# CHAPTER III

## QUESTIONNAIRE : CONTENTS AND SIGNIFICANCE

The chapter discusses the basis of sample selection, method followed for data collection and the contents of the questionnaire. In addition to discussing the contents of the questionnaire, the relevant literature on the basis of which the questions are developed are also discussed. The questionnaire is mainly notionally divided in two parts (1) quantitative and (2) qualitative aspect. The quantitative aspect studies the size and status of the branch and the qualitative aspect studies the factors given importance and techniques being followed in taking lending decision. It is in the qualitative part that the techniques/tools of management accounting are included to study its application in the lending decision.

### (A) SAMPLE SELECTION:

The banking industry in India is spread over the whole of India and the branches of Indian banks have also spread outside of the country. The banking industry in India can mainly be divided in the following groups shown in the form of genelogical tree :

- Commercial Banks
  - Non-Scheduled Bank
  - Scheduled Bank
    - Foreign Banks
    - SBI and its Associates
    - Nationalised Banks
    - Regional Rural Bank
    - Other Schedule Banks

Out of the above main groups, i.e. scheduled and non-scheduled banks, the scheduled commercial banks are at the dominant place. Out of, in total 60190 branches as on June, 1991, of all commercial banks in India only 42 branches were of non-scheduled commercial banks.[1] Thus, as the share of non-scheduled commercial banks was negligible they are not included within the purview and scope of the present study. Amongst the scheduled commercial banks, the dominant role is played by the SBI and its associates and the nationalised banks. This is clear from the following figures :

TABLE : III.1

STAKE OF EACH GROUP OF SCHEDULED COMMERCIAL BANKS AS ON MARCH, 1991

(Figures in percentage)

| Banks Group | Offices | Deposites | Credit |
|---|---|---|---|
| 1. SBI and its associates | 19.92 | 26.58 | 27.96 |
| 2. Nationalised Banks | 49.65 | 60.97 | 57.49 |
| Sub-total | 69.57 | 87.55 | 85.45 |
| 3. Foreign Banks | 0.24 | 5.68 | 7.54 |
| 4. Regional Rural Banks | 23.81 | 2.42 | 3.01 |
| 5. Other scheduled commercial banks | 6.38 | 4.35 | 4.00 |
| TOTAL | 100.00 | 100.00 | 100.00 |

Source : Banking Statistics : Basic Statistical Returns : Volume : 20, March, 1991, Published in February, 1993, Published by R.B.I.

1. RBI Bulletin, 1992, p.52.

From the above table it is clear that, eventhough the Regional Rural Banks branches are more than 20%, their share in deposits and advances is less than 5%, whereas the SBI, its associates and nationalised banks constitute around 70% of the branches and 87% and 85% of the total deposits and credit respectively of scheduled commercial banks in India. The share of foreign banks and other scheduled commercial banks is absolutely negligible. On account of the above reason, State Bank of India, its associates and the nationalised banks are kept under the purview of the study.

Coming to the second aspect of the scheduled commercial banks, the branches in the rural area are at the highest percentage i.e. 56.9% whereas the advances and deposits are at the lowest percentage i.e. 14.9% and 15.4% respectively. At the other extreme are the Metropolitan cities, where, eventhough number of branches are only 10%, the share in total scheduled commercial banks' advances and deposits was 46.3% and 39.3% respectively. Whereas so far as urban population group is concerned, the number of offices constitutes 14.3% of total offices of scheduled commercial banks and advances and deposits are 22.3% and 24.5% of total advances and deposits of scheduled commercial banks at all India level. And hence the sample selection was decided to be of urban area.

Amongst the urban area, the city of Baroda was considered suitable for sample study, considering the fact that it has a trend of industrialisation, since last few years. It has also got some nearby rural area. As a result, the advance porfolio, in Baroda, will have a mixture of all types of advances and naturally the lending officers in Baroda will be with experience of varied portfolio. And hence the sample selection of urban area like Baroda.

Out of total of 307 branches of scheduled commercial banks in the district of Baroda, 131 (42.67%) branches are situated in rural area, 17 branches (5.54%) in semi-urban area and 159 (51.79%) branches in Baroda urban area; whereas out of total advances of Rs.122605 lakhs of Baroda district, Rs.42345 (34.54%) lakhs were by rural branches, Rs.3597 lakhs (2.93%) were by semi-urban branches and Rs.76663 lakhs (62.53%) were by urban area.[2]

Out of 159 branches 146 branches were situated in Baroda city region as on December, 1992 as per the primary data collected by us.

(B) DATA COLLECTION :

As the present study is concerned with the 'application of management techniques in lending decisions by commercial banks in India' and here in as the views, policies and procedures followed by branch manager are very important as well as are of much concern, the primary data collection was thought the most appropriate method. For the primary data collection one may adopt : (i) Telephonic discussion (ii) Mailed questionnaire method or (iii) Personal interview method. Looking to the

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2. Banking Statistics : Basic Statistical Returns, Volume 20, March, 1991, published in February, 1993, p. 46.

Indian conditions, approaches, cost aspects and the type of information required, telephonic discussion was not felt suitable. The studies conducted in the foreign countries regarding banks based on primary data collection, shows that the number of respondents were substantially lower as compared to the sample size contacted in the case of mailed questionnaire method for e.g. 42 responses were received out of 100 by James Deitrick.[3] Also, the information sought for in the questionnaire was considerably in detail and it also included the case studies hence the personal interview method was considered to be the best suited. The problems attributed to mailed questionnaire method are also faced by some of the researchers in the area of accounting, which may be due to unwarranted approach in responding to the questionnaire or on account of the overburden of the work at the higher level of the organisation. In the light of this, for the purpose of data collection, personal interview method was selected. An attempt was made to contact each branch of the nationalised bank and SBI and its associates situated in Baroda city region.

In the first round, if the manager was available at his office and was in a mood to listen a person not connected with the business directly, the first meeting was introductory. There have been the cases where, either the manager had gone out for some office work like inspection, court, etc. or he may be busy with his customer solving his problems or he may be busy with the

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3. Deitrick James W. and Stamps Jennifer L., The use of Accounting Information by Bank Loan Officers : Journal of Commercial Bank Lending, November, 1981, p. 57.

proposed borrower in discussing his case, and, even the introductory discussion was also not possible in the first round. After the introductory session, there has to be series of follow-up sessions with most of the branch managers. Only in very few cases in the third or fourth meeting the reply to the questionnaire was received. Even after series of follow-up and discussion in some cases, it so happened that the managers were not willing to comply with the questionnaire under the pre-text of time and staff constraints saying they are busy with preparation of proposals/returns/court cases and in those cases if there is a very rude or negative response the only alternative left with the researcher will be to give the least consideration to that branch. On the other hand there have been the other extreeme where even-though the branch manager may be with total positive approach, but he was facing genuine difficulties and under such circumstances, there had been the cases where, by working on weekend day or holiday the manager had complied with the questionnaire. On account of first extreeme mentioned above the respondents were not total 146 (i.e. for branches situated in Baroda City Region) but approaching to it i.e. 105 (71.92%)

During the course of research it was observed that there is a basic difference between the research connected with the banking industry and research in the field of other social sciences. For example, in the area of marketing take the area of product development, the managers are to be contacted, but the things to be revealed are open, because they are also making publicity and advertisement of the products put by them in the market. In the area of consumer behaviour the researcher has to contact the consumers, where there are no time constraints, no bar on contacting the sample (consumers) on holiday. Here in case of primary data collection from bank branches the respondents are to be contacted between 11.00 a.m. and 5.30 p.m. and upto 3.30 p.m. only on Saturday. Also period between 11.00 a.m. to 1.00 p.m. is generally considered to be their peak hours and hence generally they are not in a mood to have non-business talks. In the afternoon session, they have their responsibilities like stock-inspection etc. and weekly returns also they have to file.

From the above going picture of the various situations it will be clear that the time that can be spared by the bank officials to a researcher is reduced to a substantial extent. Moreover, the sparing of the time by the bank officials to a researcher depends equally on the approach and aptitude of the branch manager to a researcher for a quick response or otherwise.

(C) BACK GROUND FOR DEVELOPMENT OF QUESTIONNAIRE :

The development of questionnaire can be put in the following stages :

i. Reference to research conducted in the area of banking, specifically, to work conducted on primary data collection.

ii. Reference to application forms required to be filled in by the borrower, while applying for advances from bank.

iii. Discussion with few lending officers.

In the first stage, the reference was made to the research conducted in the area of banking, especially on the primary data collection. A reference was also made to the questionnaire, if they, are available with the literature. One which was found the most useful, for preparation of the questionnaire was "The effect of Aggregating Accounting Reports on Quality of the Lending Decision. An Empirical Investigation" by A Rashad Abdet-Khalik[4] and 'Management Planning and control system in Commercial Banks' by Mohinder N. Kaura.[5] Both of above were containing the questionnaire, which was found useful in framing the questionnaire for present study.

In the second stage, the application forms were collected of various nationalised banks and SBI and its associates, for different types of advances for different segments. The utility of these forms lie in the information as to the details required to be furnished by the proposed borrower.

And, in the third stage the discussions were held with few branch managers regarding how the information gathered through application forms was being used and how the judgements were made

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4. A. Rashad Abdet Khalik, The Effect of Aggregating Accounting Reports on the Quality of the Lending Decision : An Empirical Investigation : Empirical Research in Accounting : Selected Studies, 1973, pp. 136-137.

5. Kaura Mohinder N, Management Planning and Control System in Commercial Banks, p. 128-139.

regarding the integrity of the borrower etc. and how a successful loan could be made. Discussions were also very useful for the purpose of preparation of the questionnaire.

D. CONTENTS OF THE QUESTIONNAIRE :

The questionnaire can broadly be divided in two groups : data based information and the subjective information.

i. DATA BASED INFORMATION :

Amongst the data based pieces of information, the information was sought regarding advances, deposits and profits of the branch for the last five years. Initially, the data were sought, for the years 1965, 1970, 1975, 1980 and 1985 to 1991 (except for the year 1988, for which there was no closing). However, the branches contacted in the beginning expressed their inability because of the non-availibility of data or because the branches were opened after 1975 and so on. And therefore the study covers the period 1985 to 1991. The branches were also very much reluctant to furnish any type of data base information on the grounds of secrecy which is well accepted. However, the researcher made an attempt to convince the branch managers about the requirement of data only for study purpose and by ensuring the confidentiality of the same. To ensure and to maintain the confidentiality of the data, to be submitted by the respondent, no reference regarding the bank or branch is kept on the questionnaire. Also considering the fact that the branch manager may not like to reveal the identity the information regarding the respondent's name, age, qualification and experience are also not included in the questionnaire.

After dropping this much information, the branch manager furnished some information, which was data based. However, the information regarding the year 1985 was still a problem. And only very few could furnish meagre information. Maximum data were available for the year 1991, and the minimum one was for the year 1985. For the year 1988, there was no closing on account of the uniform accounting year made and hence, after December, 1987 information available was for March, 1989. Amongst the items of information for advances further information was demanded regarding priority advance and non-priority advance. This information regarding deposits, advances and profits constitutes the first three questions of the questionnaire. This information regarding the branch was collected, to have an idea regarding the size of the branch and to know how with change in size there can be a change in the approach of a branch manager.

Information about the write-off : The information regarding advances written off by the branch is sought for by Q.4 of the questionnaire. This information is sought for the years 1980 and 1985 to 1991, which comprises of the number of cases, amount and the segment. The purpose of putting this question was to know the extent to which advances are being written off in various years and to have segmentwise comparision of write-off and yearwise trend analysis of write-off for branch.

This information was not furnished by majority of the branches on the following grounds :

(a) This information is considered to be confidential (b) When, once the branch moves the proposal, it is the higher authority to sanction the write-off (c) A systematic register for write-off is not available at branches (d) Even if details are kept regarding the amount written-off, it hardly gives information regarding year from which this advances have become non-performing.

Segmentwise, Facilitywise Advances :

To obtain this information Q. No. 5 was framed, wherein matrices were prepared for each year, to furnish the information regarding segmentwise and failitywise advances i.e. against each segment, columns were given regarding facility i.e. vertically there were all segments i.e. Agricultural loan, Small Scale Industries, Small Business and Retail Trader, Self employed and Professional, Transport Operator, Education, any other priority sector advance, commercial and industrial sector, advances against government securities and any other and total and horizontally all facilities viz. term loan, cash credit, overdraft, BP. BD, any other and total. Here also the difficulties were expressed by the branch managers about furnishing such minute details and under such disappointing circumstances, the researcher had to compromise with the details about total facilitywise advance and total segmentwise data, for this also there was a poor response as compared to response for question Nos. 1, 2 and 3.

The reason for putting Q.No. 5 was to have an idea about the facilitywise advance within a given segment as this can give an idea as to the specialisation of branch in a particular segment and particular facility and to see how this affected the approaches of the lending officer.

Q. 6, 7 and 8 are subjective which are discussed in part-II in the following pages.

Regularity Aspect of Advance :

This information was obtained by Q.9 of the questionnaire. Here again the yearwise matrix was prepared regarding the regular repayment, irregular repayment and non-fulfilment of the repayment schedule. The information was sought both for the amount and the number of cases. The information was further asked segnemtnwise, i.e. the above information was required for agricultural segment, SSI, BMRT, SEPR, TO, EDU and C & I. In this cases, it was very difficult for the branch managers to furnish the required information. Under the circumstances requests were made to furnish the information based on yearly health code statements. However, it was felt during the course of discussion that the format of the health code statements were not uniform for all i.e. SBI and nationalised banks. And as a consequence and as a last alternative during the course of discussion the branch managers were at a liberty to furnish information from any source available to them. In very few cases the above information was made available by the branch managers. The information given was about the bad and doubtful debts/ protested bills/suitfiled cases/over dues. In absense of detailed information available, any of this information which was made available was considered to be a problem credit.

Difficulties which are and can be faced in collection of such details regarding problem credit or overdues are also supported by the data furnished in Banking Statistics, Basic Statistical Returns, Vol. 20, March, 1991. Here table 1.24 furnishes information regarding 'distribution of overdues of scheduled commercial banks According to state and population group", here India is divided into 6 region and within each region statewise information for each population group is given separately i.e. for rural, semi-urban and urban/metroplitan the information is given regarding overdues. But the reference to the total column reveals that the information is only for 26544 branches only of which outstanding credit is Rs.5625287 lakhs. The total scheduled commercial Banks as on March, 1991 reported by the same volume are 61724 and total credit Rs.12420293 lakhs, i.e. only 43% of the branches were consistent in reporting overdues, which were constituting 45.29% of the total credit of Scheduled Commercial Banks in India. It is evident thus, even the published data do not cover all branches. The notes on table on p.361 (ibid) states that "this table is based on 26544 branches whose data on overdues reported in BSR-1 return were found to be consistent."

The purpose of putting this question by the researcher was to see, the extent to which the application of management accounting techniques affects the problem credit.

The analysis was thought necessary in view of the fact that "what is really painful is not only the volume of overdues has kept on rising but the proportion of overdues and the outstanding has been rising significantly."[6] "The scale of write offs and allowances for bad-debts in Indian Banking Industry points clearly to the prudence of identifying potential repayment difficulties earlier in the banking relationship."[7]

(ii) QUALITATIVE INFORMATION :

Q.No. 6, 7 and 8 of the questionnaire are subjective in nature and may be considered to constitute the second portion of the questionnaire.

RANKING OF FACTORS :

This information is requested through Q. No. 6. Here the information was sought regarding the factors which are given importance while taking lending decisions. The factors selected are : character, capability, security offered by the borrower, purpose, economic viability, financial feasibility, technical feasibility and national interest and suitability. The factors were selected on the basis of the literature contributed by both Indian and foreign authors. For e.g. Jeremy Taylor states, that "as lenders we learn first the elementary components of lending, the five "C" s of credit, capital, capacity, character, collateral and the conditions of business."[8] All these five points

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6. Kalra S.S., Menace of Overdues, The Banker, April, 1990, p. 25.

7. Clevel and Peter, Beyond the Balancesheet - Turning Losers into Winners, The Banker, June, 1986, p. 41.

8. Taylor Jeremy F., Credit Risk and the Logic of Lending, Bankers Monthly Magazine, May, 1986, p. 22.

are alsopointed out by David Kohl.[9] Bertz puts it as "character is the first "C" of the four "C"s of credit assessment (the others are capacity, capital and condition."[10]

Also, Cohen, Gilmore and Singer states that "answers to five key questions are analysed (1) for what purpose will the loan funds be used by the firms ? (2) what is the proposed amount of loan ? (3) What is the proposed maturity of the loan? (4) What is the proposed repayment schedule of the loan ? (5) What security is offered to the bank in connection with the loan ?"[11] Out of all the factors referred to by them, researcher tried to look into the factors which were unavoidable and accordingly the managers were required to give the ranking to the above factors and not to state whether they consider the above factors or not. The ranking has to be in the order of priority i.e. the factor which was given the most importance was to be assigned rank 1 and the factor which was to be given the least importance the rank 8.

Factorwise Analysis :

(a) Character :

The importance of this factor has been rightly pointed out by M.A. Pitcher. He says, "the character of the borrower will

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9. Kohl David M., Lending to Agribusiness, Journal of Commercial Bank Lending, April, 1990, p. 22.

10. Bertz Paul B., Rx for Credit : Recognition and Treatment of Distressed Debtors : Business Credit, February, 1989, p. 26.

11. Cohen Kalman J., Gilmore Thomas C. and Singer Frank A., Bank Procedures for Analysing Business Loan Applications - Vide Analytical Methods in Banking, ed., by Cohen Kalman J. and Hammer Fredetick S., p. 233.

always be a prime factor in any lending decision .... they lend to the man and that considerations of honesty and integrity far outweight any judgement they may make on an analysis of financial information which may be available."[12]

What is conveyed by the word character is very precisely explained by Lall Nigam in the following words : "Character is the most sought after attribute by the banker and is "invisible" which he refers to block letters by "MAN" .... It (Character) is said to be aggregate of certain mental and moral qualities. A person is noted for eccentricity, when he is governed by high sense of righteousness. Honesty is in the fore front of a well formed business personality; the other qualities being integrity, fairness, responsibilities, temperance, trustworthiness, industriousness etc. Character thus defined becomes credit character. When these traits combine to make one conscientious about his debts, so far as the evidence of character is concerned perhaps the best is along and consistent record of credit repayment."[13]

'Character' is holding the first place in "An ocean of "C"s described by Jack Crigger.[14] As pointed out by Larry White "character" is directly related to the question : will the customer repay ? Whether we are talking about business or an individual we must be able to answer this question in affirmative to extend

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12. Pitcher M.A., Management Accounting for the Lending Banker, p. 9.

13. Nigam B.M. Lall, Financial Analysis Techniques for Banking Decisions, p. 60.

14. Crigger Jack R., An Ocean of "C"s : Journal of Commercial Bank Lending, December, 1975, p. 2.

credit."[15] Corpora puts the precaution that "but before funds are dispersed the loan officer should be certain that the customer has unquestionable integrity."[16]

Providing guidelines as to how to judge the character of the borrower; Pace and Simonson point out that "each business transaction becomes an addition to the credit background which is reflected in credit reports, prior bank relationships dealing with trade creditors and dealing with customers. If background shows all debts have previously been handled as agreed, chances are that the loan will be similarly handled."[17]

Pointing out the circumstances underwhich character is of utmost importance L.C. Mather states that : "the integrity of the borrower must be undoubted particularly where the security is inadequate to cover the maximum to be advanced."[18]

As Hubert Mott states : "despite what some may say the "C"s of credit have not been repealed ! They are alive and well and cannot be ignored with impunity. Character is still of primary importance. There is still no substitute for the old maxim

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15. White Larry R., Credit Analysis, Two More "C"s of Credit, The Journal of Commercial Bank Lending, October, 1990, p. 11.

16. Corpora Leonard P., A Regulator's Look at Three of the Five "C"s of Credit, Journal of Commercial Bank Lending, June, 1992, p. 45.

17. Pace Edmond E. and Simonson Donald G., The Four Hundles of Lending (Atraining Feature), The Journal of Commercial Bank Lending, March, 1977, p. 11.

18. Mather L.C., The Lending Banker, A Review of Principles of Bank Lending Unsecured Advances and Balancesheet and the Banker, p. 11.

"know your borrowers."[19]

On this basis the factor "Character" was included as one of the eight factors in the questionnaire. During the course of discussion with the branch managers it was observed that they were least concerned with any other side of the character, but they were most interested in the consistent repayment record of the borrower and his integrity.

(b) Capability :

Pointing out the importance of this factor M.A. Pitcher states that "capability is another area of concern and it provide the opportunity to introduce an idea which is of great relevance to bankers."[20] According to Nigam "capacity signifies the ability to pay when a debt falls due. It measures the business risk of a loan and is in fact indicative of the borrower's competence to successfully w use the money requested for."[21]

With reference to the question how to judge capability White mentions that "Does the customer have where withal to repay the loan and what are these sources of repayment ?"[22] Cvigger

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19. Mott Hubert C., Commercial Loans, Their Changing and Unchanging Aspects, The Journal of Commercial Bank Lending, September, 1972, p. 59.

20. Pitcher M.A., Management Accounting for the Lehding Banker, p. 11.

21. Nigam B.M. Lall, Financial Analysis Techniques for Banking, Decision, p. 60.

22. White LarrybR., Credit Analysis, Two More "C"s of Credit, Journal of Commercial Bank Lending, October, 1990, p. 13.

puts the capacity in the following words : "Capacity the ability to pay debt..... Do we look at cash flow to determine that he can repay ?"[23]

(c) Security Offered by Borrower :

Explaining how collateral should be viewed Crigger states that "Collateral Probably the most important thing one can say about. Collateral is that we should not look to Collateral to pay a debt."[24] He further explains the care to be taken for security as follows - "correctly done the pledge should be sound, properly documented and continuously checked as to its authenticity and value. Otherwise we can wind-up with an unsecured loan and a loss."[25] Pace and Simonson state that "collateral is usually the best secondary source of repayment and the more collateral the better."[26]

Stating the Cardinal principles of bank lending Vaswani points out that "safety, liquidity and profitability (of funds lent) are thus the three cardinal principles of bank.Lending."[27]

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23. Crigger Jack K., An Ocean of "C"s, Journal of Commercial Bank Lending, December, 1975, p. 3.

24. Ibid., p. 3.

25. Ibid., p. 4.

26. Pace Edmond E. and Simonson Donald G., The Four Hundles of Lending (A training Feature), Journal of Commercial Bank Lending, March, 1977, p. 10.

27. Vaswani T.A., The Banker and the Balancesheet, p. 6.

Pointing out why security requirements be given importance L.C. Mather states that, "the liquidity of the advance in the ordinary course of business should be unquestionable and the safety requirement should usually be supported by the deposit of approved security as an insurance against unforseen development."[28]

Kolhatkar states that "the security margin is the practical safety valve for monitoring the operations in the account on a monthly basis."[29]

Ramasubramanian also states that "it is true that with the advent of social control followed by nationalisation of banks the accent has shifted from 'security oriented' to 'purpose-based' advances. Nevertheless, the basic principles of sound lending are still valid and no prudent banker can ignore them, if banks are to retain their financial soundness and continue to enjoy the confidence of the investing public."[30]

(d) Purpose :

This factor was also selected based on literature. Pointing out the importance of purpose Srivastav says that "banker should inquire into the purpose for which the loan is taken. As a matter of fact the safety and liquidity of loan depend on the

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28. Mather L.C., The Lending Banker, A Review of Principles of Bank Lending Unsecured Advance and Balancesheet and the Banker, p. 11.

29. Kohatkar A.Y., Bank Credit as a Supplementary Resources, IBA Bulletin, January, 1985, Vol. VII, No. 6, p. 91.

30. Ramasubramanian V., Bank Advances : Margin on Securities, IBA Bulletin, Vol. VIII No. 6, June, 1986, p. 101.

purpose for which it will be put."[31] Pace and Simonson put the importance of purpose in the following words "technically, business loan are most often for working capital purpose, the proceeds of such loans may be used for any several purpose including investment in short-term asset items and reduction of short-term liabilities. The specific purpose however must be concretely defined."[32]

Giving guidance to the loan officers Mills states that, "the purpose of a proposed loan is important not only in the determination of compliance with your bank&s loan policy but also in the determination of risk, proper loan structure, pricing etc. Make sure that you (banker) fully understand the specifics of how the borrower intends to use his loan proceeds before you sign the check."[33]

Amongst the questions which the banker should put first to the borrower Gene Barett states that "what purpose ? Again, the banker expects a specific comprehensive answer. A vague description, such as 'for general corporate purpose' will not suffice."[34]

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31. Srivastava R.M., Management of Indian Financial Institution, p. 187.

32. Pace Edmond E. and Simonson Donald G., The Four Hurdles of Lending (A training feature), Journal of Commercial Bank Lending, March, 1977, p. 11.

33. Mills R. Wayne, Traditional Credit Principles for Changing Times, Journal of Commercial Bank Lending, July, 1983, p. 21.

34. Barrett Gene R., What Bankers Want to Know Before Granting a Small Business Loan, Journal of Accountancy, April, 1990, p. 48.

In view of Bedi and Hardikar, "the purpose should be productive so that the money not only remains safe but also provides a definite source of repayment."[35] D.A. Egginton states that "the purpose of borrowing is a convenient and important starting point .... Purpose has considerable bearing on risk, because of the effect of borrowing on financial structure."[36]

The next three factors are more concerned with the term loan appraisal.

(e) Economic Viability :

Cooper takes a long-term view and emphasises the economic benefits in the following words : "the intended use of loan must be evaluated on the basis of analysis of the need and adequacy of the amount requested to serve that need. This involved a judgement as to the overall economic benefits such as from expansions of operations or modernizing for improvement in efficiency."[37]

Matching the loan repayment period and economic life of the asset Mr. Corpora observes that : "the purpose of loan must be economically feasible and clearly understood by the loan officer. Simply put the transaction must make good sense .... Maturities should be consistent with the economic life of asset being funded."[38]

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35. Bedi H.L. and Hardikar V.K., Practical Banking Advances, p.26.

36. Egginton D.A., Accounting for the Banker, pp.179-80.

37. Cooper P.J., Four P's for Lending (Shaking the dust off the Four C's of Credit), Journal of Commercial Bank Lending, July, 1975, p. 48.

38. Corpora Leonard P., A Regulators Look at Three of the Five C's of Credit, Journal of Commercial Bank Lending, June, 1992, p.46.

(f) Financial Feasibility :

The purpose for which loan is to be given should be financially feasible. This is applicable in both the cases i.e. (i) working capital advance and (ii) term loan advance. Emphasising financial feasibility for the purpose of repayment as per schedule, Pace and Simonson remark that "perhaps the most fundamental item of information in a loan is to know where the money will come from to repay the loan. Although the borrower may be very honest and the proceeds of the loan may be used appropriately, the loan should not be made unless the primary source of repayment is reasonably certain."[39] Mills puts the importance of financial feasibility in the following words : "Always, always be sure that your proposed loan repayment schedule is consistent with the previously determined real purpose of the loan and the borrower's existing projected financial status. If it isn't, none of your expected sources of cash for loan repayment may be available when needed."[40]

(g) Technical Feasibility :

This factor is more connected with the appraisal of term loan. The project for which term loan is proposed to be given should be technically sound. This is because if the project is

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39. Pace Edmond E. and Simonson Donald G., The Four Hurdles of Lending : (A Training Feature), Journal of Commercial Bank Lending, March, 1977, p. 12.

40. Mills R. Wayne, Traditional Credit Principles of Changing Times, Journal of Commercial Bank Lending, July, 1983, p. 23.

not technically feasible, it affects the economic and financial feasibility of the project. This factor has been taken into consideration while preparing the questionnaire, from the various application forms referred to by the researcher. Stating the importance of technical feasibility Bhattacharya states, "having established the viability of the product the appraiser should now move on to determine the technical feasibility of the project ..... In case the process innovations are untried and unproven there must be detailed technical feasibility study starting from the laboratory run of the production process to the testing report of sample product.... Hence if the project proposal is drawn on the basis of laboratory experiments, the credit appraiser must discuss it with the borrower and bring him down to reality."[41]

Emphasising the importance of technical aspects in lending decisions Jon Oliver states that " a reliable forecast often can not be made without a working knowledge of the technology and markets involved, so that the likely future performance of the individual firm, in its competitive environment can be assessed."[42]

As Tony Stevens states "An important part of technical assessment is investingating the extent to which a new product will for an initial period be protected from competition in the

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41. Bhattacharya Hrishikes, Bank Lending Principles, Theory, Practice, pp. 308-309.

42. Oliver Jon R., A New Approach to Evaluating Major Business and Technological Risks, Journal of Commercial Bank Lending, February, 1984, p. 62.

market place by patents or specialised know-how."[43]

(h) National Interest and Suitability :

"The requirements of many borrowers may be completely free from all risks, but fail to comply with this second principle (suitability), which stems from the banker's wish to concentrate his lending on purposes which are desirable from the stand point of economic health of the nation.... The purpose of the advance and its likely benefit or otherwise to the country is thus an important feature to be weighed in the balance. Sometimes the need of the borrower may be deemed so essential for economic progress or national necessity that the advance will be granted despite the heavy risk entailed and the complete failure of the proposal to fulfil the principles of safety."[44] Here it is important to note comment of T.A. Vaswani that "the purpose of loan should be in the nature of a genuine business requirement, the loan should not be utilised for speculation or for an anti-social or anti-national purpose like cornering or hoarding. In that context, the banker will assess the financial solvency and earning capacity of the borrower, his experience and know-how, technical or otherwise (in relation to his business and the purpose of the loan) or in otherwords his managerial ability, integrity, reputation and standing."[45]

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43. Stevens Tony, Servicing the New Venture Vide Banker's Management Handbook, Ed. Richard Hand Scombe, p. 157.

44. Mather L.C., The Lending Banker, A Review of Principles of Bank Lending, Unsecured Advances and Balancesheet and the Banker, p. 11.

45. Vaswani T.A., The Banker and the Balancesheet, p. 7.

This is about the factors which are selected in the present study which should be looked into while sanctioning the loan proposal. The relative importance of various factors need not remain same among different segments and hence individual responses were requested for ranking of various factors for each segment separately. The segments for which respondents were required to reply separately are agriculture, small scale industries, small borrowers and retailer, self employed and professional, transport operator, education, C & I, and others.

MANAGEMENT ACCOUNTING TECHNIQUES :

In the next question viz. Q. 7 an attempt is made to examine application of certain management accounting techniques in lending decisions by commercial banks in India. Here Shri V.N. HUKKU states that "some important points that need careful considerations in analysis are as under : (a) the profit prospects (b) Ratio of owned resources working capital and quick assets to the amount of loaned funds. (c) Cost of goods sold and line of credit ratio (d) The number of days projected sales outstanding in projected accounts receivable.

On the basis of the above considerations the bankers should fix a line of credit."[46]

According to C. Jeevanandam, "important management accounting techniques relevant to a banker are (i) planning and budgeting

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46. Hukku V.N., Bank Finance for Working Capital, The Journal of the Indian Institute of Bankers, Vol. 46, No. 4, October - December, 1975, p. 207.

(ii) analysis of projected financial statements (iii) funds flow and cash flow techniques (iv) marginal costing and break-even analysis (v) Capital budgeting (vi) management reports ..... the system of budgeting and comparing actuals with plan at periodical interval is the effective way of verifying that the unit is carrying on its operations smoothly. It may be mentioned here that the QIS of the Chore Committee is based on this concept."[47]

All the above mentioned techniques are covered up in the questionnaire for the purpose of study except capital budgeting and management reports.

Capital budgeting is not considered in the questionnaire only with a view that the methods of pay back period, net present value or internal rate of return are to be used for installation of machinery or so, for which term loan is generally being taken, financing of which is mainly governed by the financial institutions.

So far as management reports are concerned, it has been observed during the course of discussion with various branch managers that the reports which are prepared for managerial purpose are not generally open to outsiders and hence, instead of getting these copies of management reports better information can be had by verbal discussion with the staff of borrowers during periodical visits.

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47. Jeevanandam C., Management Accounting - A Handbook for Bankers, p. 212.

Over and above these techniques, the application or utility of method of costing adopted for stock valuation by borrower is also studied through questionnaire.

Thus the techniques under study are : (i) business plan, (ii) budget (iii) break-even analysis (iv) method of costing (v) funds flow statements (vi) cash flow statements and (vii) analysis of financial statement and ratio analysis.

The information regarding application of these techniques was not sought in general, but for each segment separately. This was done so considering the fact that each segment is unique by itself of its own, e.g. the characteristics of agricultural advance will differ from that of SSI, of SSI with the small borrowers, eventhough all these three are the priority sector advances. Even within small borrower advances the characteristics, and considerations for advance for education and transport operator will be considerably different than advance to small borrowers and retail trader. And the characteristics and consideration to be given to non-priority segment will obviously be different than the considerations to be given to the priority sector advance and even within non-priority sector considerations to be given for sanction of term loan and working capital advances will differ. This is because both term loan and working capital are with two different purposes. Whereas "the flow of bank credit in the form of term loans was officially enouraged as being in confirmity with the policy of rapid industrialisation under the five year plans"[48] the "working capital finance is needed for the acquisition of current assets and by and large inventory forms a major constituent thereof."[49] and hence "any over estimation of the requirement resulting in blockage of scarce funds in idle asset is both, a drain on profitability as also a reflection on the performance of management of the financing institution."[50] Considering the above aspects, the raws were kept for techniques and columns were kept for segment.

The respondents were required to s tate 'y' or 'N' only for 'yes' or 'No' for application or use of the tool, while taking the lending decision and for non-application or non-use of that tool while taking lending decision for that particular segment. Having given these 'yes' or 'No' reply depending on segment for particular techniques the respondents were required to give the response regarding the detailed aspects to be seen in that particular management accounting tool/technique.

Each tool/technique has its own wide area of application. In the detailed questions running from Q. 7A to Q. 7F no

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48. Khan N.Y., and Singh Preeti, Commercial Banks and Industrial Finance - Term Lending and Underwriting, Prajnan, January-March, 1979, Vol. VIII, No. 1, p. 55.

49. Hukku V.N., Bank Finance for Working Capital, The Journal of the Indian Institute of Bankers, Vol. 46, No. 4, October - December, 1975, p. 205.

50. Bhanot S.P., Financing of Working Capital by Banks - IBA Bulletin, November, 1985, p. 358, Vol. VII, No. 16.

detailed questions were put for the technique 'budget' (which is included in the main question No. 7). The considerations for putting separately business plan and budget in the main questior are as follows : (i) business plan may be interpreted in a very general sense whereas budget involves the details about the exact target to be reached and it involves detailed calculations.

The reason for not putting different question for budget and business plan in the detailed questionnaire are as follows:

The questions for business plan were framed in such a way that they also cover the requirement of budget because after all budget is management's plan for a business expressed in financial terms as explained in Chapter II.

DETAILED QUESTIONS :

(a) BUSINESS PLAN :

The importance of business plan for banks has been rightly emphasised by Authement and Roe in the following words :

"...... borrowers strategy is more important in building a sound portfolio of quality loans. The following checklist is recommended as a starting point to assist the loan officer in evaluating an applicant's business strengths and weaknesses in pursuing a new business venture or managing ongoing enterprises

1. What is borrower's business strategy ? Can the borrower delineate the strategy's Key component ?
2. What is the borrower's market ? Where is the market ?

3. Who are the borrower's customers ? What does he or she know about them ?

4. Who are the firm's competitors ? Where are they ? How do they compete ? What are their strengths and weaknesses ?"[51]

John Durkee and Lan Sharlit also state that "a lender requires a business plan from a customer in order to make credit decision which are financially sound and viable over the term of the bank's commitment."[52] Staurt Dyer puts the importance of business plan in the following words, "balancesheet and revenue accounts look backwards, budgets look forward. Budgets are an important aid in assessing the viability of a prospective borrower's proposition and in reaching the lending decision".[53]

Keeping above aspects in view the following questions were put to the respondents :

(i) Is the business plan given importance particularly in case of absolutely new business ?

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51. Authement Joel P. and Roe C. William, Understanding a Business Strategy, The Key to Successful Small Business Lending, Journal of Commercial Bank Lending January, 1992, p. 40.

52. Durkee John M. and Sharlit Lan B., Cash flow Planning on a less than Expected Basis, Journal of Commercial Bank Lending, April, 1982, p. 41.

53. Dyer Staurt, Bank Lending with Management Accounts and Case Studies, p. 40.

The importance of business plan lies in two directions (a) the business which is to start and (b) the business which is ongoing. And it is for the new organisations that business plan is of utmost importance and hence the question.

(ii) The second sub question regarding the business plan related to the verification of the correctness of the plan. This was put considering the fact that "targets should be set to be reached, however, ambititiously they are determined. They must take account of the company's strength and weaknesses and the environment in which it operates."[54]

While emphasising the correctness of business plan it has been stated by O'Malley that, "financial forecasting can be extreemly valuable to the commercial loan officer but should be approached with caution."[55]

(iii) Q. 7A (iii) is an extension of Q. 7 A (ii) i.e. to decide the correctness of the plan; one has to analyse the factors which affect to the achievement of the plan. The factors taken into consideration for achievement of the plan are : availibility of raw material, accessibility of raw material, cost of production, units of that industry in that area, spread of

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54. Pitcher M.A., Management Accounting for the Lending Banker, p. 27.

55. O'Malley Charles A. III, Financial Forecasting and the Credit Decision, Journal of Commercial Bank Lending, November, 1977, p. 48.

that industry all over India, and demand of the product. The importance of each of these factors is discussed in the following lines:

AVAILIBILITY OF RAW MATERIAL is important because without the availibility of raw material production can not proceed further and if the production is hampered all the subsequent activities are hampered and it has its final impact on the profitability of the organisation.

ACCESIBILITY OF RAW MATERIAL is the second important factor for achievement of the business plan. Eventhough raw material is available, but is available at far off places it is quite possible that there is delay and this may delay the production schedule and finally it may have an effect on the profitability.

COST OF PRODUCTION is the third important component of business plan. It is the main determinant for pricing and in turn it determines the profitability, therefore, the extent to which cost of production is correctly projected is very important determinant to decide the extent to which profit projections will turnout to be true/correct.

UNITS OF THAT INDUSTRY in that area is the fourth factor. It is a very important factor to decide the level of demand of the product and the extent of competition that the proposed borrower will face. This aspect is to be viewed very critically, because, if the projected sales level is shown very high by the proposed borrower but looking to the level of competition, if it is very difficult to achieve that level of sales the banker should discuss about the ground on which that demand level is shown and if the proposed borrower is convinced the projections may be adjusted accordingly.

SPREAD OF THAT INDUSTRY IN ALL OVER INDIA is the fifth factor which is also considered important for products having demand at the national level i.e. for products which are the consumer goods items, previous factor is important but for products of consumer durable nature, the spread all over India is equally important.

Last but not of the least importance factor considered is the DEMAND OF THE PRODUCT. Without the demand of the product, sales can not be materialised, and therefore, the level of demand of the product should be viewed very critically while going through the business plans submitted by the borrower, to judge correctness of the same (iv) Q. 7 A (iv) is "Do you insist for quantified business plan ?" This question was put considering the fact that if the business plans are prepared, in general, it will be very difficult to exercise any sort of control, on vague business plans and hence business plans should be quantified. "Vague aims such as 'a large increase in turnover', 'a much improved profitability', 'an increasing market share' donot provide a clearly defined path for a business. Precise objectives enable management to calculate the extent of improvements to be made if the business is moving of course."[56]

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56. Pitcher M.A., Management Accounting for Lending Banker, pp. 26, 27.

(v) Q. 7 A(v) is regarding the period for which business plans are being demanded for i.e. for one year, two years, three years or more than three years.

This information was sought with a view to analysing the number of years for which the forward planning are being sought for. The extent to which bankers try to look ahead, whether, they want to run ahead by one year, two years, three years or more than three years is very important.

This sort of forward planning is important both for the bankers and the borrowers, because when the borrowers are required to furnish this type of forecasting they are compelled to have a look in future to forsee the problems/contingencies, which may occur in business and steps that they should take to tackle with the likely growing situations. From the point of view of bankers, it provides a tool for monitoring and controlling. Controlling is not possible without planning and hence if the projections/business plans are taken from the borrowers, the bankers can see whether those projections are achieved or not and if not, the bankers can ask for an explanation from the borrower.

"The shorter the period of study, the closer the actual outcome will be to that which was projected. The reason for this is that cash projected period is typically built off the previous period and thus errors in the near term tend to get maginfied in succeeding periods."[57]

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57. O'Malley Charles A III, Financing Forecasting and the Credit Decision, Journal of Commercial Bank Lending, November, 1977, p. 48.

(vi) Q. 7 A(vi) is, "Is stress given to plans developed on current economic situation ?" This question intends to examine the importance assigned to the effect of government policy, affecting the proposed borrower while taking lending decision. This is a very important aspect to be taken care of by the bankers, because for example, if the import license is required by the proposed borrower and if the license is still not received by him, according to prevailing import license policy, one cannot decide the future course of action.

This point was taken into consideration afeer referring to the application forms, which are required to be filled in by the proposed borrower. (vii) Q. 7 A (Vii) is the last question for the technique business plan. It is, "Is consideration given to future economic trends ?" This is important from point of view that if there is a trend for liberalisation, what effect will be on the business of the proposed borrowers, should be analysed by the banker. For example, effect on the business of the proposed borrower, if customduty rates are being reduced. All such things are required to be analysed by the banker and the bankers are required to see whether these aspects are taken into consideration by the borrower or not while developing the business plan.

b) BREAK-EVEN ANALYSIS :

For the purpose of lending decision break-even point is of utmost importance. As Brenda Gilliam rightly puts it "unless a firm is operating above break-even, the chances of repayment from operations are slim."[58]

At what level of production and in which year the borrower will reach to break-even level is very important. Moreover, the proportion of the fixed cost and variable cost also holds the place of importance.

Break-even analysis can tell the banker, what sales level his borrower must achieve to cover his costs. Break-even analysis is an important component of determining the profitability of the potential borrower.

The information about contribution is very important for bankers to know from which year the organisation will be capable to repay the loan. However, the fixed cost will also include the overheads. There may be expenses which are non-cash, hence what is more important is the cash break-even. As it is rightly stated by V. Srinivasan that "from the banker's perspective cash flows would appear to be more important than the company's net income or operating profit as the case may be."[59] and the author has shown that the cash flow break-even is somewhat lower than the accounting break-even because of the exclusion of non-cash charges.

As pointed out by Laudeman "break-even analysis goes beyond identifying the sales level at which a company can meet existing expenses and loan obligations. It can be used for a number of

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59. Srinivasan Venkatesan, More on Break-even Analysis, Journal of Commercial Bank Lending, July, 1984, p. 56.

58. Gilliam Brenda, Can this loan be repaid ? The Bankers Magazine Nomember-December, 1990, p. 77.

different business decisions but perhaps the most meaningful is the use of break-even analysis in considering the feasibility of increasing a company's level of borrowings."[60]

In the light of the above and discussion in Chaper II the detailed questions on break-even analysis were framed as follows :

Break-even Analysis and Type of Organisation :

i. Whether the technique is adopted for established customer for ongoing organisation ?

ii. Whether the technique is adopted for established customer for new organisation proposed to be commenced ?

iii. Whether used for new customer (who has come for the first time to your bank) but has established business ?

iv. Whether used for new customer proposing to inaugurate new organisation ?

This group of four questions was put with a view to study for which type of borrower the technique is adopted the most and for which type of borrower it is adopted the least. Only marginal difference was kept between these four types of borrowers.

Various Factors and Break-even point :

Q. 7 B (v) is regarding the factors linked with break-even analysis. Factors are, (a) percentage of total capacity at which break-even point is reached, (b) number of years that organisation will take to reach break-even level and (c) proportion of fixed cost and variable cost.

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60. Laudeman Mark L., A Practical Approach to Break-even Analysis, Journal of Commercial Bank Lending, January, 1987, p. 45.

Looking at the importance of these factors,it is attempted to study whether all these factors are being given importance or not,these three factors were put.

The first factor is important considering the fact that if at a very ligh level of installed capacity break-even pointx is reached, it is not worthwhile looking to the fact that the costs of installations of equipments are being recovered at a very latter date.

The number of years that organisation will take to reach break-even level is important, to decide the repayment schedule.

Proportion of fixed cost and variable cost is important, from the point of view that on the fixed cost generally lower control can be exercised either by the borrower or by the banker. To illustrate, once installation of plant and machinery is made there will be specific depreciation charge on the same. Similarly, it is very difficult to reduce the level of salary. For utilities, whether production is there or not certain minimum charges are to be paid. The level of break-even also depends on the composition of fixed cost and variable cost.

With these considerations above three factors were included in the Questionnaire.

To emphasise this point more and to study in detail the factors,two cases were developed. The details of cases and the analysis thereon is given alongwith the discussion of analysis.

The third case is put to see the consideration given to the percentage of installed capacity at which break-even point is reached. This case is also discussed alongwith analysis.

Margin of Safety and Break-even Analysis :

(vi) Q. 7 B (vi) is regarding "Is the margin of safety (sales-BEP) taken into consideration while sanctioning the loan ?"

Margin of safety is very important for bankers to decide the repayment schedule, as is rightly put by Srinivasan, "Combined with operating leaverage, the margin of safety can enable the bankers to assess the degree of risk involved by lending to a proppective buyer or the committed risk in the case of an existing borrower."[61] Pancras states that, "the banker should ensure that the projets which are highly risky and uncertain should possess a high degree of margin of safety so that any drop in sales or increase in costs would not jeopardise the viability of the project and would not affect the repaying capacity of the organisation."[62]

Here also is developed one case. The details and analysis of which are given in the Chapter VI.

Q. 7 B (vii) deals with the use of information regarding margin of safety in deciding the repayment schedule. This is connected with Q. 7 B (vi).

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61. Srinivasan Venkatesan, More on Break-even Analysis, Journal of Commercial Bank Lending, July, 1984, p. 58.

62. Pancras U., Break-even Analysis and Lending Banker, Credit Management (Planning, Appraisal and Supervision (Ed. by S.L.N. Simha), p. 254.

Introducing Probability and Sensitivity Analysis to Break-even Analysis :

The next question i.e. Q. 7 B (viii) concerns itself with the use of statistical test of probability made to get more clear idea about level of sales and deviations in profitability level. The question was put taking into consideration the aspects discussed in Chapter II. Here, it is assumed that not only that the quantity can change but it is also assumed to be the random vatiable and hence the mean and standard deviation of the quantity are given and the probability of profit being greater than zero is worked out in the given cases and the respondents were requested to give their judgement as to out of the given two borrowers to whom they will sanction the advance. The case and analysis to the response are discussed in Chapter VI.

The aspect of sensitivity analysis is discussed by Q.7B(ix). The aspect of probability and sensitivity analysis could have been merged in one question and one case to bring it nearer to reality; however, in view of some exigencies it was felt that it would be better if both these aspects (probability and sensitivity) are studied separately. Hence in this question the aspect of sensitivity is put separately.

The sensitivity analysis here taken was a very simple situation mathematically; however, it was a very essential and an important aspect to be considered before the lending decision is finalised.

Here an attempt is made to examine, the respondent's approach to judge viz. what will be impact on profitibility level and on BEP of a change in any of the factor affecting to the profit ? Here, as it should be very clear, the factors affecting the profit are the fixed cost, variable cost, quantity of sale and selling price. The variation in quantity of sale over a period of time are accepted by the business world, however the likely variations in the sales-price, fixed cost and variable cost are not being considered generally. Here, in the given case, the likely changes in variable cost per unit, fixed cost and sales price per unit are considered one after the another and effect thereof is worked out on profit. The case and the response thereon are discussed in the Chapter VI.

Multi Product Firm and Break-even Analysis :

The application of break-even point in multi product situation is inquired into by Q. 7B(x). In the rapidly developing business world; the enterpreneurs are generally not concentrating on the production of single product, however, there is a trend for the multi-product. Now when there are more than one product, the importance of break-even analysis further increases. Here, the first and simple thing is to have a composite break-even point. By composite break-even point is meant that break-even point is found out together for all the products in rupee terms and them it is converted into units considering their price, and hence the question put here is "In the case of multi product firm, we would like to know that how product-wise break-even point is found out by bank or demanded by bank ? What is the accepted base for allocation of fixed cost between various products ? Is it distributed equally between all the products ?"

Application of Break-even Analysis to Bank Branch :

Over and above its application for analysis of borrowers, break-even analysis has its application to bankers also. This aspect is examined by Q. 7B(xI). Here respendents were required to inform whether the analysis (i.e. Break-even analysis) is used by bankers while taking lending decisions to find out the effect on profit of composition of loan portfolio.

The question was put mainly to convey the idea floated by S. Singh. According to him "a banker will hardly be interested in break-even analysis per se..... Change in price will lead to an upward shift of total revenue. This in turn will lead to a downward shift of break-even point to the left. For a branch, change in prices of its products is practically out of question as lending rates, service charges and locker fees etc. are all given for the branch. But the branch can certainly evolve an advance mix which is superior to the existing one in terms of better returns. For example, lending under DRI is at 4%, lending to small people may be at 12% or 13%, to other priority sectors such as small scale industries and agriculture may be 14 to 15% and to other traditional sector the rates may go upto even 16.5%. Similarly the decision to lend may generate income ranging from 4% to 16.5% while decision not lend, but to remit the balances to head office may yield at least a notional return of 9 to 11% to the branch. Here again, there is a choice before the branch to lend or not to lend. Generally, a decision to lend would be more profitable for the branch. A dynamic branch would like to improve its earnings by planning to add more of such products in the advance mix which are more profitable for the branch.[63]

In the countries where the interest rates are determined by the bank itself with open competition in the market, considerable research has been carried out. The following remark gives an idea regarding the same. i.e. "there is a break-even point at which the monthly cash flow of interest payment invested will provide enough incremental revenue to offset the cost of billing and collecting these funds. Anything over this point will contribute to profits and anything under this point will dilute profits. There is nothing to suggest that these findings cannot be extra-polated for larger banks."[64] Delton Chesser's comment on this point is also worth noting. He states that, "the conclusion is that if the bank plans to break-even, that is, to equate the gains and losses that are expected to result from this loan, the applicant must be charged an interest rate of 12%. Because of competitive condition and usury statutes, banks may not always be able to change the computed break-even rate of interest."65 But under the present scenario of Indian Banking system, research

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63. Singh S., Performance Budgeting for Commercial Banks in India, p. 65.

64. Polinsky Richard M., "Break-even Analysis for Commercial Loan Billing, Journal of Commercial Bank Lending, August, 1976, p.53.

65. Chesser Delton L., Determination of the Break-even Interest Rate, Journal of Commercial Bank Lending, March, 1975, p. 42.

on this line has a limited scope. Thus by questions put for this technique an attempt is made to examine the various aspect of Break-even analysis including the application thereof to Bank branches.

(c) COSTING TECHNIQUE :

The costing technique determined plays a very important role in the managerial decision-making as discussed in Chapter II. There it is discussed with main reference to stock valuation. It is explained in the said chapter how with change in method of charging each issue of inventory, the stock valuation differs and this stock valuation further affects to the profit figure, value of current assets, current ratio and net working capital. One further impact of stock valuation directly on cash flow can be explained as follows - Assume the two proposed borrower from the same industry. Assume also same composition of inventory content at the year end. If one of the proposed borrower follows FIFO method and the another follows LIFO method, the first one will show higher inventory (when the prices are rising), higher current assets, higher profits and higher net working capital as compared to the borrower following LIFO method, of stock issue. The effect of higher profit (to borrower following FIFO method) will be on tax liability, which obviously will be higher (provided that the organisational structure of both the borrowers is same). This higher tax liability will directly affect cash outflow, which will increase the need of borrowing and this higher borrowing means higher interest burden and the circle continues.

On the above back ground it can be said that the strength of company following LIFO is higher than the company following FIFO, however, in the context of the basis of lending, one finds that it is the current ratio and working capital based on which the permissible bank finance are being worked out and hence the remark by Bohan and Rubbin[66] becomes very important for consideration of bankers under such circumstances.

During the survey of literature it has been observed that much work is carried out in foreign countries on the subject[67] however it seems that very little has been carried out in the Indian scenario. Still it is clear from the remark of Mehrotra

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66. Bohan Michael P. and Rubbin Steven, LIFO : What should be disclosed ? The Key : Help for Users of Financial Statements, Journal of Accountany, February, 1985, pp. 72-74.

67. (a) Anchin Howard, Zimmerman Morris, Anchin Block and Anchin: Some Facts on LIFO for Lenders, Journal of Commercial Bank Ledning, September, 1974, p. 37 to 43.
    (b) Swindell Robert M. (Jr.), Adjusting for the Effects of LIFO : A Worksheet, Journal of Commercial Bank Lending, June, 1986, pp. 60-71.
    (c) Nelson Carl L., The Big Rush to LIFO, Journal of Commercial Bank Lending, December, 1975, pp. 31-39.
    (d) Bohan Michael P. and Rubbin Steven : LIFO : What should be discbosed ? The Key : Help for Users of Financial Statemenbs, Journal of Accountancy, February, 1985, pp. 72-74.
    (e) Morision T. Lincoln : The Last Word on LIFO, This Week ! Journal of Commercial Bank Lending, September, 1980, pp. 2-18.
    (f) Gibson Scott, LIFO Vs. FIFO : A Return to the Basics, Journal of Commercial Bank lending, October, 1991, pp. 36-40.

that the method of valuation of inventory can be used as a tool to manipulate the profit, which is put in the following lines for ready reference." Change in valuation of inventory (LIFO to FIFO or vice versa) writing back depreciation, change in depreciation system (straight line to WDV or vice versa), under provision of liability, revaluation of assets etc. are usually accepted practice to inflate/manipulate profit."[68]

To study the above aspect question put to the respondents was, "whether costing technique followed or to be followed by the proposed borrower is taken into consideration while sanctioning the loan ?" and further to these three cases were also developed which are discussed in the Chapter VI.

(d) FUNDS FLOW STATEMENT :

Use of this statements for analysis of borrower's health is becoming of increasing importance now-a-days for bankers; and hence this is included in the questionnaire, N. Vinayakam emphasises the importance of these technique for bankers in the following words - "when financing is resorted through borrowings by business concerns, bankers and financial institutions invariably insist on the filing of funds flow statement alongwith the loan application. All searching and intricate issues pertaining to the financial affairs of the concern such as overall credit worthiness of the concern, the feasibility of the scheme for which the loan is required, the current ratio, the source of

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68. Mehrotra Shyamji, Cash Flow Analysis : Reading Borrower's Health" Prajnan, Vol. xix, No. 3, 1990, pp. 287-288.

repayment, current funds generating capacity through normal operations, various sources of financing adopted and the like can be best understood by reference to the funds flow statement.[69]

Emphasising the use of funds flow as a tool of planning, Anthony states that "as a tool of planning, the projected funds flow statement is an essential device for planning the amount, timing and character of new financing. Estimated uses of funds for new fixed assets, for working capital, for dividends and for the repayment of debt are made for each of the several future years usually at least two or three but in some cases 10 years or more."[70]

On utility of funds flow statement for bankers B.M. Lall Nigam states that, "the banker, for example, can successfully evaluate the financial habits of the company, i.e. managerial attitudes towards spending and financing. He appraises impact and quality of investments and disinvestments."[71] He continues further that, "the fact is that the funds statement tends to answer the four leading questions which a banker would like to put to his constituent : 'How much do you need ? What for ? When can it be repaid ? from what source ?'"[72]

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69. Vinayakam N., Management Accounting : Tools and Techniques, p. 314.

70. Anthony Robert N., Management Accounting : Principles, p. 258.

71. Nigam B.M. Lall, Financial Analysis Techniques for Banking Decisions, p. 158.

72. Ibid., p. 158.

Pointing out the importance of funds flow statement K.M. Chitnis states that "the scrutiny of the projected funds statement has been regarded as an important tool in the appraisal procedure -

1. Funds statement shows the capacity of the borrower in generating funds out of business operations whether the profits have been retained in the business.

2. Does the funds statements show diversion of short-term funds for long-term uses ? How does the borrower proposes to remedy the diversion ?

3. Does the statement incorporate provisions for payment of income tax ? Encroachment on working capital funds will have adverse effect, if the tax-liability is paid out of working funds."[73]

The following questions were put for the funds flow statement in the questionnaire :

(i) Whether funds flow statement is demanded for future one year or more ?

As such the statement of sources and application of funds is being prepared from the balancesheet. It is a secondary statement. But when the projections are being demanded by the bankers, what is important that how those projections are to be met with i.e., suppose the proposed borrower gives three year's projections where he may show differing level of fixed assets/ investments. How this increase is being met with is very

73. Chitnis K.M., Credit Appraisal in Banks, p. 102.

important. Moreover, one of the method of preparation of funds flow statement is showing change in working capital. When, it is shown specifically, how the increase in working capital will be met, will be apparent from the statement of sources and application of funds and therefore, for what period in advance these details are being demanded by the bankers is very important.

(ii) The aspect of comparision of actual achievements with the projections is inquired into by Q. 7D(ii). This is important considering the fact that the controlling is the main important aspect of management. If the projections are not compared with the actuals, there is no monitoring and in that case the purpose of submission of project is not served. So far as this comparision aspect is concerned S.G. Shah states that "the lending skills of bankers consist of two elements : first the assumption regarding the earning potential, healthy cash flow and good performance on which the credit sanction rests and second the comparision of actual performance of the borrower from month to month with the assumption. In the past these skills were informal. Senior bankers used them as a rule of thumb and kept them exclusively to themselves. Much of them were based on the personal judgement and individual decisions.

This was possible when lending was simple and Banks lent only to large, selected credit worthy elite of industrial enterprises. In the new environment with the complexities of business and extensive retail banking, this process of making assumptions and comparing performance with reference to them has to be formalised."[74]

Q. 7D(iii) is an extension of Q. 7D(ii). Here the information was requested from the respondents regarding their experience for percentage of correct projections. The experience, was broadly divided in three parts viz. the actual positions matching with projections in less than 50% of cases, about 50% of cases and more than 50% of cases. This information throws light on the extent to which realities tally with projections.

Q. 7D(iv) examines the utility of funds flow statement in deciding repayment schedule. i.e. how the information regarding funds flow is useful in determining the repayment schedule of the borrower.

(e) CASH FLOW STATEMENT :

Cash flow is very important for any organisation. As pointed out by M.A. Pitcher, "Profit is an opinion but cash is a fact is an often expressed thought in banking circles."[75]

Nigam emphasises the importance of cash flow for bankers in the following words : "Surprisingly enough, this typical tool of management-self evaluation-has emerged as a heart land of newly articulated techniques for bankers, as distinguished from other suppliers of funds. As a financial model for the future, it reveals a good deal to the banker."[76]

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75. Pitcher M.A., Management Accounting for Lending Banker, p. 28.

76. Nigam B.M. Lall, Financial Analysis Techniques for Banking Decisions, p. 183.

74. Shah S.G. Bank Credit Supervision over the use of funds by and monitoring the phyical and financial performance of the borrower, p. 8.

Differentiating the income and cash flow Peter Tischler mentions that "the accrued nature of income does, however, suggest that accrued income and true cash income might be quite different monetary values. Therefore, it is advisable to determine how much these two value may differ and then to ascertain which of these values is a more reliable indicator of the firm's debt payment capacity."[77]

Also Jerry Viscione mentions that "the data also indicate that net income plus depreciation and (net) working capital from operations can be poor proxies for cash flow from operations."[78]

Following remark of Shyamji Mehtrotra points out the importance of cash flow statements for banks - "an experienced banker was once asked about the secret of his decision-making. He replied that before taking any lending decisions he wanted the prospective borrower to satisfy him on two basic points, firstly how is he going to pay back the money and secondly what should he (banker) do to know that his plans on which repayment depends are really materialising."[79] He further states that "cash flow is one of the tools to have this information (about the health of his borrower's business), and more precisely borrower's ability to meet his obligations as and when they mature."[80]

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77. Tischler Peter J., Evaluating a Firm's Liquidity and Bank Credit Risk, Journal of Commercial Bank Lending, October, 1974, p. 26.

78. Viscione Jerry A., Assessing Financial Distress, Journal of Commercial Bank Lending, July, 1985, p. 40.

79. Mehrotra Shyamji, Cash Flow Analysis, Reading Borrower's Health, Prajnan, Vol. xix, No. 3, 1990, p. 287.

80. Ibid., p. 287.

Cash flow statement provides information regarding sources and uses of cash i.e. the movement of cash between the two balancesheet dates.

There are the ways and means to manipulate / inflate profit, however, there are no methods/accounting conventions to manipulate cash flows and thereby to hide significant flows from the banker.

For the utility of cash flow Shyamji Mehtra states that "but cash flow analysis provided us with deeper insight into the financial affairs of the company rather than what is revealed by the funds flow analysis. Hence one can conclude by saying that by a systematic study of cash flow statement, a banker can easily identify the strength and weaknesses of the borrowers. It is a better indicator of borrower's solvency and liquidity. It highlights the weaknesses of the borrower and can be used as an instrument to identify incipient sickness because the liquidity crunch always precedes losing profitability."[81]

Pointing out the importance of cash flow Roger Nordgren states that, "cash flow analysis theory is for many the corner stone of financial analysis, yet it is too often misunderstood or only superficially comprehanded."[82]

Pointing out the weakness of financial statement and emphasising the importance of cash flow Loyd Health states that, "accrual-based income statements, statement of charges in

81. Ibid., p. 293.

82. Nordgren Roger K., Understanding Cash Flow, A Key step in Financial Analysis, Journal of Commercial Bank Lending, May, 1986, p. 3.

financial position based on changes in working capital and current-non-current classification of assets and liabilities do not provide the insight into the amounts and timing of a company's future cash flows that is needed by today's bankers when making loan decisions."[83]

Explaining how the time factor of cash in flow and outflow affects the requirement of advances Nordgren mentions that, "For bankers, the key element in the asset conversion cycle is time. Timing differences between cash inflows and cash outflows are responsible for the need to borrows money. If cash is flowing out over a period of time faster than it is flowing in, an external cash source or sources will be necessary to keep the business going until cash begins to flow in faster than it flows out. Looking at two balancesheets and an income statement does not always reveal the reasons for temporary imbalance in cash flows."[84]

He further states that, "to the sensitive analyst, the cash flow report presents a company's history and the skill of its managers in rich detail. Ultimately, the confidence a lender has in the management ability of a firm determines to a great extent a willingness to extend credit."[85]

83. Health Loyd C., Financial Statements, Credit Analysis and the Forgotten Banker, Journal of Commercial Bank Lending, March, 1981, p. 12.

84. Nordgren Roger K., Understanding Cashflow: A Key Step in Financial Analysis, Journal of Commercial Bank Lending, May, 1986, p. 15.

85. Ibid., p. 15.

Contrary to general belief about short-term aspect of cash flow Jim Eck ford emphasises the long-term aspect of cashflow in following lines, "cashflow problems are contrary to popular belief, long-term problems, cashflow problems do not arise, overnight and are not the problems of last year and the years previous, Lending bankers should be able to identify good and bad cashflow generators."[86] He further states that, "it is unfortunate that most users (readers) of the funds flow statement do not appreciate the difference between cashflow and profit flow."[87]

Pointing out the general confusion existing amongst bankers regarding increase in working capital and cash consumption Jim Eckford states that, "bankers find it slightly more difficult to understand that increase in working capital consume cash unless they are funded by creditors finance."[88]

Stating cash to be a king Jim Eckford states that "cash-flow accounting/analysis is a valuable additional tool in the hands of the financial analyst/banker cash flows are what matter. It is not possible to lie, mould, bend, distort real cash flows. Cash is king.[89]

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86. Eckford Jim, Cashflow Accounting Part I: Scottish Banker's Magazine, Vol. L. xxv, No. 300, February, 1984, p. 149.

87. Ibid., p. 150.

88. Ibid., p. 152-153.

89. Eckford Jim, Cash flow Accounting Part II : Scottish Banker's Magazine, November, 1984, p. 114.

Explaining in a fine manner, how the increase in profitability can affect to cash-shortages Kester states that : "understanding how a firm can become profit rich and cash poor can lead to more appropriate loan structuring. Detailed financial projections are needed to estimate the amount and timing of the borrower's financing requirements and subsequent repayment ability. Such an analysis, of rapidly growing firms reveals the borrower's inability to make principal payments during the growth period and indicates that a revolving credit arrangement would be an appropriate loan structure."[90]

Coming to the questions put in the questionnaire for cash flows, the first question is

(i) For which period cash budgets are being demanded-monthly, quarterly, six monthly, or yearly.

The purpose of putting this question was, to examine whether the bankers look a month ahead, a quarter ahead, six month ahead or a year ahead ? On the basis of above theoratical discussion it is very clear that to take the precautionary action and to plan the loan structure, information regarding cashflows play a very important role and with that consideration only this question was put.

(ii) Q. 7E (ii) is "Are these cash budgets demanded at the time of sanctioning the advance ?"

This was with a view to looking into the point of time at which information regarding cash position is being sought for by

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90. Kester George W., "Why Borrowers Become Profit Rich and Cash Poor, Journal of Commercial Bank Lending, October, 1992, p. 53.

bankers. The time of sanction of loan proposal is very crucial for lending decision, both for term loan and working capital. In the case of temm-loan eventhough it is for a fixed period of time, once the loan is disbursed and if the repayment does not come in then the recovery procedures are to be commenced and all these are the time consuming things. As it is stated by Kalra, "in the recent years slow process of recovery of advances has posed a big problem for the banks in the deposit mobilization because the total strength of the bank staff is geared towards effecting the recovery which is also not satisfactory."[91]

Q. 7E (ii) is pertaining to the utility of cash flow statement in deciding the repayment schedule. The projected financial statements are sought from the borrower, now if the repayment schedules are fixed for the borrower on the basis of the above mentioned statements, it may be difficult for the borrower to meet with those repayment schedules because the real repayment capacity of the borrower depends on the cash flow i.e. to say if the cash generations and profitability are not moving in one line the repayment capacity may turnout to be slender/weak. Therefore, cash flow statements should be used to decide the repayment schedule and hence the question was included in the questionnaire.

Q. 7E (iv) is regarding comparision of actual cash position with the original budgets submitted by the borrower. This is also very crucial to the fact that the comparision of the budget with

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91. Kalra S.S., Menace of Overdues, The Banker, April, 1990, p. 25.

the achievement gives an important clue regarding the capability of the borrower and real situations. A quick and timely comparision of these data may also help the bank in rescheduling of the repayment schedule, providing additional temporary help to the borrower to save the borrower from going out of order and thereby avoiding loan to be turning into a badloan decision/loan losses. With these said aspects in consideration, this question was framed.

Here, there was no need to have bifurcations of this information according to segments in which loan is assigned, because, the application or otherwise of cash budget is decided at the very beginning stage in the main question. Facilitywise also bifureation was not considered necessary considering the fact that may it be working capital advance or may it be term loan, the information regarding cash budget plays an important role to decide the requirement of fund and to decide repayment schedule respectively. No bifurcation was thought necessary according to the amount for which loan is to be sanctioned, because the amount of the loan big or small, is not important, what is important here is the relevent cash flow because it plays an important role.

(f) FINANCIAL STATEMENT ANALYSIS AND RATIO ANALYSIS :

Explaining why the management accountant should view the financial statements from banker's view point Lewis and Leslie stated that : "The balancesheet and accounts of firms or companies are looked at from various view points by those concerned with them, such as creditors, shareholders, bankers etc. The management accountant must be able to interpret them from all these points of view, because he may be required to advise from any of them, why he should consider the accounts from banker's position may be less obvious but if he is to advise on the best way of raising new finance the chances of success in raising a short-term loan or overdraft and to what extent it may be possible he will need to work out some idea of the bank manager's likely reaction."[92]

In the opinion of Christy George "the borrower's financial data base contains a wealth of information we can use to track our loan porfolio's vulnerability to major change in the economy. It also functions as an efficient early warning system for specific borrowers."[93]

Kenneth Sorensen also makes a remark that, "Financial statements present the financial effects of transactions conducted by the business enterprise and should be a primary tool used by the lender in evaluating credit worthiness and risk."[94]

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92. Brown Lewis J. and Howard Leslie R., Managerial Accounting and Finance, p. 621.

93. Christy George C., Problem Loan Prevention and Management from Portfolio Point of view, Journal of Commercial Bank Lending, October, 1988, p. 9.

94. Sorensen Kenneth, A., Your Customer's Financial Statements and how the Lender should view them, Journal of Commercial Bank Lending, November, 1975, p. 37.

About the utility of ratio analysis William Bjork states that "ratio analysis is a powerful tool in gaining a more complete understanding of the business activity."[95] Paul Patrick believes that "ratios are important tools in ascertaining significant relationships of business fact. These relationships are worthwhile indicators .... not ..... absolute indicators of impending financial difficulties."[96]

Giving a word of caution about the use of ratios for judging soundness of the organisation Sivasankaran states that "a banker has only the financial statements for verffying the credit worthiness of a proppective borrower. But the statements are basically figures which can easily be dressed up. An intelligent banker is one who sees through the cover and finds out the real financial position of the borrower."[97] He further states that "ratio analysis is a tool available to a lending banker for arriving at a lending decision. It should be remembered that these ratios are computed on the basis of financial statements supplied by the borrower. And there lies the pit falls. The two financial

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95. Bjork William E., The Judgement Factor in Commercial Credit Analysis, Journal of Commercial Bank Lending, September, 1983, p. 40.

96. Paul J. Patrick, A Comparision of Ratios of Successful Industrial Enterprises with those of Failed Firms,- Certified Public Accountant, Fourth Quarter, 1932, p. 598 as quoted by Bettinger cuss in "Bank ruptcy Predicition as a Tool for Commercial Lenders" in Journal of Commercial Bank Lending, July, 1981, p. 20.

97. Sivasankaran K., Importance of Ratio Analysis in Industrial Advances, IBA Bulletin, December, 1989, p. 262.

statements are profit and loss account and balancesheet. As balancesheet is prepared as on a particular day it has been likened to a snap shot taken of something in motion. It is possible to dress-up a balancesheet to give a good picture."[98]

Emphasising the improvements which can be incorporated in the method of computation and use of ratios. L.C. Gupta states that, "the prevailing practices are too conventional to be wholly satisfactory and take no account of the change in environment. Such change has invalidated many of the old practices, e.g. practice of taking into account only long-term debt instead of total debt for debt equity ratio and several other practices too."[99]

He further states that "definite scope exists for making ratio analysis a sharper tool for appraisal and forwarding."[100] and also "financial ratios have traditionally been used in research to classify failed and non-failed firms."[101] In opinion of Baruch Lev. also "One technique frequently employed by bank loan officers is ratio analysis. Ratio analysis is an approach to financial statement interpretation, that is accomplished by

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98. Ibid., p. 265.

99. Gupta L. C., The Forewarning Property of Financial Ratios, Prajnan, Vol. xvi, No. 2, 1987, p. 163.

100. Ibid., p. 163.

101. Gentry James A., New Bold Paul and White Ford David, Predicting Bankrupty.: If cash flows Not the Bottom Line What is ? Financial Analyst Journal, Vol 41, No. 5, p. 4756 as quoted in The CFA Digest, Spring, 1986, Vol. 16, No. 2, p. 41.

reducing several financial variables to a relatively small set of ratio."[102]

C.T. George while specifying weight for various ratios within a given range notes that, "analytical study of solvency, liquidity, profitability and productivity gives a near-safe performance profile for determining the on-going viability and prosperity of any economic activity."[103]

Coming to the question put in the questionnaire for ratio analysis the first question is

(i) Whether information about various ratios is demanded at the time of sanctioning loan ?

This is important from the view point that the strength and weaknesses of the proposed borrower should be judged in advance, before indulging into the business with him i.e. before the loan is sanctioned to the proposed borrower, maximum possible study should be carried out of the borrower.

(ii) After the above question the next question is regarding collection of information about financial status of borrower until the loan is repaid. Therefore, the question is 'periodically until the loan is repaid'.

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102. Baruch Lev., Financial Statement Analysis, A New Approach, p. 34, as quoted by Deitrick James W. and Stamps Jennifer L., The Use of Accounting Information by Bank Loan Officers, Journal of Commercial Bank Lending, November, 1981, p. 52-53.

103. George C.T., Effective Credit Administration Through Weighted Average System, IBA Bulletin, September, 1991, p. 21.

Moreover, the position for cash credit is also inquired into.

Above question is followed by an inquiry regarding the selective examination of the ratios or general, i.e. whether the information regarding ratios is demanded from all types of borrowers or from the selected borrowers. Here the borrowers are divided in four groups i.e. (i) advance amount less than Rs.25,000 (ii) advance amount more than Rs.25,000 but less than Rs. 2 lakhs (iii) advance amount greater than Rs.2 lakhs but less than Rs.10 lakhs and (iv) advance amount greater than Rs.10 lakhs. And for this purpose the information was sought regarding 19 ratios.

The meaning and interpretation of these 19 ratios is presented in Chapter II and hence the same is not duplicated here. However, wherever necessary importance to bankers is highlighted.

The ratios under study are divided in five broad groups which are as follows :

Short-term Liquidity Ratios
Long-term Liquidity Ratios
Profitability Ratios
Turnover Ratios and
Coverage Ratios

Basil Mavrovitis also states that the 'focus on liquidity, leverage, and profitability ratios when performing financial statement analysis. They are the three key business variables that must be balanced to be an ongoing entity."[104]

SHORT-TERM SOLVENCY RATIOS :

The first group of ratios is of short-term solvency ratios. Here the ratios under study are : current ratio, acid test ratio, absolute liquidity ratio, inventory to working capital and current liabilities to networth.

In addition to discussion on all these ratios in Chapter II in detail, first two i.e. current ratio and quick ratio are discussed here from bankers' angle.

Current Ratio :

Current ratio seems to be the most popular in the banking world and is acclaimed to be a key quotient. If we look to the development in discipline aspect of bank lending, the report of the Tondon Committee in moving from first method of lending to the third method of lending the current ratio is made more and more sound. It is the current ratio only which is referred to while discussing the three methods of lending.

While discussing the proposed method of lending in the first method, current ratio is kept as 1.17:1, in the second method to be 1.33:1 and in the third method (which is considered to be the ideal standadd) current ratio given is 1.79:1.

This ratio seems to have been given importance on account of the fact that it talks well about the short-term solvency, how

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104. MavroVitis Basil P., Fifty Thoughts on Financial Statement Analysis, Business Credit, February, 1991, p. 10.

well the organisation can meet with its liabilities out of its assets. C.T. George also states that "a professional banker should make a sensitivity study of the current ratio, if he wants to find out the real financial health of the unit."[105]

Mavrovitis Basil states that, "Current ratios under 1:1 and quick ratios under 0.5:1 generally reflect firms that are approaching illiquidity."[106]

Also "the Reserve Bank of India has laid down the following crieteria for definition of a sick enterprise : (a) cash losses for the previous year, the current year and anticipated for the next year (b) current ratio being less than one (c) detriorating debt equity ratio."[107]

It may be noted, this has not escaped criticism, and in this context V. Srikrishna states, "the twelve month concept was introduced mainly to counter the problems posed by the operational cycle. According to this method, all assets/liabilities turned over within 12 months itself means nothing to any firm. Hence two concepts are combined when current assets include all operational assets (i.e. inventory and trade debtors) and form part of operational cycle concept, and other assets form part of 12 month concept. Similarly, current liabilities include trade creditors and form part of opezational cycle concept, and all other liabilities form part of 12 month concept.

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105. George C.T., Financial Statements and the Banker, IBA Bulletin, March, 1985, Vol. vii, No. 8, p. 139.

106. Mavrovitis Basil P., Fifty Thoughts on Financial Statement Analysis, Business credit, February, 1991, p. 10.

107. Iyer T.N. Krishna, Guidelines for Financing of Small Scale Industries (A Hand Book for Bankers), p. 100.

For the RBI sample of 1867 Public limited companies, inventory and trade debtors constituted about 75 percent of current assets and "all other liabilities' were 63 percent of current liabilities. This means that definition of current asset is largely operational cycle based whereas the definition of current liability is largely 12 month based."[108] He further quotes the findings of William Bever and states that, "William H. Bever examined the predictive power of thirty different financial ratios for a period upto 5 years prior to failure. He concluded that the current ratio was among the worst predictors of failure (the most effective being the ratio of cash flow to total debt.)"[109]

ACID-TEST RATIO :

This ratio is used in conjuction with current ratio. It gives more clear view of the firm's potential ability to meet its immediate obligations.

K.V. Rao here notes that, "the relationship between current assets and current liabilities both of which are balancesheet items relates to the last working day of the accounting year, a day before which or after which it could be materially different; thus the current ratio can be over emphasised, particularly if the shorter-term movement of the ratio is not keenly watched.

The acid-test ratio also poses the same problems as current-ratio calculated."[110]

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108. Srikrishna V, Current Ratio Revisited, Prajnan, Vol. XVIII, No.4,1989, p. 462.

109. Ibid., p. 463.

110. Rao K.V., Strengths and Weaknesses of Current Ratio, IBA Bulletin, March, 1987, Vol. ix, No. 3, pp. 45.

LONG-TERM SOLVENCY RATIOS :

The next group of ratios discussed is that of long term solvency. This should also be of much interest to the bankers. The ratios included in the questionnaire here are - Debt equity Ratio; fixed assets (Net) to tangible net worth, and net worth + long-term liabilities to net block.

As the meaning and importance of these ratios are already discussed in Chapter II the same is not repeated here. However, so far as bankers are concerned, the following remark of the Tandon Committee Report is very important for debt equity ratio and hence the same is represented here : "if the end product of industry has to be sold at a cheaper price and adequate dividends are also to be given to make equity attractive to the investor, no company can afford even if it were possible to trade, entirely on owned funds, nor rely too heavily on borrowed funds. There has to be a balance between the two what the company provides and what it borrows."[111]

Edgar puts the importance of debt equity ratio in loan management function as follows." perhaps the best indicator of impending problems is the debt to equity ratio. When this ratio exceeds industry norms the lender ignores the problem only at great peril. Although, the emphasis on an inadequate networth goes in and out of fashion, the function of networth as a margin of error is a constant."[112]

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111. Report of Study Group to Frame Guidelines for Folow up of Bank Credit - RBI, Bombay, 1975, Chapter 9, Para 9.7, p.50.

112. Morsman Jr. Edgar M., Effective loan Management, p. 111.

Regarding debt equity ratio A. Rogar Bosma states that, "One of the bench marks that analysts and loan officers seview carefully is company's debt to worth ratio.... Although there is no particular right or wrong debt-to-worth ratio, it is important to track changes in the ratio overtime, abrupt changes might indicate that samething is a miss."[113]

In a study conducted by Henry Kennedy for four financial ratios viz. tangible equity to debt ratio, current ratio, inventory to turnover ratio and quick ratio he found that equity to debt ratio proved to be most useful in terms of predictive value.[114]

PROFITABILITY RATIOS :-

For a banker who chooses between one borrower and another or between one industrial security and another, the profit record is by far the most important crieterion. It is the key consideration in assessing credit worthiness or eligibility for a loan, a certain minimum rate of profit has generally been mandatory. Everything else being equal, the banker's choice will be on the borrower who shows a more consistent profit performance.

But the banker like any other analyst is not interested in absolute profits. He wants to know as to how those profits stand in relation to the earlier years of the same firm, to those of

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113. Roger Bosma A., Diagnosing Credit Weakness Some Early Warming Signs - The Banker's Magazine, November, December, 1988, p. 77

114. *Vide* Bettinger Cass, Bankruptcy Prediction as a Tool for Commercial Lenders, Journal of Commercial Bank Lending, July, 1981, p. 21.

the industry as a whole and to some of the lending units of the industry. For such a comparision the statistical relationship have to be found out.

Amongst the statistical relationships, those understudy are : gross profit to sales (G.P. ratio), net profit to sales (N.P. ratio); earnings after tax to net block + working capital (ROI); profit after tax to common equity (ROCE); net profit to net block + current assets (ROTA).

All these relationships are of a very high significance to the lending banker. The meaning and interpretation are already discussed in Chapter II, however, for net profit ratio, we would further like to state as follows.

Net profit ratio used in conjuction with gross profit ratio will give certain worthwhile signals to the lending bankers. If gross profit ratio remains steady and the net profit ratio falls, the lending banker should examine the expenses which have caused this fall and whether such expenses are extra-ordinary, non-recurring etc.

For profitability ratios also Morsman considers them important for problem loan identification. He states that "although many indicators can be selected, perhaps, net income/ total assets is the best. The business of business is to make a profit, and when adequate profitability does not exist, the lender must question the viability of the borrower."[115]

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115. Morsman Jr., Edgar M., Effective Loan Management, p. 112.

TURN OVER RATIOS :

Under this group following ratios are understudy : inventary turnover ratio, receivable turnover ratio, average collection period and asset turnover ratios. The meaning and interpretation of these ratios is already discussed in Chapter II, hence the same is not repeated here. However, it is important to note here the comment by Hester Donald on inventory turnover ratio. He states that, "if an applicant's inventories are rapidly growing or particularly high, banks are cautious when extending credit. The ratio of inventories to sales for a firm relative to its industry is a measure of whether inventories are controlled."[116]

COVERAGE RATIOS :

Here the ratios under study are times interest earned and the fixed coverage ratio. The meaning and interpretation are already discussed in Chapter II. However the following comments are found important for bankers for these two ratios and the same are as follows. For the fixed coverage ratio David Bradlow states that "bankers have traditionally placed a great deal of reliance on a borrower's assets. They have also tended to focus on accrual-based income or profitability. However, from a creditor's perspective, the critical issue is whether the borrower is generating enough cash to service and repay the debt."[117] Dev. Strischek states that "besides applying funds to

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116. Hester Donald D., An Empirical Examination of a Commercial Bank Loan Offer Function, Vide Analytical Methods in Banking Ed. Cohen Kalman J. and Hammer Frederick S., p. 184.

117. Bradlow David A., Early detection of problem loans, Journal of Commercial Bank Lending, April, 1986, p. 49.

the payment of interest expense on its long-term debt, a firm must also commit funds to repayment of the debt principal. Scheduled repayments of principal are just as mandatory as interest payments .... A conservative analytical approach is to assume that the debt will be repaid as agreed. Scheduled debt repayment is equally as important in appraising a firm's solvency as is interest expense factor."[118]

The times interest earned ratio gives bankers an idea of the extent to which earnings could contract before such interest obligations are threatened, and hence they place much faith in this ratio. As stated by Dev Strischek, "one of the most widely used solvency ratio is the TIE."[119]

A.K. Sengupta emphasises the importance of this ratio in the following words : "a very important indicator for judging the financial strength of a company with reference to its ability to meet the interest obligations is indicated by interest coverage ratio or times interest earned ratio."[120]

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118. Strischek Dev., (a) Analysing the Quantity and Quality of Cash flow for Long-term Borrowing", Journal of Commercial Bank Lending, May, 1980, p. 35. (b) Solvency : The Concept and an Approach for the Analysis of Long-term Borrowers, Journal of Commercial Bank Lending, February, 1973, p. 36-38.

119. Ibid., (a) p. 34 (b) p. 35.

120. Sengupta A.K., Risk Appraisal in Bank Lending, Prajnan, Vol. xix, No. 3, 1990, p. 257.

MONITORING AND FOLLOW-UP :

Once the loan is sanctioned, its periodical monitoring and follow-up are equally important. The objective of monitoring and follow-up will mainly be to ensure that the funds are used for the purpose for which they were given, the things are moving as per original projections submitted by the borrower, to keep a watch on any dues which are accumulating and detect the signals and symptoms of sickness at the incipient stage for initiating timely corrective action.

The importance of follow-up is emphasised by Tondon Committee in the following words : "a bank has to follow-up and supervise the use of credit to verify first whether, the assumption on which the lending decision was taken continue to hold good both in regard to the borrower's operations and the environment and second whether the end use is according to the purpose for which the credit was given."[121]

Monitoring includes supervision, and review function goes alongwith follow-up. Here, Hingorani and Chawla expain supervision, follow-up and review in the following words.

"Supervision generally relates to the behaviour of the account as per bank's norms and limits fixed periodically, usually each month, on the basis of information provided by the borrower.

Follow-up generally relates to assessment of operating performance of the borrower as compared to the data provided by

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121. Report of the Study Group to Frame Guidelines for follow-up of Bank Credit, RBI, Bombay, 1975, p. 40.

the borrower initially at the time of fixation of limits. It is more or less an evaluation of actual performance as conpared to that promised.

Review generally relates to an evaluation of the borrower on the basis of supervision and follow-up as the borrower with a view to finding out how 'good' is the account. On the basis of this review a bank decides on the extent of commitment of funds extendable to a particular borrower.

Supervision, follow-up and review are different versions at different time intervals towards the common goal of examining the safety of an account."[122]

As Bidani and Mitra put it, "a bank has to follow-up and supervise the units to find out if utilisation of credit is in accordance with the purpose for which it was allowed. The bank has also to verify assumptions on which the loan was sanctioned continue to hold good with regard to operations and the environment and whether the promotors are adhering to the terms and conditions of sanction. This is done by evolving system for obtaining information at regular intervals or making visits to the unit."[123]

According to Sampat Singh, "follow-up is closely related to the basis of lending. If the basis of lending be the man behind

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122. Hingorani N.L. and Chawla O.P., Management Accounting, p. 18.

123. Bidani S.N. and Mitra P.K., Bank Finance for Industry Working Capital and Term loans, p. 144.

the operation, the follow-up shall have to be zeroed on to him. If the basis of lending is the security then the follow-up shall have to focus on the stock statements, documentation, insurance cover and the physical inspection of goods. But if the basis of lending really be the level of quality of operations of the borrower, then the follow-up shall also have to be based on them ..... To control quality of lending is virtually to control quality of industrial operations."[124]

The change required in system of follow-up with change in style of lending is explained by Bidani and Sahee as follows :

"This Change in Style and approach has necessitated the adoption of a scientific system of supervision and follow-up which from the banker's view point can be defined as a systematic evaluation of the performance of loan-taking enterprise to ensure that it operates economically and if problem arise, to suggest practical solution."[125]

According to Ravindran G., "any absense or tardy of recycling of lendable funds will affect the prospect of further lending and ultimately may jeopardise the prospect of further credit supply both at macro and micro level."[126] "In general good credit maintenance practices can help minimize loss exposure and

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124. Singh Samptat P., The Lending System in Transition, Prajnan, January-March, 1981, Vol. x, No.1, p. 38.

125. Bidani S.N. and Sahae P.B., How Bank Credit is Administered, p. 13.

126. Ravindran G., Recovery and Follow-up of Advances : Agricultural Banker, October-December, 1988, p. 10.

increase the likelihood of a solid port folio."[127]

Edward Altman also opines similarly and he mentions that "if a bank is very efficient in recovering all or a significant proportion of bad-loans the net effect on bank profitability will of course be less severe than if it is inefficient in this endeavor."[128]

Now the point is which of the following tools are used for the purpose ? Here the tools which were inquired are : Cash budget, funds flow statement and ratio analysis.

Business plan, break-even analysis and costing system should obviously not form part of monitoring because business plan once submitted remains the same except in the case of revised projections. Hence, the function remains only that of comparing the actuals against the plan. The break-even point has also to be found first given the investment decision. This can also be checked, i.e. whether it is actually achieved or not. So far as costing system is concerned once it is decided, it is to be adopted for number of years consistently, with a condition that change if any has to be reported alongwith impact of change in the year of change in the method of costing (Particularly for change in the method of stock-valuation).

Hence, the above three techniques i.e. cash budget, funds flow and ratio analysis are specifically included in the group of monitoring and follow-up.

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127. Bird Ant, Preventive Medicine for Loan Portfolios, Journal of Commercial Bank Lending, December, 1990, p. 61.

128. Altman Edward I., Some Estimates of Cost of Lending Errors for Commercial Banks, Journal of Commercial Bank Lending, October, 1977, pp. 51-52.

The use of cash flow in prediction of business failure is identified by Jay Alix and Elmer Heupel, in the following words: "two quantitative financial testing or detection procedures should be employed by lenders from the earliest signs of changes in financial position if not in an across the board manner on all significant loan exposures.

Cash flow analysis can lead to a deep understanding of any company, no matter how successful or stable. The value of this analysis in identifying troubled companies cannot be over emphasised."[129]

Also so far as the warning signals are concerned it is given by cash flow in a better way than by others. This is pointed out by Aziz and others in the following words : "the quality of signals - as given by the cash flow based on (CFB) variables and historic cost accounting measures of performance may be assessed from the following example.

A.M. International, Mc Louth Steel, Nucorp Energy, Sambo's Restaurants, Saxon Industries, Seatrain Lines and Wickes in 1981 had price-earnings multiples significantly higher than market but their cash flows were not encouraging. They all filed bankruptcy petition under chapter 11 in 1982."[130]

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129. Alix Jay and Heupel Elmer E., Predicting Business Failures : Let the Lender Beware, Journal of Commercial Bank Lending, April, 1990, p. 58.

130. Aziz Abdul, Emanuel David C. and Lawson Gerald H., Bank-prediction, An Investigation of Cash Flow Based Models, Journal of Management Studies, 25-5, September, 1988, p.421.

The utility of financial statements for monitoring purpose in explained by Martin in the following words : " ..... obtaining, spreading and analyzing financial statements at pre-determined intervals. This function obviously will determine whether or not the borrower is in compliance with existing credit agreements."[131]

The use of ratio analysis is also not unknown as a predictor of failure. As IAN Zimmer puts it "the paper indicated that financial ratios based on conventional accounting information are useful to loan officers for the purpose of predicting corporate failure."[132]

Thus, it can be said that, "loan monitoring, on the other hadd consists of post approval credit analysis in order to detect deterioration in loan quality."[133] Here "the future goodness - or - badness of loans can be accurately predicted based on a continuously updated analysis of loan officer's past loan evaluations."[134]

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131. Martin K.D., Problem Loan Signals and Follow-up, Journal of Commercial Bank Lending, September, 1973, p. 38.

132. Zimmer IAN, A Lens Study of the Prediction of Corporate Failure by Bank Loan Officers, p. 635, Journal of Accounting Research, Vol. 18, No. 2, Autumn, 1980.

133. Udell Gregory F., Loan Quality, Commercial Loan Review and Loan Officer Controcting, Journal of Banking and Finance 13 (1989), p. 369.

134. Rothenberg David, Predicting the Status of Your Loan, Three Years from Now, The Journal of Commercial Bank Lending, April, 1980, p. 28.

For proper monitoring and follow-up the Tandon Committee suggested the following measures :

Monthly stock statement in the revised form

Periodical stock inspection

Quarterly performance or budget information

Half yearly proforma balancesheet and profit and loss account within 60 days.

Annual audited accounts within 3 months.[135]

So far as the system of quarterly information suggested by Tandon Committee is concerned it is stated in para 5-21 of Chore Committee Report that " ..... the system recommended by Tondon Committee has yet to take firm roots."[136] and to get over this difficulty simplified forms were suggested by the Chore Committee.

So far as half-yearly financial statements are concerned their importance is also recognised by the foreign countries. Richard Hamm puts it in the following words : "considering the increased availibility of interim financial statements and the later delivery of year end financial statements, interim

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135. Report of the study group to Frame Guidelines for follow-up of Bank Credit, RBI, Bombay, 1975, p. 47.

136. Report of Working Group to Review the System of Cash Credit, RBI, Bombay, 1979, p. 36.

financial statements are becoming more important to the commercial lending process."[137]

Also certain informations are useful for obtaining warning signals. In the opinion of V.S. Kaveri and S.K. Agarwal, "banks get the required information for obtaining signals from the following sources :

(a) Ledger account of the borrower (b) Stock statement submitted by the borrower on a monthly basis (c) Factory inspection and meeting held with the borrower during the year and (d) Financial statements received from the borrowers on an annual basis."[138]

So far as periodical stock statements are concerned it is suggested by Nareshkumar Mittal that 'if possible, an attempt must be made to exclude the stocks which remained unsold for a period of more than six months, as they have become obsolete."[139]

Edgar Morsman also gives importance to non-financial information and he states that, "there is always a lagtime in receipt of financial data and in a deteriorating situation, a

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137. Hamm Richard A., Using a Disclosure Checklist to Increase the Value of Interim Statements, Journal of Commercial Bank Lending, September, 1992, p. 31.

138. Kaveri V.S. and Agarwal S.P., Study of Ledger Account Data, Prajnan, Vol. xix, No. 4, 1990, p. 403.

139. Mittal Nareshkumar, Credit recovery : Precautions for a Bankers, IBA Bulletin, August, 1985, Vol. VII, No. 13, p. 302.

lender can be examining statements reflecting better times in the past. Therefore, the frequency of receipt of financial information is critical and is part of the ongoing loan monitoring process originally established at loan approval. If a lender is not receiving adequate interim financial data, non-financial aspects must be relied on to detect problems."[140]

Considering all above aspects the techniques studied for monitoring and follow-up are cash flow statement, funds flow statement and the ratio analysis. In addition, to these three specific tools, one option was "anyother please specify". This open option was to include in it any other mode/tool/technique used for monitoring and follow-up.

CONCLUSION :

This Chapter presents the grounds/logic for sample selection, methodology followed for data collection and contents with detailed reasoning of the questionnaire. The cases which are put in the questionnaire are kept out of purview of this chapter, considering them to be well-suited at the place of discussion and analysis of responses.

The analysis of response to above questions follows in the next chapter.

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140. Morsman Jr. Edgar M., Effective Loan Management, p. 105.