

# **RISK EVALUATION OF FINANCIAL PERFORMANCE IN MANUFACTURING INDUSTRY – A CASE STUDY FROM BANKERS' PERSPECTIVE**

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## **INTRODUCTION**

The strategy of going global offers various challenges in the field of finance, the most widely emphasised goal of the firm is to maximise the value of the firm to its owners which is the driving force to make the organisation successful. This is possible only when, it has sufficient financial resources to meet the long term and short term requirements. Business can be carried on successfully with proper arrangement of funds. Funds are invariably required to carry on the various activities of a business which should be pursued on fulfilling the firm's long-term and short-term commitments. To meet long-term commitment, a firm needs permanent capital and for its short-term commitment, working capital is needed.

Regardless of whether the business is big or small, government or non-government, business without finance is a wingless bird. Thus, Finance is a significant facet of every business. Funds can be procured through various modes. Banks play an important role in the industrial economy of India. Bank Loans are the primary source of funds for private limited companies. Though lending is the primary activity of the bank, they are very cautious in granting the loans to their clients because their funds are collected from the general public in the form of deposits that can be withdrawn at a short notice at any time.

As soon as the borrowers approach the banks for loan, along with the supporting data and documents, including their estimates of loans required, the banks determine the credit limit to be granted to a particular borrower depending upon the credit worthiness of the borrower. In other words, before providing finance to the company, they assess the ability of the business to repay its debts on maturity through their financial statements. Analysis of financial statements helps the banker to know the financial position of the business which enables the banker to take better decisions. Among the various tools for evaluating the financial statements, ratio analysis is the most widely used tool, as it helps us to measure the financial and operational performance of any business. Ratio analysis will facilitate meaningful and purpose oriented decision making, depending on the evaluator's requirements. The author has made an attempt to provide complete information about banker's perspective in risk evaluation through this study.

## **RATIONALE OF THE STUDY**

Lending always invokes some amount of risk. The banker should evaluate the borrowers' credit history i.e. track records which reveal the morale of lenders. The basis for analysis and decision-making is financial information. Financial information is needed to predict, compare and evaluate the firms earning ability in all respects. The financial information is reported through the financial statement, and other accounting reports. It contains a wealth of information that if properly analyzed and interpreted can provide valuable insights of purposes, which range from a simple analysis of short-term liquidity position of the firm to comprehensive assessment of the strengths and weakness of the firm in various areas. In other words, financial statements are mirrors, which reflect the financial position and operating strengths and weaknesses of the concern. These statements are useful to management, bankers and other interested parties. The company should be careful while supplying the information to the stakeholders, especially Bankers. Hence, the present study seeks to make an in-depth analysis of the performance in manufacturing company from a banker's perspective.

## **REVIEW OF LITERATURE**

Many of the research works have been conducted, over the period to evaluate the financial position of the company with the help of the various ratios or by applying the Multiple Discriminant Analysis to predict the corporate failure. L.C Gupta (1999)<sup>1</sup> attempted a refinement of Beaver's method with objective of predicting the business failure. Whereas Mansur. A.Mulla (2002)<sup>2</sup> made a study in Textile mill with the help of Z score model for evaluating the financial health with five weighted financial ratios and followed by Selvam M, and others (2004)<sup>3</sup> had revealed about Cement industry's financial health with special reference to India Cements Limited. Bagchi S.K (2004)<sup>4</sup> analysed about practical implication of accounting ratios in risk evaluation and concluded that accounting ratios are still dominant factors in the matter of credit risk evaluation. Krishna Chaitanya (2005)<sup>5</sup> used Z model to measure the financial distress of IDBI and concluded that IDBI is likely to become insolvent in the years to come. From the above reviews, the researcher identified the research gap which could be dealt in this study.

## **OBJECTIVES OF THE STUDY**

The objectives of the study are as follows:

1. To assess the short-term and long-term solvency of the company.
2. To know the efficiency of financial operations.
3. To predict the financial health and viability of the company with special reference to the debt capacity.
4. To provide suggestions for improving the financial position.

## **HYPOTHESES OF THE STUDY**

Keeping the above objectives in mind, the following hypotheses have been formulated and tested during the study period.

1. There is no significant difference between the five years average of current ratio to the standard.
2. Correlation between working capital and total assets of this company is not significant.
3. Correlation between sales and total assets of this company is not significant.

## **RESEARCH METHODOLOGY**

The study has been done in one of the leading private limited companies. To maintain anonymity, the name of the company is not mentioned, and is further referred to as 'the company.' This study is based on secondary data, which have been obtained from published sources i.e. Annual report for the period of Five years (2000-01 to 2004-05). The collected data has been analysed with the help of ratio analysis, and also through the application of statistical tools such as t test, Correlation, Mean, and Standard Deviation.

## **LIMITATIONS OF THE STUDY**

- This study is limited to five years.
- The study is restricted to the application of ratio analysis.
- This study is limited to only one company
- The data of this study has been primarily taken from published annual reports only.

## **FINDINGS OF THE STUDY**

- ♣ On an average, this company's return on capital employed ratio is maintained at a satisfactory level. But last two years' ratio show that there has been deterioration in the operational as well as managerial efficiency.
- ♣ The operating profit ratio is lower than the required level in all the years especially the relevant ratios of past two years show that there has been deterioration in the operational as well as managerial efficiency.
- ♣ An increase in the current ratio indicates that the company is strengthening its liquidity position. Though the current ratio is increasing, the ratio is lower than the conventional norm (2: 1). However, bankers view it as a satisfactory level (1.33:1).
- ♣ The correlation coefficient of current ratio is positive (0.82) which was tested and concluded that the mean current ratio differs significantly from the standard.

- ♣ During the study period, the liquid ratio is found fluctuating every year and is also lower than the conventional norm (0.8:1). It may be due to overstocking. This company's liquidity position as well as inventory management is not satisfactory and the company's cash ratio is not satisfactory (0.75: 1).
- ♣ Cash ratio is a more rigorous measure of a firm's liquidity position. The company holds a meagre amount of cash. The company has reserve borrowing power in banks, yet its cash position ratio is not satisfactory.
- ♣ The fixed assets ratio indicates that the working capital of this company is funded by long-term funds which indicate efficient funds management.
- ♣ The proprietary ratio is lower than the required norms (0.5).
- ♣ The company's lenders have contributed more funds than owners.
- ♣ The coefficient of correlation between working capital and total assets of this company is 0.57; this was tested and concluded that working capital and total assets of this company is not significant.
- ♣ The coefficient of correlation between working capital and total assets of this company was 0.91; this was tested and concluded that sales and total assets of this company is significant.

In order to support these findings, the results are given in the annexure as Table 1.

## **SUGGESTIONS OF THE STUDY**

On the basis of the analyses and observations, the author offers a few suggestions as below.

- ♣ The company is a profit seeking one; it has to commit all of its resources to achieve its goal as it is trying to enhance the value of its own and thereby to its shareholders. To achieve this, profitability, liquidity and solvency position are crucial elements to be monitored carefully, thereby the trade off can be reached.

- ♣ This company's ability to meet its current obligations is satisfactory though it does not meet the conventional norm. This company maintains current liabilities more than the amount of current assets which has to be viewed seriously and improvement of this ratio is required to achieve the optimum level.
- ♣ Overall performance and effectiveness of the firm are not satisfactory due to ineffective working capital management. Therefore this company should concentrate on working capital management and it should be managed effectively, and reviewed periodically and thereby optimum utilization of fixed assets is possible.

## **CONCLUSION**

The present study reveals that the liquidity position of this company is comparatively good as it approaches the standard norms throughout the period of study. The ratios reveal that the company's ability in managing the current assets is found inadequate which require generation of more sales. On the whole, it can be concluded that the company's overall risk evaluation process is not at desired level and the author has made the realistic recommendation for the improvement in operational and managerial efficiency of the company as to maintain and increase further by effective utilisation and control of all the assets.

## REFERENCES

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*Annexure 1*

**Table 1**  
**SELECTED RATIOS FOR RISK EVALUATION OF FINANCIAL**  
**PERFORMANCE**

Year	Return on Capital Employed Ratio	Operation Profit Ratio	Current Ratio	Liquid Ratio	Cash Ratio	Fixed Assets Ratio	Proprietary Ratio	Debt Equity Ratio	Working Capital to Total Assets Ratio	Total Assets Turnover Ratio
2000-2001	2.49	0.018	1.17	0.66	0.002	0.83	0.22	2.43	0.22	1.05
2001-2002	3.04	0.021	1.18	0.65	0.002	0.79	0.21	1.68	0.10	1.22
2002-2003	3.57	0.025	1.32	0.77	0.001	0.71	0.19	1.92	0.15	1.39
2003-2004	0.51	0.003	1.37	0.82	0.0	0.62	0.17	2.14	0.19	1.35
2004-2005	0.59	0.004	1.51	0.75	0.009	0.60	0.18	2.26	0.22	1.53
<b>Mean</b>	<b>2.04</b>	<b>0.014</b>	<b>1.31</b>	<b>0.73</b>	<b>0.003</b>	<b>0.71</b>	<b>0.19</b>	<b>2.09</b>	<b>0.17</b>	<b>1.31</b>

Source: Computed using MS-Excel Spread Sheets from the data available in annual Reports of the company concerned.