**Financial Statements Analysis and Reporting**
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**Lecture - 42**
**Liquidity Ratios-Grasim Industries Part-I**

Welcome students. So, we were talking about the liquidity ratios, and in my previous part of discussion I discussed with you that how we calculate the current ratio and what is the meaning of it, and what is the relevance of the current ratio as for as the liquidity management is concerned. And this is the first ratio which is we calculate that is by taking the total current assets divided by the total current liabilities, and as I told you that the rule of thumb of this ratio is 1.33 is to 1. So, normally what happens that say why it is 1.33 is to 1 earlier the rule of thumb was 2 is to 1, current ratio the rule of thumb was 2 is to 1, and now it is revised rule is 1.33 is to 1.

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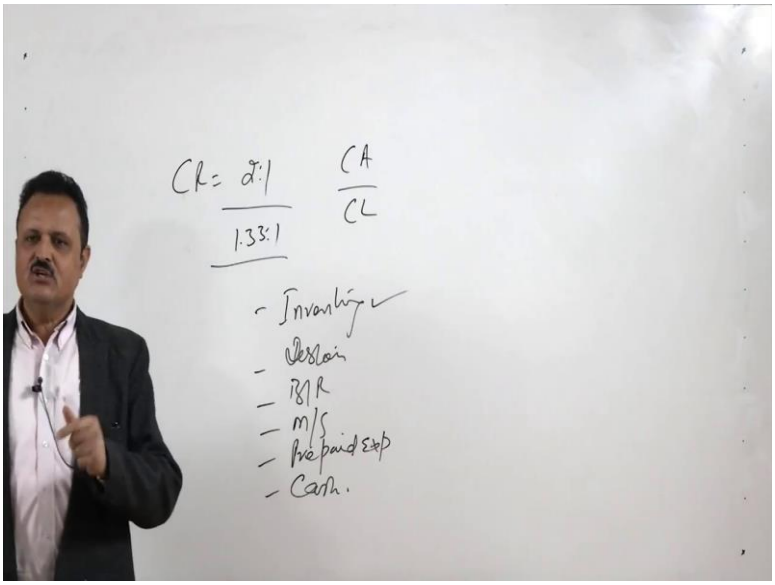


So, why it has been revised and why it has been lowered down. I will discuss with you just for 2 minutes the background of lowering the ratio, now it is acceptable; acceptable ratio is 1.33 is to 1, earlier this ratio was to 2 is to 1. So, see when we talk about the current assets, because current ratio is the current assets divided by the current liabilities CA is divided by the CL, that is a total current assets divided by the total current

liabilities. So, current assets are 2 times of the current liabilities if the ratio is 2 is to 1 and current assets are expected to be 1.33 is to 1 when the current ratio is 1.33 is to 1.

So, in this situation why the ratio has been lower down; the ratio is which is acceptable now is 1.33 is to 1, earlier what was the situation that one we are required to keep the ratio, when the industries required to keep the ratio 2 is to 1, it means the current assets should be equal to the means 2 times of the current liabilities. And when you talk about the current assets what are the current assets? Say we start with inventory, in the balance sheet you say it is the inventory then there are the debtors, then there are the bills receivables, then there are the say marketable securities, then there are the say prepaid expenses and then is cash. And when we are expecting the ratio to be 2 is to 1, it means we are expecting the firm the industry to maintain this level of current assets as double of the current liabilities.

But it is very expensive to maintain the high level of current assets very very expensive; and no firm can afford to keep high amount of the current assets. We call them these are the assets, we call them these are the assets inventory is asset, debtor are the assets, bills receivables are assets, marketable securities are assets, prepaid expenses are asset, and cash is also asset. But and is to say we should talk about these assets look at the lower part of the balance sheet, here we have the current assets and current assets are interest, accrued on investments, inventories, sundry debtors, cash loans and advances these all are the current assets.

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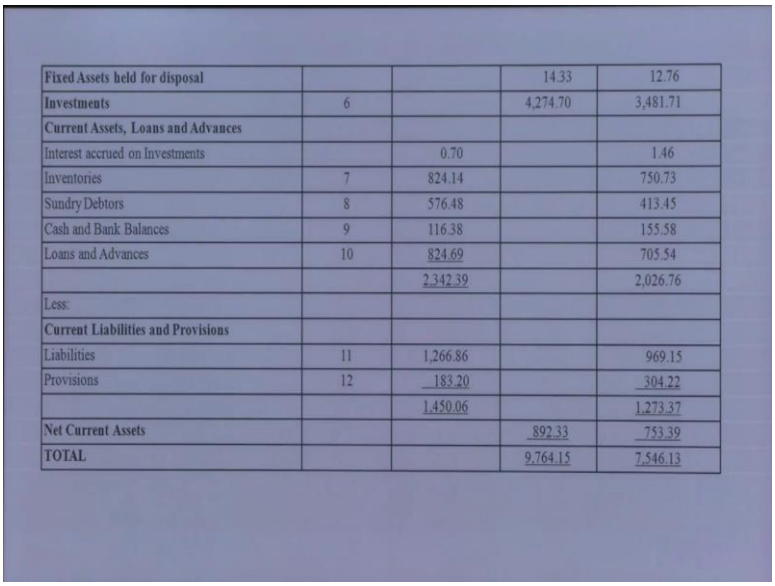

| | | | | |
|---|---|---|---|---|
| **Fixed Assets held for disposal** | | | 14.33 | 12.76 |
| **Investments** | 6 | | 4,274.70 | 3,481.71 |
| **Current Assets, Loans and Advances** | | | | |
| Interest accrued on Investments | | 0.70 | | 1.46 |
| Inventories | 7 | 824.14 | | 750.73 |
| Sundry Debtors | 8 | 576.48 | | 413.45 |
| Cash and Bank Balances | 9 | 116.38 | | 155.58 |
| Loans and Advances | 10 | 824.69 | | 705.54 |
| | | 2,342.39 | | 2,026.76 |
| Less: | | | | |
| **Current Liabilities and Provisions** | | | | |
| Liabilities | 11 | 1,266.86 | | 969.15 |
| Provisions | 12 | 183.20 | | 304.22 |
| | | 1,450.06 | | 1,273.37 |
| **Net Current Assets** | | | 892.33 | 753.39 |
| **TOTAL** | | | 9,764.15 | 7,546.13 |

Now, with these assets are current assets are called as assets they are assets, but in the real sense if I am a business man, and if I am given a chance not to keep any amount of the current assets in my balance sheet or in my concern, I would be the happiest person; why? Because current assets only have a cost no returns; they only have a cost no returns did not help any miss the firm to earn any return on this investment in the current assets. So, when there is no return on these current assets, why should one keep the current assets in the balance sheet?

Now, for example, how why there is a no return say for example, we talk about the inventory; when we keep the inventory in the firm, we keep the inventory because you cannot sell everything in the market whatever we produce. Part of our production compulsorily remains un sellable because we keep on producing the production process is continuous one, we cannot stop the production process that I have already produce a lot and first I sell that in the market, and then again I will resume the production that is not possible, we have to continuously produce the production process is to go on plant cannot be stopped.

But at the same time everything cannot go to the market, this we would like to have some voices kind that say raw material is stay coming back coming from the supplied or supplier or suppliers place, a truck load of the raw material is coming straight way it is going to the plant, in the plant we are converting that in to the finish product, and finish

product from the plant itself 100 percent finish product is to going to the market, and nothing to coming to the warehouse as the finished goods, we are not require to keep any inventory of the finished goods, and everything is straight way from the plant is going to the market.

So, it means I am not keeping any inventory of raw material, I am not keeping any inventory of the work in process, and I am not keeping any inventory of the finished goods. So, I am the safest one, because when it keep inventory of raw material you have the cost of maintaining that inventory, we have the cost of godown, we have cost of people who are looking after that inventory, we have the cost of say miss the godown the space, the building, the human resources. So, maintaining and managing inventory only has a cost; and inventory when we talk about the returns it has no returns, means only we will be selling that in the market.

So, you sell this inventory today in the market, you will sell after three months in the market is going to be the same price. Some time when you sell today's inventory when you sell after three months in the market, you get less returns on that. May be some time the price may come down or may be because of obsolesce quality may be getting deteriorated, or everything may be possible. So, returns are going to be maximum what you have to going to get today you are going to get a three months; and if the price falls down because of the obsolesce quality of the that finished goods go down, packaging gets disturbed then sometime the price will go down. So, price is going to remain the same or is to going to get reduced, but cost is going to increase because in maintaining inventory has a cost. We must be knowing about that inventory has three kind of the cost: first is the say holding cost, then is the stock out cost, and then we have the say you can call it as carrying cost. Carrying or the holding cost, then say stock out cost, and then we have the say managing cost of the inventory itself has a cost.

So, it means you have the cost only in the inventory; returns no extra returns are available. So, if I am given a chance to not to keep the inventory of raw material or the finished goods, then I would be the happiest persons so why should I keep inventory. It has a cost only no extra returns. Similarly talk about the debtors, who are the debtors when the debtors are adjust in the balance sheet; debtors only adjust in the balance sheet when we sell them on credit, and as it true businessman would I like to sell my production or production in my factory in my unit on credit in the market, why should I

do that? I would be the happiest person if I love to celebrate on cash, but that is not possible.

Because you cannot sell everything total production in the market on the cash basis, part of the production has to go the market on credit basis so debtors come up in the balance sheet. We call these debtors as a asset, but I think I will be the last person who would like to have even not even like to have not even I out of the debtors; no debtors I do not know sell on credit. And the firms who are having that commanding position in the market, they do not sell anything on the credit they sell everything on the cash. Most of the MNCs who are operating in India for example, talk about the Samsung; now Samsung is having good market for their product. So, largely they are selling their products their passing it on the dealers and dealers are to get it on cash from Samsung.

Because Samsung has a market Samsung has a demand for the product, why Samsung should get the credit to the dealer. Similarly talk about the car manufacturing companies; car manufacturing companies when they sell the cars to the dealers normally these cars are sold on cash, they have to send a draft along with the total demand note, they have to send a draft of that total amount and was the company is seized the draft and the payment then a truck load of cars is sent. So, if you have a good demand for a product in the market, we have a good market for your product then there is no issue, you can even sell everything on cash you can refuse the sell on credit.

But if there is a problem and you see that today we are in a competitive economy, we are in a competitive era why they are in a highly competitive economy? Because the fact of the liberalization is that after a liberalization of Indian economy, one thing is has happen that it has improved the supply side, once it has a improved the supply sided means competition has intensified. When the competition as intensified it means today there is not only one manufacturer who is selling the one product in the market, there are multiple suppliers who are say manufacturing and selling their product in the market. See if the one is not selling on credit other will sell. So, when the competition as increased supply side has improved, now people have lot of options available. So, it means the companies the manufacturers are bound to sell on credit earlier.

In the Indian market say for example, we talk about the electronics industry. They are so many people manufacturing cc TVs and other electronic products, but leading names

were only 2 in the market one was Oneida, second was Videocon. So, Oneida having the best name in the market at that time till 98- 99 or maximum till 2000; they both considered as the best product in the market and Oneida was selling the costliest color TV in the market, and largely they are almost say large part of the transaction were on cash nothing on credit, but when this multinational Samsung, LG, Sony came up to Indian market now these companies are bright out of the Indian market, they are not existing in the Indian market they are they are disappeared from the Indian market.

Today nobody buys Oneida TV, though the TVs existing in the market; today nobody buys the Videocon TV, though the TV is existing in the market. So, Oneida and Videocon today because of the improved supply side, because of intensified competition, because of having a better product in the market, they have to compulsorily sell their product on credit. And most of the sales 80 percent of their sales are on credit, and because of the sales debtors come up. So, you see when debtors are there are these debtors are going to earn anything for this firm? Only firms funds are blocked in these credit sales, and whatever the amount of funds are blocked in the credit sales they have to arrange poor those funds from the other source is end and their cost increases.

For example sell this product in the market, creditors is debtors who are bought it on credit they are going to pay after 2 months or 45 days, they are going to pay something extra like the for the interest part, but some time or the most of the time part of the credit sales are not recovered also and they are called as bad debts, they are called as bad debts. So, bad debts are also there. So, it means when you are creating the debtors in the balance sheet, debtors only have a cost they do not have no returns, they do not have a any returns only cost. So, we have to be careful that we should sell as low as possible on the credit and our maximum sales should be on cash, but that is not possible because we have to sell it on credit.

At the same time the firms were selling on credit they also buy on credit. They raw material comes on credit, you see that this stable are there, and this stable of sundry creditors are what? They are the supplier's accounts who has supplied to the firm on credit. So, debtor's burden is being balanced by creating the creditors in the balance sheet, that if the firm is bound to sell the product on credit finish product on the credit, they are also entitled to have the credit from their suppliers. So, this is in voices which keeps on working, but as a business man if I am given a chance to sell my product in the

market, I would love to sell everything on cash and nothing on credit, and if that cash happens debtors will not exist in the balance sheet and my cost will go down.

Similarly, we talk about the bills receivable almost the same thing; then we talk about the will discuss marketable securities later on, we talk about the prepaid expenses. Would you like to pay for anything in advance? Why should I pay for anything advance? If my electricity bill is becoming due after 30 days, I should pay it after the due date not before the due date; means on the due date not before the due date. Similarly if I am getting some raw material on buying some raw material from some source, I would like to take to that source for the raw material only after receiving the material, but not before receiving the material.

What is a material is of that kind of means that nature, which material is of that nature which is scares is supplied. So, to ensure my supply I would have to make advance payments. I have to make advance payments to the source and so that my supply of the raw material is assures. So, then I making the advance payments, Am I getting some discount on that? I am not getting. So, why should I pay in advance rather it has a cost no returns. Similarly we talk about the cash, you keep cash in hand or we keep cash at bank; in both the cases it is going to cause you the cost no returns, cash in hand earns nothing for us, and cash at bank also does not get any returns to the business it is a current account in the bank not savings account. And current account does not earn any interest for the business, only savings account earns I that to very nominal only 4 percent.

So, I will also want to like to keep cash beyond a particular level. So, it means all these current assets are causing the cost they are not helping anything to earn extra revenue. So, I would like to keep either 0 amount of current assets or minimum amount of current assets or maximum the amount of current assets I would like to keep is, that amount which is called as optimum amount of current asset. And to fund these current assets I would like to have sufficient current liabilities with me, so that my own investment in the business is very very less. So, if you are require to keep the double amount of current assets as compare to current liabilities, you think how much your cost is going to go up. And you see that when it was a closed economy, India was a closed economy then competition was not that much.

So, at that time we were ignoring the financial cost; we would not bothering about how much is the financial cost for us, we were only talking about the production cost, we were only talking about the marketing cost, we were only talking about the distribution and sales and advertising cost, but we had the financial cost, but we were we were not careful about the financial cost, but if you today keep more funds blocked in the current assets, like keeping double amount of the current assets against current liabilities, then your investment in the current assets is going to walk; and that investment is costly and if you invest extra here your cost increases your returns will get affected.

Because these current assets are current assets, we are kept only for months not for years. So, if you save even a single term here that will reflect in to the increased profits; if you invest extra money here that will also reflect into the increased cost. So, it means nothing extra should be kept here, and that is why the current ratio is brought down. Actually why this 1.33 current ratio is important? This current ratio is important only and only if any firm has to go for seeking the short term finance from the banks, this is the requirement of the banks this is not the requirement of anybody else; there are many companies in the market who are keeping current assets and less than the current liabilities, and they are running the show with the negative working capital.

But if you are to go for financing our inventory, we borrow money from the banks. We for financing our debtors we borrow money from the banks; for making the prepaid expenses we borrow money from the banks, and sometimes you need cash also the borrowed the cash. And that bank finance comes in the three forms in India one is cash credit limit, another is the working capital loan, third is a discounting of the credit sale bills. So, when you have to go to the bank and in and I would like to share with you that in India most of the short term finance, most of the working capital finance in the Indian concerns comes from the banks in India. We have 10 12 sources of say short term finance or the working capital finance; we have bank finance, we have public deposits, we have inter corporate deposits, we have factoring, we have commercial paper, we have derivatives.

But hardly these sources are of any use in India as for as working capital finance is concerned, most of the requirements for fulfilling the requirements of working capital finance, they are fulfilled through the bank finance. Now when we go to the bank and seek the working capital of the short term finance from the banks, bank would like to

make sure that yes we are ready to give you the short term finance, but we would like to make sure that your firm is maintaining sufficient liquidity; sufficient liquidity and for that they demand that your current ratio.

Earlier they were demanding that the current ratio should be 2 is to 1, we have to keep 2 times of the current assets as compared to the current liabilities so that even part of the current assets are not convertible in to cash immediately, even you have sufficient amount of current assets remaining assets sufficient amount of the current assets are there, that the firm is maintaining liquidity and firm will be making the payment of their finance returning it as in when it becomes due, that is the principle as well as interest. But there is a liquidity problem with the firm, because they are maintaining very low level of current assets and part of the current assets for example, inventory does not become convertible into cash sometime debtors also are not convertible in to cash, similarly, marketable securities are also not easily convertible in to cash then you have left with the cash and prepaid expenses are is less liquid.

So, it means and if you are cash amount is less available with you, other assets are not convertible in to cash even though the firm wants to make the payment back to the bank on time, but firm does not have the liquidity. So, bank wants that they should be a question in terms of the extra current assets, and there straight was a required to keep the current ratio 2 is to 1. But now because as I told you after liberalization when the competition has intensified, many multinational companies have entered the Indian market, and now for Indian companies also is tough to competing such a competing environment. So, now, they have also realized that even the finance also has a cost; and if they are keeping more amount of the current assets in their balance sheet, it means their financial cost is going to go up.

So, they are request to the banks that he should be allow to bring down the level of current assets, so that we can manage our financial cost properly. And here now that is why the current ratio has been allowed by the banks to be brought down from the 2 is to 1 level to the 1.33 is to 1. So, that still there is a question by one third of the level of current assets. They have 33 percent current assets more than the current liabilities, so that even part of the current assets number 1 because all the current liabilities are not becoming due to the paid on the same date and same time. It means only some of them will become due one. Second thing is if even one-third of the current assets are more

than the current liabilities, it means even some of the current assets are not convertible in to cash, still bank firm has sufficient current assets which are convert easily convertible in to cash either they are in the cash form or they are convertible in to cash.

So, it means the liquidity problem is solved, and the form has sufficient liquidity all the times, and the bank can ensure be assured that your funds will be paid back to you as and when they become due. So, they have agreed that not 2 is to 1, but still you have to keep a positive current ratio. And that positive extent is 1.33 is to 1, you have to maintain the level of current ratio at the level of 1.33 is to 1 so. But if you do not need to go to the bank, if you do not require any working capital from the bank, if you do not need any short term finance support from the bank, then this current ratio is not the mandatory requirement, you can even keep 0.5 is to 1 is the current ratio no problem.

But then we have to be careful that when we keep the current ratio very low, then the firm has to be very careful that as and when the short term liabilities become due to the paid there should be sufficient liquidity. So, they have to maintain the liquidity though they can maintain a negative current ratio, but they should not be default on the account of making the payment of the current liabilities as and when they become due. Because if the firm is not able to make the payment on due date, then that situation is called as technical insolvency of the firm; firm is not insolvent, but technically the firm is insolvent.

Because they are not able to pay for their current liabilities on the due date, so that is a very important issue. So, you maintain any ratio if you do not want to go to the bank, but you careful be careful that your payments are made on time, and you have sufficient amount of cash you have sufficient amount of liquidity. So, this is the current ratio importance of the current ratio. So, now, the background is earlier it was 2 is to 1, but because of intensified the competition, now we are allowed to bring this ratio down and the ratio up to 1.33 is also acceptable, and by keeping 33 percent extra current assets the show can be run.

So, we have discussed the current ratio means the in my previous part of discussion we have calculated the current ratio for the Grasim industries, and we found that the current ratio in case of the Grasim industries was somewhere around 1.25. So, this is not a very high amount of the current ratio and we have found it that they are able to maintain the

current ratio at this level less than 1.33, because we are hardly going to the bank. If you look at this, they have the short term borrowings they had taken the short term borrowings, but over all the companies' position is so good that it may not be simply the bank finance it may be from the other sources.

So, if they are using the other sources they are not (Refer Time: 25:02) they not specified in the balance sheet, that they have the bank borrowings. So, then they do not have the bank borrowings, you will look at the current liabilities current liabilities amount is say 1266 per 86 [FL] and it is mentioned in the additional information given here that secure loans include short term debt that is 331.2, and unsecured is 75.51. So, one reason could be that it is not bank finance, and even if it is a bank finance then may be the bank has permitted them to keep the ratio less than 1.33, because their overall performance is very good excellent.

So, it means still it is a positive ratio do not 1.33 is to 1, but normally if a normal for not like this, but not having the sound financial position like this, but if a normal firm has to go to the market and is go to the banks for raising the working capital finance, in that case they will have to maintain the current ratio 1.33 is to 1. Now we will calculate the other ratios for Grasim industries, and you will calculate the ratios for the Grasim industries other ratios other liquidity ratios say for example, the next ratio is the Quick ratio.

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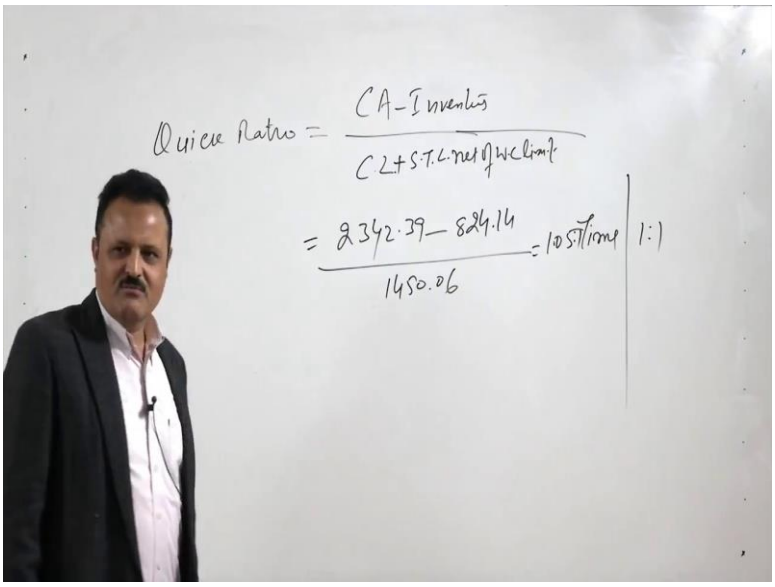

Quick ratio, this is the quick ratio. So, if you calculate means you have to calculate the quick ratio for the Grasim industries, and in my previous discussion I told you that the formula for calculating the quick ratio is current assets minus inventories divided by the current liabilities.

This was the formula I discussed with you in my last part of discussion, but it can be further more refined. Further more refined could be that in the denominator also we make some change, and here you can take that current assets minus inventories divided by the current liabilities, plus short term debt, plus current liabilities though be when we are writing when the short term debt we are writing here the current liabilities increased it means we are including everything, we are including the short term debt also.

But sometimes further refinement of this ratio has been done recently, and I would like to make some I may say what we discussed earlier, I would like to share with you that you can correct this ratio and calculate by this way, that in the denominator you can take that is a current liabilities, plus short term loan net of working capital limit (Refer Time: 27:50) of debt only will include that short term debt, which is a borrowed money not a working capital limit.

If some companies having a cash credit limit then that limit is not considered as a current liability; because there in the working capital limit in the CC limit we keep on I will discuss with you the CC limit also that in the next part of discussion, but in the CC limit it is not a borrowing kind of only it happens on the continuous basis, that whenever you need funds you borrow from that account, but whenever you gets surplus means you get the sales collection, he deposit the funds back in to that account; that is the CC limit account or the working capital limit account.

So, that much part should be subtracted from the short term debt, because where we withdraw also next day we deposit also, withdraw also deposit also, withdraw also deposit also. So, it means that is not a loan that it will become due to be paid after three months or after six months and then we should have to have the liquidity No. We are withdrawing also we are depositing also withdrawing also depositing also. So, in that situation that amount should be separated.

So, we are writing here current liabilities plus short term loan, net of the working capital limit; and if any working capital limit is being used that from the short term debt that

much of the amount should be reduced. So, this is the formula of calculating the quick ratio. So, in this case we will talk about the quick ratio here we will say that what is the level of the current assets we have seen earlier, and the level of current asset was 2 3 4 2 .39 minus inventory; and inventory is amount is 824.14; we have to separate that, and in the denominator we have the total amount of the current liability is how much 1266. So, total is plus provisions. So, it is 1450.06 this is the amount of the current liabilities.

This is the amount of current liabilities and in this we have for calculating the current ratio, we added the amount that is 406.71 [FL], that was added as the a say short term debt. But if the short term debt part of is that part of the short term debt, which is through working capital limit should be subtracted. So, let us see is there any amount as a working capital limit we are using.

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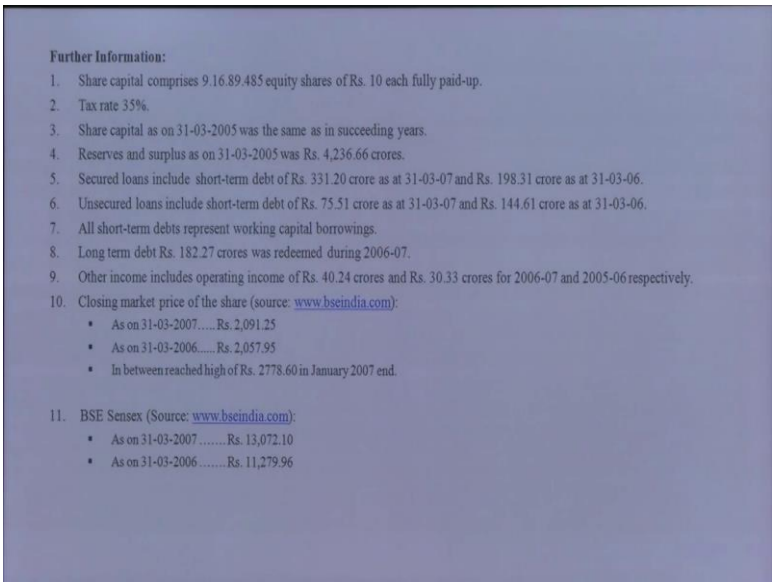


So, it is given here in the additional information that all short term debt represents working capital borrowings. All short term debts represent the working capital borrowing it means we have not to take the short term debt in to account here. So, only current liabilities will be taking in the denominator, and if you take the current liabilities in the denominator this works out as 1450.06 and if you calculate this works out as 1.05 times for the year 2007, and if you talk about the previous year this ratio is 1 is to 1. So, it is 1.505 times is to 1, and for the previous year it is 1 is to 1.

So, now this ratio as I told you the rule of thumb is therefore, the quick ratio the rule of thumb is that it is should be 1 is to 1, and in the both the cases it is nearer to the 1 is to 1. Remaining liquidity ratios I will talk to you in the next part of discussion.

Thank you very much.