most concerned with the current debt paying ability of the enterprise i.e. short-term financial strength, debenture holders, and long-term lenders are mostly concerned with the long-term financial strength of the enterprise. While judging the financial strength of a business, it has to be assumed that the balance sheet is a continuing statement of financial condition of the business. This is the basic assumption before proceeding to judge the short-term as well as long-term financial strength of a business.

To judge the financial strength of the Banhatti Co-operative Spinning Mill Limited, the technique of ratio analysis has been applied. The chapter has been divided in two parts interms of short-term and the long-term financial strength.

5.3 SHORT-TERM FINANCIAL STRENGTH

Short-term creditors of the enterprise are primarily interested in knowing the its ability to pay short-term creditors as and when they become due. For this purpose, creditors focus their attention on the enterprise's cash generation power and total current assets in relation to the total current liabilities. As observed by Tracy, "short-term solvency analysis begins with the comparison of total current assets to total current liabilities. It is usually expressed as ratio[3]".

Thus, ratio analysis plays a dominant role in evaluating the financial strength of an enterprise. Two important liquidity ratios are calculated to measure the short-term financial strength viz. 1) current ratio, and 2) quick ratio. Therefore, for analysing the short-term financial strength of the Banhatti Co-operative Spinning Mill, these two ratio have been used in the present study.

(a) CURRENT RATIO :- The current ratio, also called as working capital ratio, is the most widely used ratio. It is the ratio of current assets to current liabilities and is espressed as

$$\text{CURRENT RATIO} = \frac{\text{Total Current Assets}}{\text{Total Current Liabilities}}$$

The basic point underlying the computation of this ratio is to judge the ability of a business to meet its current obligations with a margin of safety i.e. after making allowance for a possible shrinkage in the value of current assets such as, inventories and receivables. Keeping in mind the possibility of 50 percent shrinkage in the value of current assets, the rule of thumb about the current the current ratio has been set at 2:1. That means, the current assets of the business should be twice the amount of current liabilities, in order to call the business as technically solvent (i.e. the ability of a business to meet its current liabilities duly as and when they become due). If the ratio is two, there will be no adverse effects on business operations in payment of current liabilities. If it is less than two, there will be difficulty in the payment of current liabilities and daily operations may suffer. It it is more than 3, it is very comfortable for the creditors but for the concern it is an indicator of idle funds and lack of enthusiasm for work.

It appears from TABLE 5.2, that inventories constitute the major portion of the current assets of the Banhatti Spinning Mill. As such, the rule of thumb is that the current assets should not be less than twice the current liabilities applied fully. During the period of study from 1986 and 1990, the current ratio varied from 2.37 times to

TABLE 5.1 CURRENT ASSETS & CURRENT LIABILITIES

(Rs. in lakhs)

	1986	1987	1988	1989	1990
CURRENT ASSETS					
1) Cash in hand, bank & P.O.	12.76	9.27	9.47	7.96	28.06
2) Accounts Receivables	15.45	42.41	75.32	72.79	47.39
3) Inventories	107.13	154.94	382.55	367.24	408.61
TOTAL CURRENT ASSETS	**135.34**	**206.62**	**467.34**	**447.99**	**484.06**
CURRENT LIABILITIES					
1) Cotton Pledge Cash Credit	-	-	-	-	-
2) Yarn Pledge Cash Credit	-	-	-	-	-
3) Hypothecation	33.74	0.80	53.18	65.78	90.59
4) Export Yarn Pledge Cash Credit	-	-	-	-	-
5) Export Cotton Pledge Cash Credit	-	-	-	-	-
6) Other Liabilities	23.26	97.65	287.81	247.32	125.54
TOTAL CURRENT LIABILITIES	**57.00**	**98.45**	**340.99**	**313.10**	**216.13**

TABLE 5.2 CURRENT ASSETS, CURRENT LIABILITIES & CUREENT RATIO

YEAR	CURRENT ASSETS	CURRENT LIABILITIES	CURRENT RATIO
1986	135.34	57.00	2.37 : 1
1987	206.62	98.45	2.99 : 1
1988	467.34	340.99	1.37 : 1
1989	447.99	313.10	1.43 : 1
1990	484.06	216.13	2.24 : 1

SOURCE : Compiled from Annual Reports of the Mill

2.24 times. It was less than two times in 1988 and 1989. But in the years 1986, 1987 and 1990, it was more than two times indicating a very satisfactory short-term financial strength in these three years. The ratio being so high as 2.99 times in 1987. This was due to accumulation of heavy inventories and cash credit loans were not taken by the mill. Besides these the expenditure was managed by the mill with its own resources.

In the year 1986, the current ratio is satisfactory. This indicates good short-term financial position.

In the year 1990, the current ratio is near to the standard. However, the short-term financial strength is some what doubtful.

In the year 1989, the current ratio is less than two i.e. 1.4 : 1, and there was large capital locked in the form of inventories. Therefore, the short-term financial position was doubtful.

On the other hand, in the year 1986, the ratio is more than satisfactory. It appears that the current assets are 2.2 times the current liabilities. But major part of current assets was covered by inventories. This might

indicate sound short-term financial strength from the creditor's point of view, but on the other hand, it also indicates mis-management of working capital from the management point of view.

(b) QUICK RATIO :- The quick ratio is another widely used device for judging the short-term debt repaying ability of the business in the near future. The ratio is designed to show the amount of cash available for meeting immediate payments. For calculating this ratio, the total of quick assets is divided by the total of current liabilities. The term quick assets means those current assets, which are either in the form of cash or can be easily converted into cash. Quick assets include cash balance in hand and at bank and receivables. Inventories are not included in quick assets because the emphasis is on the availability of cash in case of liquid assets. The inventories must be sold before their proceeds can be used for the payment of current liabilities : selling them involves the uncertain factors of marketability of inventories as well as the element of time required for conversion of raw materials and goods-in-process into finished goods. The formula used for calculating quick ratio can be expressed as follows.

$$\text{QUICK RATIO} = \frac{\text{Quick Assets}}{\text{Current Liabilities}}$$

TABLE 5.3 QUICK ASSETS & QUICK LIABILITIES OF THE MILL

(Rs. in Lakhs)

	1986	1987	1988	1989	1990
QUICK ASSETS					
1) Cash in hand, bank & P.O.	12.76	9.27	9.47	7.96	28.06
2) Accounts Receivables	15.45	42.41	75.32	72.79	47.39
3) Cotton Dept. Receivables	-	-	-	-	-
TOTAL QUICK ASSETS	**28.21**	**51.68**	**84.79**	**80.75**	75.45
CURRENT LIABILITIES					
1) Cotton Pledge Cash Credit	-	-	-	-	-
2) Yarn Pledge Cash Credit	-	-	-	-	-
3) Hypothecation	34.74	0.80	53.18	65.78	90.59
4) Export Yarn Pledge Cash Credit	-	-	-	-	-
5) Export Cotton Pledge Cash Credit	-	-	-	-	-
6) Other Liabilities	23.26	97.65	287.81	247.32	125.54
TOTAL CURRENT LIABILITIES	**57.00**	**98.45**	340.99	313.10	216.13

TABLE 5.4 QUICK ASSETS, CURRENT LIABILITIES & QUICK RATIO

(Rs. in Lakhs)

YEAR	QUICK ASSETS (Rs.)	CURRENT LIABILITIES (Rs.)	QUICK RATIO
1986	28.21	57.00	0.49 : 1
1987	51.86	98.45	0.52 : 1
1988	84.79	340.99	0.25 : 1
1989	80.75	313.10	0.26 : 1
1990	75.45	216.13	0.35 : 1

SOURCE : Compiled from Annual Reports of the mill

This ratio is the test of going-concern solvency of a business. As a general rule, when quick assets equal or exceeds the current liabilities, the financial position may be considered satisfactory. It is the measure of the extent to which the liquid assets are available to meet the immediate liabilities. This indicates the ability of the business to meet its commitments as they fall due for payment.

TABLE 5.4 indicates total quick assets and total current liabilities as well as quick ratio of the Banhatti Co-operative Spinning Mill. During the study period, the quick ratio is not satisfactory for the three years namely, 1988, 1989 and 1990. However, the ratio is satisfactory in years 1986 and 1987. The quick ratio varied from 0.25 in 1988, 0.26 in 1989, and 0.35 in 1990. In these three years, the ratio is less than two. This indicates unsatisfactory financial position. In the years 1986 and 1987, the ratio is more than two times and show satisfactory financial position. This may be due to better price of yarn and continuous economical policy of the mill, it was possible for the mill to manage with its own resources. Hence, there was no need felt to raise short-term loans during the years 1986 and 1987.

TABLE 5.5 CURRENT RATIO AND QUICK RATIO

YEAR	CURRENT RATIO	QUICK RATIO
1986	2.37 : 1	0.49 : 1
1987	2.99 : 1	0.52 : 1
1988	1.57 : 1	0.25 : 1
1989	1.43 : 1	0.26 : 1
1990	2.24 : 1	0.35 : 1

SOURCE : Compiled from Annual Reports of mill

5.4 LONG-TERM FINANCIAL STRENGTH

The short-term creditors are most interested in short-term financial strength or liquidity ratios. Whereas, the long-term lenders are most concerned with the long-term financial strength. They are primarily interested in whether the enterprise has the ability to pay regularly the interest due to them and to repay the principal at the maturity date. These lenders would also wish to assess the economic viability or vulnerability of the business enterprise. Therefore, for the long-term financial strength of the enterprise, the capital structure of the enterprise is to be taken into consideration. According to Kennedy and Mc Mullen, "there are many questions to be answered in studying the long-term financial position of the business. Two such questions are (a) What investment of capital has been made in the various types of assets? (b) What are the sources of this capital i.e. borrowed funds or owner's equity? The analysis of long-term financial strength can reply these questions[4]".

Three important ratios are calculated to measure the long-term financial strength of the spinning mill. These are (a) debt-equity ratio, (b) ratio of capital gearing, (c) fixed assets to net worth ratio.

(a) DEBT-EQUITY RATIO :- For analysing the composition of capital structure, normally debt-equity ratio is employed as a major tool for financial analysis. The term debt signifies total indebtedness of the company as consistency of its long-term obligations. Equity refers to the own funds as represented by net worth. Net worth means total of preference share capital. Equity share capital and reserves and surplus minus miscellaneous expenditure, if any.

The fundamental object of calculating this ratio is to measure the company. From the creditor's point of view, it measures the extent to which their interest is covered by owned funds. Higher the coverage of owned funds, the lower will be the protection to the creditors against the possible losses in the event of liquidation. This ratio is also important for judging the financial policy of the management as to whether the company is following over-conservative policy of financing or not. An ideal norm of the ratio is 100 percent i.e long-term debt should not exceed the owned funds in the business.

TABLE 5.9 shows the net worth of the Banhatti Spinning Mill for the period of five years. TABLE 5.6 shows total long-term debt for the period of five years and TABLE 5.7 shows debt for the years under present study.

TABLE 5.6 LONG-TERM DEBT (EXTERNAL EQUITIES) OF MILL

(Rs. in lakhs)

YEAR	IFCI LOAN	IDBI LOAN	ICICI LOAN	TOTAL
1986	75.00	162.00	75.00	312.00
1987	75.00	162.00	75.00	312.00
1988	69.24	161.29	69.24	299.77
1989	69.24	159.04	63.48	291.76
1990	51.96	118.66	46.20	216.82

SOURCE : Compiled from Annual Reports of the mill

TABLE 5.7 DEBT, EQUITY & DEBT-EQUITY RATIO

(Rs. in Lakhs)

YEAR	DEBT (Rs.)	EQUITY (Rs.)	RATIO
1986	312.00	587.37	53.11
1987	312.00	563.47	55.37
1988	299.77	556.03	53.91
1989	291.76	572.74	50.94
1990	216.82	608.76	35.61

SOURCE : Compiled from Annual Reports of the mill

TABLE 5.8 CAPITAL GEARING RATIO

(Rs. in lakhs)

YEAR	EQUITY CAPITAL (Rs.)	FIXED INT. BEARING LONG-TERM LOAN (Rs.)	CAPITAL GEARING RATIO
1986	383.02	312.00	0.81
1987	399.34	312.00	0.78
1988	399.43	299.77	0.75
1989	399.54	291.76	0.73
1990	399.54	216.82	0.54

SOURCE : Compiled from Annual Reports of the mill

TABLE 5.9 NET WORTH OF THE MILL

(Rs. in lakhs)

YEAR	EQUITY CAPITAL (Rs.)	RESERVES & SURPLUS (Rs.)	NETWORTH
1986	383.02	204.35	587.37
1987	399.34	164.13	563.47
1988	399.43	156.60	556.03
1989	399.54	173.20	572.74
1990	399.54	209.22	608.76

SOURCE : Compiled from Annual Reports of the mill

According to TABLE 5.7, the long-term financial strength of the Banhatti Spinning Mill was very sound during the period of study as the proportion of debt in 1987 to 1990 was less than the equity. The ratio registered a decreasing trend, in 1986 the ratio was 53.11 percent, in 1987, 55.37 percent; in 1988, 53.91 percent; in 1989, 50.94 percent and in 1990 the ratio was 35.61 percent. The mill is capital intensive but, it has to depend on equity funds and resilience on borrowed funds goes on decreasing during the period under study i.e. 1986-90. There is vast scope for the said mill to raise funds through long-term borrowing.

(b) RATIO OF CAPITAL GEARING :- The relation of ordinary shares (equity capital) to preference share and loan capital is described as the capital gearing[5]. The main idea behind this is to compare the composition of the capital employed by classifying the components into two groups i.e. funds bearing fixed charges or fixed interest and other funds which constitute equity shareholder's funds and do not bear fixed charges or fixed dividends. The ratio of capital gearing is calculated by dividing the total of long-term borrowed funds & paidup preference share capital by equity share capital. A highly geared capital is one which has a relatively large proportion of equity capital, which is

generally adopted by the companies having uncertain demand for its goods and which earn unstable rate of return.

TABLE 5.8 shows capital gearing ratios of each year during the period under study. From the table it appears that the Banhatti Spinning Mill was highly geared during the period under study. However, the capital gearing ratio shows a decreasing trend. This is mainly due to the fact that in the initial stages the mill has borrowed large amount from the Government, S. F. C., I. D. B. I., and I. C. I. C. I. Whereas, equity capital is very less. But as the production of mill started from the year 1983-84, the repayment of the loan was started and hence the ratio shows decreasing trend. But even today, the mill is overburdened by borrowed funds. During the study period, the mill relied to large extent on fixed charge capital.

(c) FIXED ASSETS TO NET WORTH RATIO :- The investment in fixed assets involves commitments of funds for longer periods into the future and usually are difficult and costly to reverse often they are in large increments[6]. Therefore, the management should be very cautious in dealing with and deciding about the investment in fixed assets. Along with the decisions for investment in fixed assets, the management has also to decide about the funds to be used as working capital in the business.

TABLE 5.10 FIXED ASSETS AND NET WORTH OF THE MILL

(Rs. in Lakhs)

YEAR	FIXED ASSETS (Rs.)	NET WORTH (Rs.)	RATIO
1986	1,001.36	587.37	170.48
1987	1,076.74	563.47	191.09
1988	1,118.99	556.03	201.24
1989	1,139.89	572.74	199.02
1990	971.35	608.76	159.56

SOURCE : Compiled from Annual Reports of the mill

The long-term investors, creditors and the share holders are most concerned with the investment policy of the management in fixed assets. This ratio indicates the percentage of fixed assets to the tangible net worth. The ratio is calculated by using the following formula.

$$\text{Fixed Assets to Net Worth} = \frac{\text{Fixed Assets}}{\text{Net Worth}} \times 100$$

This ratio is an important tool for judging the margin of safety for long-term creditors. The lesser the ratio, the greater is the margin of safety for long-term creditors. The fixed assets to net worth ratio enables one to judge the use of long term borrowed funds and the sources of financing the working capital. If this ratio stands 100 percent, it indicates that all the long-term borrowed funds are being used as working capital in the business. If this ratio exceeds 100 percent, it indicates that a part of borrowed funds has been used for financing fixed assets and the remaining part is being used for financing the working capital. In case the ratio is less than 100 percent, it is an indication of working capital is being financed by long-term borrowed funds plus the amount of owned funds to the extent to which the percentage is less than 100.

The fixed assets to net worth ratio of the Banhatti Spinning Mill during the period 1986 to 1990 registered an

increased trend except in 1990, varying from 170.48 percent in 1986 to 156.56 percent in 1990. In the year 1986, the ratio was 170.48 percent which indicates that about more than one and half the fixed assets were financed by the borrowed capital. In the year 1988 and 1989, the ratio was near too near two hundred, which indicates that all the fixed assets were financed by borrowed capital. Again in the year 1990, the ratio reduced to 159.56 percent. It indicates that half of the fixed assets were financed through the borrowed capital. In 1986 to 1990, the fixed assets were financed by borrowed capital but this cannot be taken as a sign of weak financial position. If whole portion of the fixed assets is financed by net worth, the return to the equity shareholders would have been considerably reduced due to failure to take advantage of trading on equity. So during the period 1986 to 1989, the ratio shows a increase in trend. The mill started borrowing to a more and more extent year by year. In the year 1989-90, the mill started repaying its borrowings to a great extent. Year by year, the mill raised capital and accumulated huge capital. During the study period, fixed assets were financed by borrowing capital, which shows that the mill's long-term financial strength was sound from the creditor's point of view.

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