Financial Statements Analysis and Reporting
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Lecture - 37
Ratio Analysis Part-III

Welcome students. So, we are discussing the financial statement analysis with the help of ratio analysis and in the morning we discussed the first two categories of ratios, these two categories were return on investment ratios and then the solvency ratios.

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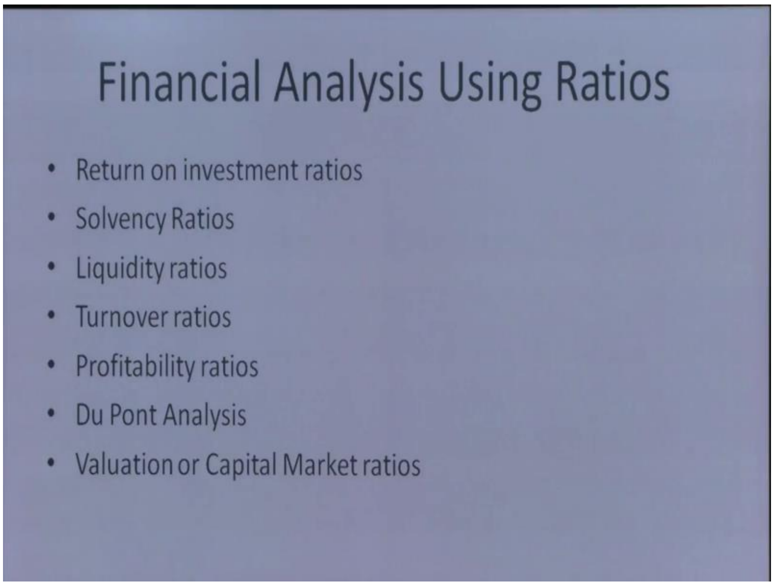

So, with the help of RoI ratios we try to know the return on investment made by any stake holder may be the share holder or the say especially the share holders who are the internal owners of the company, internal members of the company, internal suppliers of the company and return on their investment that with the help of (Refer Time: 01:07) try to find out that how much return is going to be available that is a profit after tax and then we talked about the say EPS earning per share and the EPS ratios and then the solvency ratios which help us to understand the overall you can call it as the strength fullness of the business that how strength full the business is, how powerful the business is.

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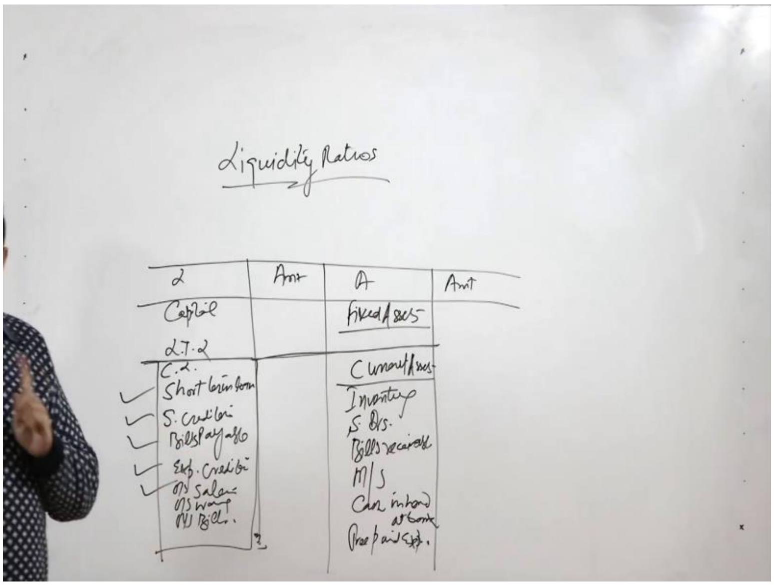

So, these two ratios, these two set of ratios and now we moving to the third set of ratios that is liquidity ratios, liquidity ratios, liquidity ratios. So, when we talk about the liquidity ratios liquidity means cash ability of the firm, cash ability of the firm, that how liquid the firm's assets are, how liquid the firm's assets are we try to study the liquidity position because liquidity is a very important part in the firms, liquidity is a very important part in the firms because if you have the profits, but they are not the liquid profits you do not have the cash profits then these profits are of no use.

Similarly, if you have the assets and these all assets are the fixed assets we do not have the current assets or we do not have the cash has one of the assets, so it means those assets are of no use for us. So, because we have to make the payments if you look at the balance sheet here this is the balance sheet of the firm and in this balance sheet we see that we have different type of the liabilities and assets here we talk about the liabilities, here we talk about the assets and when we talk about the liabilities here is the capital then we have the long term loans different sources then the current liabilities, current liabilities are the short term liabilities you can say and in the current liabilities you have the sundry creditors similarly we have the bills payable then we have some other expense creditors, expense creditors means like your salaries outstanding salaries, wages or some bills utility bills like these are some of the liabilities.

So, when we talk about the current liabilities here is the sundry creditor’s bills payable expense creditors then the outstanding salaries outstanding wages and outstanding bills of the utilities different things are there. Apart from these liabilities we could have some say short term loans also short term loans and when we talk about the short term loans yes they are also important source of funding you have the long term source of funding capital very long then the long term loans which are for 5 to 10 years, then we have the short term loans which are say if we should put it in this order; this the order is like when we talk about the current liabilities here are the current liabilities and first we say for example, the short term loan. So, these are the current liabilities. So, we are a phone is using the long term sources also then they are very long then the long term source is then they are using the short term source is as the short term finance as the short term borrowings from the banks.

Then we have the spontaneous finance this is the third category of the finance there is a sundry creditor’s bills payable and then the some expense creditors like you are on outstanding salaries, outstanding wages, outstanding bills of power electricity, similarly the water of the kind of things. So, these are the source from where the funds are being generated and when the funds are being generated especially when you talk about this lower part the current liabilities part here the funds being generated from these sources they have to be paid in a short time as well, maximum within a period of 12 months or maximum within a period of 1 year we have to return it back.

If we do not pay these funds back to the sources then its spoils the reputation of the firm and if you have to make the payment on the due date if you the firm never wants to default in that case we need the proper liquidity. Now, from where the liquidity will come? Say here you talk about we have the fixed assets, here we have the fixed assets and the fixed assets if you talk about we have the land buildings plant machinery furniture fit fittings and so many other kind of things. So, these things cannot be sold to repay these current liabilities it means we have to have some other kind of the assets and these assets which are used as a source of funding current assets and in the current assets first of all we take the inventory, inventory is the stock all kind of stocks that is of the raw material that is of the work in process and that is of the finished goods all three kind of the stocks are there. Then we take here as the sundry debtors.

Sundry debtors are the one other current asset then we take the bills receivables, bills receivables they are also current assets then we have say the marketable securities and then we have the cash - cash in hand and cash at bank, cash at bank and then we have the say prepaid expenses, prepaid expenses, prepaid expenses. So, see these assets when they are converted in to cash they generated the cash and this cash is used to pay the first current liability, short term liabilities and then they are used for the long term liabilities right. So, it means to know the liquidity position of the firm we have to look at the asset side of the balance sheet of the firm and if you look at the upper part of the balance sheet you will give you the fixed assets and fixed assets are of no use as such as for as a liquidity of the short term paying capacity or the firm is concerned.

It means we have to come down to the lower part and we have to compare this balance sheet where the current liabilities and the current assets are of importance to us as well as the liquidity ratios are concerned. Only this part of the balance sheet, we do not care for the proper part of the balance sheet, we do not care how much fixed assets firm has how much capital and how much long term loans firm has we are only concerned with how much short term assets firm has, how much short term liabilities firm has, because if you do not to make the proper use of the fixed assets you need the sizeable amount of the current assets also right acceptable amount optimum amount of the current assets. And if you want to raise the fixed assets you need the long term sources and to make the proper use of these long term sources and to make the proper use of the fixed assets you need the short term sources also and short term sources are always available and they are continuous in supply, they are always available to the firms if they are being regularly paid back as in when these current liabilities are becoming due and they are only possible to be paid if you have the liquid current assets here.

Now, when you talk about the overall liquidity, we take all the current assets in to account because inventory is also kind of a short term asset is a current asset within a month two three or four months you can easily convert that inventory in to the cash or you can sell that inventory in the market. So, maybe we are not selling the inventory on cash we are selling it on credit. So, maybe we are giving a credit of sale maximum of two months. So, we will sell the inventory today and even you sell it on credit. So, after say 60 days you will get this funds back will be converted in to the cash because inventory first will be converted in to sundry debtors and sundry debtors will be converted in to cash and if you talk about the time period in India the credit sales period is normally from 45 to 60 days we do not get normally in the normal circumstance the form is doing well and their product is equally acceptable in the market and if there is no issue especially with the product and services of the firm in that case the normal credit period is from one and half months to the two months.

Now, after two months that inventory will miss the first inventory will be converted inventory sold today may be on credit will be converted in to sundry debtors today itself and after two months that will be converted in to cash. Similarly the sundry debtors already we are saying that two months maximum, within two months that will be converted in to cash, same with the case with a bills receivables then we have the another current asset is the marketable securities. Marketable securities are basically very short term investment almost liquid investments what happens that when you keep more amount of cash in hand and cash at bank that does not generate any interest for us, we does not generate any income for us this cash has no income it does not generate any income or any output because cash in hand is useless is not generating any income we have kept it for a day to day expenses.

Similarly, when you talk about the cash at bank, cash at bank also business cash for the cash or the business firms is in the bank that is in the current account and the current account does not I mean earn any interest from the side of the bank that is only for keeping the safe amount of the cash. So, whenever you need to have receipt and payments you can have the receipt and payments through that bank account, but on that bank account bank does not pay any interest it is not a saving account saving account is for a individuals and when any firm is having for the short term current receipt and payments any account they open that is called as the current account. So, current account is also not earning any interest rather sometime bank charges from the firm for using the current account more than or beyond a permissible level of transactions.

On any transaction current account the number of transactions permitted per day by the bank is fixed say 3 4 5 transactions, but when for makes more than the permitted number of transactions in that case the bank has to charge or the firm has to pay to the bank has the charges for using the current account beyond the permissible limits. So, this also does not any income and then we, it means what happens that there is no point to keeping the cash more cash or cash more than the optimum level in the cash form may be the cash in hand or cash at bank.

So, what the firms do that after certain in that how much cash we normally requires say we go for the process of cash budgeting and cash budgeting may be if the firm is really very good having very good resources then the cash budgeting can be on the weekly basis, you make the budget for one week cash budget for one week you can easily make out that, how much cash we are going to receive in this week, how much cash we are going to pay in this week and what is going to the difference. If the receipts are going to be more than the payments in that case we do not need the cash from the bank or in hand. So, we what we do we convert that cash in to the marketable securities surplus cash in to marketable securities. Marketable securities are like even very short term investments say called deposits as in when you get the deposits that money to some other form in the market use and may be as in when you ask within 24 hours that can be asked back and you can make use of it and for that period of time for which the firm will make use of this money they will pay the interest. Or sometime it can be weekly deposits fortnightly deposits or monthly deposits can be given investments or securities can be bought from the market.

So, its better because keeping the cash in hand or at the bank is not going to earn any interest and we are sure with the help of cash budgeting that we are not going to earn any interest on we are not requiring cash beyond particular amount in that case you convert that in to marketable securities and marketable securities are also current assets very short term assets as in when you go to convert that in to cash you can sell those securities in the market and convert them in to cash and then we have the cash itself as I talk to you, but when we talk about the prepaid expenses they do not generate any cash for us. So, setting this aside, prepaid expenses we can have cash in hand and cash at bank marketable securities sundry debtors and bills receivables and inventory these are the all current assets.

So, when you have now to maintaining balance between this and this side because if you are having the short term sources to be used in the firm it means when we are borrowing the money from these sources we have to pay it back very quickly also and in a very short period we have to return it back also and that return is only possible when the firm has the sufficient amount of the current asset because they are the sources of liquidity.

So, if you are keeping a sufficient amount of the current assets and then you have the equal amount of the current liabilities then any time any current liability becomes due that any means you have sufficient amount of cash and when the cash adjust we convert the marketable securities in to cash and when they are also over we can have the sundry debtors.

Now, sundry debtors normally the amount will come on the date of expire on the expiry of the credit period, but there is a source of funding with the help of sundry debtors that these debtors can be sold to the banks or may be got discounted from the banks. When we have the sundry debtors and we have sold the goods some goods firm in the market in that case will be the money is coming after two months because we have given the credit period to the buyers, but here those bills can be taken to the bank before the due date we can discuss with the bank that we are sold these goods to this firm or these different firms they are expected to pay a after two months or one and half month so, but we need the cash today. So, please keep these sundry debtors with you or bills with you or invoices with you, give us the money and on the due date when the firm will pay us we will return your money to you and will settle the account.

So, if the buyer is good these sundry debtors are good accounts who have bought from the firm, from this firm in that case banks may feel that yes this investment is safe and secured so this no harm in discounting these bills. So, bank will keep these bills and immediately up to 80 percent of the bills amount can be given to the firm and on the due date when the buyer or the say debtor will pay back to the firm either directly the debtor can pay back to the bank because bill is discounted from the bank. So, seller informs buyer that on the due date it send the amount to the bank and if it comes to the seller the creditor then the seller goes to the bank that we have got now the cash and we have received our credit sales amount.

So, you can settle the account at that time bank will say calculate the first the interest on that 80 percent amount which is given as advance and then some administrative charges plus commission. So, these three heads bank will charges own expenses plus interest and after remaining 20 percent it is something is left then it is paid return back to the firm it is not left to the 20 percent is the banks cost then at least the firm got 80 percent of the advance 45 or 60 days before.

So, sundry debtors are also almost cash they can easily converted in to cash provided we are sold our goods to the good quality buyers or the good (Refer Time: 17:22) buyers then there is no issue there is no problem as such. And inventory is the least liquid we can say, but still we are saying that the life of the inventory is also in a few months. We can convert the that inventories sell that in the market either we can sell it on cash then there is no issue, but we sell it on credit we converted it into sundry debtors and sundry debtors as I told you can we got discounted from the bank if we need the funds before the due date.

So, this side current assets are funded by current liabilities, but when the current liabilities become due to be paid cash is generated by converting this current assets into cash and then cash is used. So, we want to study with the help of liquidity ratios that what is the extent of the liquidity in the firm. So, it means whether whatever the current liabilities or spontaneous finance sources the firm has used, if the firm in the position to pay it as and when as in when they become due to be paid. So, that is the study of liquidity and if the liquidity position of the firm is good in that case nobody would be bothering about say for example, we are the suppliers. The two companies - one is xyz limited they are the buyers of particular raw material and abc limited is the supplier of their raw material.

Now, xyz wants the raw materials supply on credit and the credit period for two months in that case the abc also has no problem they can supply the material to xyz limited, but they wanted to be sure that on the expiry of the credit period whether xyz limited would be able to pay it back to abc or not. And if the abc is sure that yes the firm is not going to default because sufficient liquidity exist from the (Refer Time: 19:05) it can be seen from the say current assets position in that case this firm will be get the automatic supply regular supply of raw material and as in when the bills become due they have sufficient liquidity on this side and then the bills can be paid on the due date and the this some invoices can go on the continuous basis.

Similarly, when we talk about the say even there is expenses credits or sometimes we talk about the say salaries to the employs salaries also, means employees also do not care they means without any condition, they keep on giving the services to the firm at least for a period of 30 days. So, the firm gets spontaneous credit of for 30 days, but employees are only sure if there is a sufficient cash available on this side, if the cash is not available employees may be under the doubt that whether we will get the salaries paid after 30 days or not.

So, we talk about whose other who is the supplier, similarly talk about the short term loan. Now firm takes short term loan from the banks normally in India the short term financing to the manufacturing sector firms to any business sector firms comes from the banks, there is no other source means hardly there is use of other source. We are 9 10 total source of the short term finance like you have this loans from banks or cash credit limit from the banks in total the short term finance from the banks. Second we have the factory, we are forfeiting, we have public deposits, we have inter corporate deposits, we have commercial paper, we have the now derivatives also short term derivatives, but hardly these other sources are of any use in the Indian scenario nobody uses these I mean the other short term sources of finance because the bank finance in India is very easily available to fulfill the to fulfill the short term requirements of the firms.

But once when banks get short term finance to the firms they also make the liquidity analysis of the firms. They see that yes we are ready to give you the working capital loan or working capital in the firm or short term finance in the form of the cash credit limits, but are we going to get our funds back from you on time or not. If some loan is given for three months then yes that loan should be returned by the firm on the expiry of 3 months, there should not be any default similarly some CC limit is cash credit limit is sanctioned by the bank to the firm then they should be both the things when you need money you would withdraw the funds, but when you have to surplus you deposit the funds back in the CC limit.

So, these all this liquidity analysis is of the interest to manage stake holders like the banks as the suppliers of the short term finance may be in the form of the short term loan may be in the form of CC limit or may be has a discounter of credit sale bills. They need to be sure that yes that firm is going to have sufficient liquidity and that liquidity is going to have the firm to return our funds back one. Then is the sundry creditors: sundry creditors are suppliers generally who has the sundry creditors and they also have the bills means the firm has the bills payable in favor of them. So, both means all kind of suppliers before supplying to the firm make the liquidity analysis of the firm that we are ready to supply you, but are you able to make the payment on the due date may be on the expiry of the credit period or not.

If you are not able to make the payment on the expiry of the credit period then they will stop the supply of raw material. So, before entering in to any kind of agreement a long term agreement for supply of raw material their payment should be assured and they also make the liquidity analysis. Similarly your salaried means employees workers and similarly the other say suppliers of these utilities they can also make the utility this liquidity analysis of the firm’s financial position that they will give you may be without any condition without any kind of the varying factor that we should supply the inputs to this firm provided the firm is going to make us the payment on the due date and we are not going to have any problem with regard to the receipt of the payment.

So, it means this all the lower part of the balance sheet is important for us then we are to going to talk about the liquidity analysis of there that we are going to make the liquidity analysis of the firm. We are only going to talk about the current assets, and we are going to talk about the current liabilities and with the help of the current assets and current liabilities, we are going to make sure that whatever the short term source is or spontaneous finance source firm is going to use the firm is going to make the payment of these sources on the due date as an when these payment to these sources becoming due we have the sufficient funds with us and we will be able to make the payment. If this is assured by the firm then would bothers whether it is bank whether it is supplier ,whether it is employees, whether it is creditors, anybody is there they will be able to have the better relation with the firm.

And another important aspect of looking at the liquidity position of the firm is that if the firm has a sufficient good liquidity position in that case the source is from there the long term funds are generated they will also be little confident that whenever loan will become due to the paid by the firm, the firm will have the sufficient liquidity and when the interest will be due to be paid by the firm one of long term loan then they will not be a problem the firm will be able to make the payment.

Similarly, in case of the share capital when you talk about when the people make investment in the shares of the companies and people are desiring good amount of the dividend. So, dividend can be paid by the firms who have the sufficient liquidity and liquidity comes only when the firms has a larger amount of the sales on cash not on credit and the maximum amount of the profit is in cash. So, that they are also interested in the liquidity part and then another important component is a fixed assets if the firm has only fixed assets or very good amount of fixed assets the use of the those fixed assets to a larger extent will depend upon if the firm has sufficient amount of the liquidity or not.

For example if you not have the inventory, if you your sales are not going to the market if your say sufficient amount of the cash is not available in that case what these fixed assets will do. So, if you want to make the proper use of the fixed assets and if you would not to improve it turnover ratio which will be the next set of discussion for us turnover ratios. So, if you want to maximize use of the fixed assets you need the sufficient amount of the optimum amount of the current assets. So, liquidity position is important, study of the liquidity position is important for all and different stake holder you talk it about that is the suppliers or the employees or the investors or the lenders everybody is interest in the liquidity then the firm is maintaining sufficient amount of the liquidity then it is fine nobody bothers they sure that their payments will be made on due date.

But when the liquidity is a problem with the firms then in that case everybody thinks twice or may be thrice or four times whether they should do business with a particular form or not. And it has been seen that due to the lack of liquidity many good firms many properly running firms have become the sick firms. So, study of the liquidity position of the firm is very very important and they will be analyzing the liquidity position of the firm, different firms and we will learn how to analyze the liquidity position of the firm and we will use make use of certain ratios for that and with the help of those ratios you can easily make out whether the firm is maintaining sufficient liquidity in itself or not. And this solve all the ratios the liquidity ratios which are of interest to us and use to us I will be discuss discussing with you in the next lecture.

Thank you very much.