CHAPTER VI

THE ROLE OF BORROWED CAPITAL
Nature And Importance of Borrowed Capital

Corporate undertakings usually obtain their initial capital by the sale of shares. This is how the share capital comes into being and it represents ownership interest in the company. But as the company expands, the necessity for additional capital arises for financing the expansion. This demand for additional capital is often met by borrowing rather than by the issue of additional shares for a number of reasons which are enumerated below:

i) It enables the management to meet the additional demand for fund without losing control of the business;
ii) market may not be receptive for the sale of shares;
iii) authorised capital of the company may be a limitation for further issue of shares; iv) since, against borrowing, a company has to pay only interest at a fixed rate, borrowed capital and its use along with the equity capital exercises a healthy effect on the cost of capital with reference to which optimality in the capital structure may be secured;
v) ownership capital represented by shares is rigid in the sense, once received it cannot be refunded to the shareholders except in accordance with the procedures laid down in the Companies Act. As such adjustment of capital according to the needs is not possible if capital is raised only by the issue of shares, vi) borrowed capital enables a company

to take the advantage of cheap money policy; vii) borrowed
capital contributes substantially to enhance the earning
per share in the period of rising prices which is technically
known as the income effect of the leverage; viii) borrowing
is again a device to mobilise the savings of the cautious
investors who are unwilling to shoulder the risk inherent
in the investment in the equity capital; ix) borrowing has
great response from the investors during depression or when
the possibility of inflationary profits is very uncertain;
x) from the standpoint of taxation also borrowing has an
edge over ownership capital since interest on borrowed capital
is a deductible expense for the purpose of taxation of profit
of the company but dividend enjoys no such advantage; xi) it
does not involve the necessity of making a public disclosure
of the affairs of the business, if borrowings be made without
public offering of bonds.

But despite the manifold advantages of borrowed
capital a company cannot resort to borrowing ad infinitum.
If borrowed capital is too heavy, then after the payment of
interest nothing may be left for the owners. Again, in the
period of falling prices and falling profits servicing of
borrowed capital will be a problem. This is technically
known as the risk effect of the leverage. The nature of

3. Sankatha Singh - 'Optimum Capital Structure of a Corporate
   Enterprise.' - The Indian Journal of Commerce., Vol.XXI,
   Part II, No.75 June 1968, p.69.
4. Ibid.
the industry that the company represents, is also a factor in determining the quantum of borrowed capital in the capital structure. If the industry which the company belongs to is subject to greater seasonal or cyclical variations, then it should rely more on equity finance and vice versa. Again to what extent a company can borrow depends upon its stock of fixed assets which it can offer as security against borrowing. The ratio of fixed asset in a business is directly related to the size and nature of it. As such the proportion of borrowed capital tends to be higher in the large size groups than in the smaller ones. Further, a company can raise borrowed capital from the Capital market when it has been capable of earning confidence among the investing public. These factors also go to explain why borrowed capital is usually a non-starter. Now-a-days, however, where a very large capital is required, a part of 'even' initial capital is raised by borrowings particularly from banks by way of overdraft.

In popular parlance borrowings are classified into long term, medium term or intermediate term and short term.

5. Ibid.


8. Ibid. p.36.

The basis, however, of the classifications of the borrowings into above those broad categories is not very clear. Short term borrowing is one which is to be paid back within the same accounting period or financial year. Medium term or 'intermediate term' borrowing ranges between above one year to ten years. Any borrowing for a period extending beyond ten years is taken as long term borrowings. It may even run for twenty years or more. Though classification of the borrowed capital into above three categories appears to be related to the time period after which borrowed capital becomes repayable, the terms of maturity are not strictly the guiding factor particularly when the financial management, with an object of flexibility, uses short term funds for long term purposes and vice versa. In the situation the nature of the instrument used and the purpose of the loan may help to distinguish the type of borrowings.

Under the Companies Act, 1956, borrowed capital has been divided into three categories viz., secured, unsecured and current liabilities. Current liabilities, as short term loans, are rather components (negative) of working capital instead of its sources. It has already been observed that short term loans amounting not below the base of quantity

always remain in the business and, as such assume the character of a long term borrowing. Nevertheless, for the purpose of present study, the emphasis is on the other types of loans only, i.e. on secured and unsecured long term loans.

Every company has implied authority to borrow money for its purposes even if the Memorandum of Association contained no specific mentioning about 'the borrowing power'. The utilisation of borrowed capital in the capital structure of a company is influenced by external forces such as monetary policies, tax treatment and the role of financial institutions. Borrowings of a company are also influenced by internal factors.


The position regarding borrowing powers of the Central government companies is that their authority for borrowings from the market by the issue of bonds and debentures is provided in the Articles of Association of the companies. Borrowings to be made by those companies upto Rs. 2 lakhs do not require any prior permission of the Central Government. But any borrowing beyond this limit is not possible by a decision of the Board of Directors without any prior approval of the Central Government. This implies that internal management of the Central government companies has no voice

in deciding the role that could be assigned to the borrowed capital in the capital structure of Central government companies. It is decided externally by the administrative ministries of the Central Government. This embargo on the independence of the internal management to use borrowed capital, besides impairing of autonomy of the internal management of the company, stands in the way of the attainment of the flexibility of the capital structure of Central government companies. It makes them rigid as indicated earlier. If independence of the internal management of the Central government companies, in regard to borrowings, would have been allowed, it would serve to gauge the trust and values that the investors reposes on these operating Central government companies in the public sector. There would naturally set in a competition for funds in the capital market between companies in the private and public sectors. And, it is needless to say that, the fund would have gone to the more efficient units. In fact there was nothing inconsistent in the occurrence of such a competition in the context of mixed economy in India. If regulations of borrowings by the Central government companies had been the objective behind their being required to obtain prior permission for borrowings in excess of Rs. 2 lakhs, the same could have been achieved subjecting the Central government companies to the mechanism of the control of capital issue. This would have also the effect of leaving the internal management of the company unassailed and less dependent on the external forces for the efficient financial management of the company.
It has been pointed out previously that Central Government's attitude towards loan as a source of capital in the Central government companies took a definite shape only from June 1961. It may be recalled that in June 1961, the Government came out with a circular directing the administrative ministries to maintain a ratio of 1:1 between debt and equity while financing the capital projects in the public sector undertakings. The role of borrowed capital, under the spell of the aforesaid circular, in the capital structure of Central government companies between 1960-61 and 1969-70, and also in financing their net fixed asset and working capital has been shown in Tables 20 and 21 respectively. The data in Table 20 further bring out clearly the impact of increasing borrowed capital on the net worth of the Central government companies.

It will be observed from Table 20 that in the first two years of the period covered by the present study, i.e. in 1960-61 and 1961-62 borrowed capital had relatively less important role in the capital structure of the Central government companies. Its share in the total capital mix of the companies had been only 26.5% and 27.9% respectively in those two years. But in the year 1962-63 there was a sudden spurt in the amount of borrowed capital as an after effect, possibly, of the aforesaid circular and its percentage to the total capital of the Central government companies increased from the previous year's 27.9% to 47.4%. Thus, over an accounting cycle of one year, the percentage of borrowed
Table - 21


(Figures in Crores of Rupees)

<table>
<thead>
<tr>
<th>Particulars</th>
<th>1960-61</th>
<th>1969-70</th>
<th>Increase over the period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Borrowed capital</td>
<td>379.9</td>
<td>1256.4</td>
<td>876.5</td>
</tr>
<tr>
<td>*Net Fixed Assets</td>
<td>573.9</td>
<td>1337.3</td>
<td>763.4</td>
</tr>
<tr>
<td>Net Current Assets</td>
<td>178.9</td>
<td>430.0</td>
<td>250.1</td>
</tr>
<tr>
<td>Total capital in the capital structure</td>
<td>753.8</td>
<td>1767.3</td>
<td>1013.5</td>
</tr>
</tbody>
</table>

Vide - Appendix 5.


* In the calculation of Net fixed assets expenditure on 'capital work-in-progress' have been excluded.
capital registered a rise by 69.9% in the capital structure of Central government companies. Since 1962-63, the rising trend in the percentage of borrowed capital to the total capital mix of the Central government companies had continued. This trend was maintained till the end of 1969-70, as the percentage of borrowed capital as compared to that in 1960-61 in the total capital mix of the company, recorded a rise by 127.9% as pointed earlier. This does not, however, mean that the said increase in the percentage of borrowed capital was altogether uninterrupted. In fact there was a reversal trend in the same in the consecutive two years of 1963-64 and 1964-65 when the share of borrowed capital in the total capital mix of the Central government companies had recorded a fall by 3.6%, 2.6% respectively as compared to those of respective immediate previous year.

The position with regard to the increasing trend of the percentage of borrowed capital in the capital structure of the Central government companies reached its climax in the year 1966-67 when the proportion of borrowed capital in the total capital mix of the Central government companies exceeded the proportion of equity capital. The position remains the same whether such capital was considered alone or after adjustment of retained profit which continued to be in the negative as hinted earlier, right from 1962-63. This edge of the borrowed capital i.e., the creditorship capital over equity i.e. ownership capital in the capital structure of the Central government companies continued unabated over
the period between 1866-67 and 1969-70, the end of the period of present study, as its share had been found to be 60.4% as against that of equity being 39.6% of the total capital mix in the Central government companies. An interesting aspect of the change of the proportion of borrowed capital in the capital structure of the Central government companies, as disclosed in Table 20 has been that, right from 1961-62 with every increase in borrowed capital the net worth recorded a decline both being expressed in terms of percentage of net capital employed. Thus, over the period between 1960-61 and 1969-70 the net worth of the Central government companies fell by 46.1% compared to its position in 1960-61. The greatest single year decline in the percentage of net worth occurred in 1962-63 as the percentage of fall in the net worth of the companies in that year had been 27.0% following sudden spurt in the amount of borrowed capital. But the position would have been worst but for interest holidays declared on loans granted to a number of giant companies such as Heavy Engineering Corporation, Hindusthan Steel Ltd., and Mining and Allied Machinery Corporation Ltd. Such interests would have either reduced the surplus or increase the deficit or alternatively add to the borrowings further.

Table 21 brings out clearly the impact of increasing borrowed capital in the financing of net fixed asset and working capital in the 34 Central government companies. These

16. The 34 companies cover industries like Engineering and Shipbuilding (14); Chemical (8); Steel (1); Mining and Minerals (5); Aviations and Shipping (1); Trading (1); Miscellaneous (4).
companies were chosen on the basis of the availability of data over the years between 1960-61 and 1969-70, covering the period of present study. It shows that in the year 1960-61 borrowed capital had been in use in the 34 Central government companies and the amount of said capital had been Rs.379.9 crores as against a total capital (net fixed asset plus net current asset) of Rs.753.8 crores. This represented 50.4% of the total capital in the 34 Central government companies. Since 1960-61 borrowed capital had steadily gained importance in the capital structure of Central government companies. And by the end of 1969-70, borrowed capital in the aforesaid companies had been Rs.1256.4 crores out of a total capital of Rs.1767.3 crores.

This means that by the end of 1969-70, the share of borrowed capital to the total capital of 34 Central government companies had been 71.1%. Thus it will be observed that over a period of ten years borrowed capital in the aforesaid 34 companies increased by Rs.876.5 crores. Expressed in terms of percentage it meant a leap by 41.1% over the percentage of borrowed capital in 1960-61. And the same had been employed in financing net fixed asset and working capital which increased by Rs.763.4 crores and Rs.280.1 crores respectively making a total increase of Rs.1013.5 crores over the same period. In the circumstances the contribution of share capital and retained profit together with the total increase

[27. In the calculation of net fixed assets, expenditure on capital works-in-progress have been excluded.]
of capital had been only Rs. 137 crores. Expressed in terms of percentage the respective contribution of share capital and retained profit to the total increase of capital in the aforesaid 24 companies had been only 13.5% as against the share of borrowed capital to the extent of 86.5%.

Needless to mention that the spectacular increase of the percentage of borrowed capital in the capital structure of Central government companies detected in Table 20 and 21 was not the outcome of any managerial effort to secure optimality in the capital structure of the companies. Nor could it be ascribed to the desire for minimising the total or average cost of capital. It was rather the outcome of the government policy to try to attain ultimately the debt-equity ratio of 1:1 in the capital mix of the Central government companies. The excessive borrowings are evidently ascribed to the attempt made to reach that target.

**Impact of Borrowed Capital on the Long Term Solvency of the Central Government Companies between 1960-61 and 1969-70.**

In Table 20 and 21 of the present study it has already been observed how the borrowed capital came to have increasingly a substantial share in the capital structure of Central government companies over the decade between 1960-61 and 1969-70. It has also been shown in those tables how the said borrowed capital was utilised in financing the net fixed asset and working capital and how the same affected the ratio between borrowed capital and net worth in the Central government companies. The rising trend in the said ratio evidently
reflected a systematically gradual fall in the long term solvency of the Central government companies. This aspect of the capital structure has been dealt with in Table 22 below.

Table 22
Solvency Ratio (Debt to Net worth) in the Central Government Companies between 1960-61 and 1969-70

<table>
<thead>
<tr>
<th>Year</th>
<th>Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>1960-61</td>
<td>...</td>
</tr>
<tr>
<td>1961-62</td>
<td>1:2.77</td>
</tr>
<tr>
<td>1962-63</td>
<td>1:2.59</td>
</tr>
<tr>
<td>1963-64</td>
<td>1:1.11</td>
</tr>
<tr>
<td>1964-65</td>
<td>1:1.19</td>
</tr>
<tr>
<td>1965-66</td>
<td>1:1.25</td>
</tr>
<tr>
<td>1966-67</td>
<td>1:1.06</td>
</tr>
<tr>
<td>1967-68</td>
<td>1:0.86</td>
</tr>
<tr>
<td>1968-69</td>
<td>1:0.73</td>
</tr>
<tr>
<td>1969-70</td>
<td>1:0.65</td>
</tr>
</tbody>
</table>


It shows that in the year 1960-61 the ratio of borrowed capital to net worth as a measure to test the solvency of the Central government companies, had been 1:2.77. This ratio began to rise gradually since the year 1961-62 and
by the end of 1969-70, the ratio of borrowed capital to net worth in the Central government companies went up to 1:0:66. Thus over a decade the change in the solvency ratio of borrowed capital to net worth of the Central government companies recorded a rise by 38.9% with its corresponding adverse impact on their credit-worthiness. One may, however, argue that credit worthiness has limited significance for the purpose of borrowings by the Central government companies since they had mostly borrowed capital under a rigid policy of financing for all practical purposes, as well be seen later on from a single source viz., the Central Government. Another interesting point to note in this connection is that the rise in the ratio of borrowed capital to net worth or, the decline in the ratio of net worth to borrowed capital in the Central government companies since 1961-62 was not however without any break. In fact as against the declining trend in the ratio of net worth to borrowed capital in the Central government companies since 1961-62, it showed signs of improvement in the two consecutive years of 1963-64 and 1964-65 by 5.4%, 3.4% respectively. From the year 1965-66, however, there was again a declining trend till 1968-69. In the year 1969-70 compared to 1968-69 net worth position remained unchanged.

Composition Of Borrowed Capital In The Central Government Companies:

It has been stated earlier that for the purpose of present study the classification of borrowed capital as available in Schedule VI of the Companies Act, 1956, has been
followed. As such the borrowed capital of the Central government companies may be said to comprise Secured Loan, Unsecured Loan and Current Liabilities. But it has also been indicated previously that current liabilities are rather, negative components of working capital. Accordingly, it is excluded from borrowed capital in the consideration of the capital structure of Central government companies.

Any detailed information about the break-up into secured and unsecured loans in the combined balance sheets of the operating Central Government companies as published in the Reserve Bank Study is absent. The analysis of accounts, enterprise-wise, given in the Annual Reports published by the Bureau of Public Enterprises, also do not contain them. Therefore, for analysing the role of secured and unsecured loans in the borrowed capital, reference has been made to published annual accounts of one set of three companies as at the end of 1960-61 and of another set of three companies as at the end of 1969-70. From the analysis of the accounts it is found that, at the end of 1960-61 these companies had a borrowed capital of ₹7.10 crores in their capital structure. Out of this total, secured loan had been ₹6.03 crores and the unsecured loan ₹1.07 crores. Thus,


19. The three companies in 1960-61 were Garden Reach Workshop Ltd. (Garden Reach Shipbuilders and Engineers Ltd), Indian Rare Earths Ltd., and Hindustan Shipyard Ltd.

20. The three companies were Garden Reach Workshop Ltd., Indian Rare Earth Ltd., and Fertilisers and Chemicals, Travancore Ltd.
secured loan constituted 84.9% and the unsecured loan 15.1% of the total borrowed capital of these companies. This position, however, changed materially in case of the other set of three companies as at the end of 1969-70. The analysis of the published accounts of these three companies, revealed that they had a total borrowed capital of Rs. 48.3 crores at the end of 1969-70. Out of this total secured loan had been only Rs. 6.8 crores and the unsecured loan Rs. 42.0 crores. Therefore, expressed in terms of percentage, the share of secured loan had been 14% and that of the unsecured loan 86%. Thus, it will be observed that over a span of ten years, so far as the composition of the borrowed capital in terms of secured and unsecured loans, in the Central government companies is concerned, the position actually reversed. Though the samples considered for arriving at this conclusion were different, there was nothing to prove that each of them failed to represent correctly the actual population that is all the Central government companies taken together. This trend in the composition of the borrowed capital in the Central government companies, it may be interesting to observe, had been just opposite to the trend in the private sector companies, as revealed in the study of the capital structure of jute industry between 1959-1968. The said study revealed that in the jute industry at the end of 1968, out of its

21. This excludes foreign supplied credit in the form of Deferred payment and interest thereon which is guaranteed by the Government of India.
Sources of Borrowed Capital In The Central Government Companies And Their Analysis:

It will be recalled that among the different categories of borrowed capital in the Central government companies it was the unsecured loan which dominated at the end of 1969-70, though in the initial year, that is, in 1960-61 secured loan had a greater edge than the unsecured loan. Further, it is to be noted that the Articles of Association of Central government companies provide for their market borrowings by the issue of bonds and debentures. In reality, however, those companies had little recourse to this method for procurement of borrowed capital in their capital structure. Another interesting point to note in this connexion unlike what is done in case of companies in the private sector the choice of the sources of borrowed capital and the negotiation of their terms and conditions was not left to the internal management of the company. It was rather determined externally from the top by the Central Government itself. For instance, the Ministry of Finance,

Department of Economic Affairs, Government of India, in its Office Memorandum No. F/7(4)-Wand M/68, dated 10th June, 1968, laid down in precise terms, the broad principles regarding terms and conditions of loans to be granted to the industrial and commercial undertakings of the Central Government. It also laid down the sources to be used for obtaining borrowed capital for the purpose of financing fixed and working capital requirements of the Central government companies. In the circumstances, there will perhaps be nothing wrong if one concludes that the Central government companies had a set pattern of loans in their capital structure and they had little scope to take the advantages of low money market rate by adjusting the amount of borrowed capital in response to the changes in the market rate. Even if the government, in such cases, reduces the rate of interest charged by itself, as stated earlier, the public has to suffer if the said rate goes below the rate at which the government had borrowed the fund.

Table 23 of the present study will indicate the sources of secured and unsecured loan of the Central government companies as per the above-mentioned memorandum and the contributions each of these sources had to the total borrowed capital in the capital structure of the said companies over the period between 1960-61 and 1969-70. It showed that the sources of secured and unsecured loan in the Central government companies had been:

1. The Government and Semi-Government

* This is as per classification available in the Reserve Bank Study.
Loan from the Government and Semi-Government:

It includes borrowing of all kinds from the Central Government, State Governments and foreign Governments. So far as the borrowings from the government is concerned, they also include the amount received in respect of foreign exchange cost of a project under project tied credit from foreign Governments. Where such cost has been financed by projects tied credit from foreign Governments to the Government of India, the liability for the payment of capital and interest lied with the Central Government. As such the enterprises had no direct liability vis-a-vis foreign lenders. The liability is that of the government. An interesting feature in respect of such loans had been that there was no fixed relationship between the rate of interest charged by the foreign lenders from the Government of India and that charged by the Government of India from the company concerned.

It will be observed from Table 23 that loan from the Central Government had been the most important of all the sources of the borrowed capital in the capital structure of the Central Government companies over the years between 1960-61 and 1969-70. Even in the year 1960-61, when the Government did not have any clear cut policy regarding

the role of borrowed capital in the capital structure of Central government companies, the contribution of this particular source to their total borrowed capital had been 72.5% as against 21.5% from banks and 6.0% from financial institutions. The position of loan from the Central Government showed further sign of improvement in the year 1961-62, after the inunciation of the Government policy for financing the projects in the public sector undertakings in terms of a debt-equity ratio of 1:1. As such, the share of loan from the Central Government to the total borrowed capital of the Central government companies increased to 75.3% in the year 1961-62 and 93.4% in the year 1962-63. The corresponding declines in the share of loan from banks and financial institutions resulting out of that rise have also been recorded. Thus, over a period of two years, the share of bank loan to the total borrowed capital of the Central government companies came down from 21.5% in 1960-61 to 3.8% in 1962-63 (i.e. a decline by 82.3%) and that of the loan from financial institutions from 6.0% in 1960-61 to 2.6% in 1962-63 (i.e. a decline by 62.3%). From the year 1963-64 however, the share of Central Government loan to the total borrowed capital of the Central government companies showed a declining trend with 89.6%, 86.2%, 85%, 80.9%, 80%, 79.1% and 78.4% respectively in the years 1963-64, 1964-65, 1965-66, 1966-67, 1967-68, 1968-69 and 1969-70. The corresponding increases in the shares of loan from the both sources of banks and financial institutions took place in all
the years except in the year 1965-66 when the increase had been in the area of loan from banks alone. As against all these, in the years between 1963-64 and 1969-70, the loan from other sources in the total borrowed capital of the Central government companies, however, increased from 2.6% in 1963-64 to 13.7% in 1969-70. This meant a rise by 427%. Nevertheless, it may be observed that, in all the years between 1963-64 and 1969-70 the share of loan from the Central Government in the total borrowed capital of the Central government companies had been higher than it was in the year 1960-61 and 1961-62.

Features of Central Government's Loan to the Central Government Companies:

The borrowed capital of the Central government companies obtained from the Central Government, had some special features in them. First of all Central Government's loan was to be directed towards meeting the long-term capital requirements of the company. To finance the working capital requirements the Central government companies were directed to resort to borrowings from the bank. Demand for working capital could also be met by the short-term loan from the Central Government but only under circumstances when their working capital requirement could not be met by the bank.


28. Ibid.
Analysis of the composition of Central Government's loan to three Central government companies with reference to their Annual Reports at the end of 1969-70, revealed that, out of the total loan of Rs.36.2 crores from the Central Government the share of unsecured loan had been Rs.35 crores and that of the secured loan Rs.1.2 crores. This meant that 96.7% of the Central Government's loan to these companies had been unsecured and as against that 3.3% only secured. The nature of security that had been furnished by these companies against their secured loan, was a written undertaking by the company in favour of the President of India that the company shall not, without the written consent of the President, encumber or alienate, create any mortgage, lien or charge by way of hypothecation, pledge or otherwise or create other encumbrances of any kind whatsoever in any part of land or buildings or other structures and plant and machinery or any other fixed assets owned by it, which was registered by the company with the Registrar of Joint Stock Companies. The plausible explanations for the predominance of the unsecured loan in the borrowed capital received from the Central Government by the Central government companies may be that normally security is offered by the borrowers to inspire confidence of the lender. But in the cases of Central government companies the Central Government was,

+ The companies were Garden Reach Workshop Ltd., Fertiliser and Chemicals Travancore Ltd. and Indian Rare Earths Ltd.

practically speaking, both the debtor and creditor. And such the government perhaps did not feel it necessary to demand security from itself.

The second features of the Central Government's loan to the Central government companies had been that in the initial years there was no standard procedures regulating the terms of such loans. But, from the year 1961, the same has been remedied. In consequence the duration of the Central Government's loan to Central government companies, other than financial companies, had been fixed up to a maximum of 15 years. Repayment of loan by the Central government companies in the initial years, could commence after 2-5 years, from the date of disbursement of loan. But the same had been revised in 1968, and it was decided that payment of Principal could ordinarily commence one year after the project commences production. The actual number of instalments in which the loan would be repaid was to be determined with reference to the financial projection and repaying capacity specified in the project report.

Thirdly, the rate of interest payable by the borrowing company had been related to duration of the loan. Thus, at the end of 1968-70, the rate of interest payable by the borrowing companies other than the financial one,

31. Ibid.
32. Vide Circular No.F.Y(4), W and M/68 dated 10th June,1968, of the Ministry of Finance (Department of Economic Affairs) reported in Compendium of B.P.E. Circulars, B.P.E., pp.63-64.
had been 6% per annum for all loans having duration between 1 to 4 years, 6½% per annum for all loans having duration between 4 to 9 years and 7½% per annum for all loans having duration between 9 to 15 years.

Fourthly, the rate of interest charged on the loan advanced by the Central Government had not been kept divorced from the market rate of interest. In fact, it was revised along with the revision in the bank rate. In this respect a similarity of practice may be traced with reference to actions taken by private sector companies, who adjust their debts in accordance with the change of rate of interest though at the instance of the management itself. Thus within the period of present study, one such revision was made in the year 1965 when rates of interest on all the loans having different time durations had been increased by unity with effect from 1st May, of the year following the revision of bank rate in the country.

Fifthly, for encouraging timely payment of interest and repayment of principal, a system of rebate had been kept in vogue since 1961 with a break in 1964, when the granting of the same on loans after 1st October of that year was withdrawn. It was, however, reintroduced in 1968 at the rate of ½% in respect of all loans granted after 10th June, 1968. This was in force even at the end of 1969-70. Since

June 1968 there was also the provision for the payment of interest at a panel rate of 8½% on all over-due instalments in the event of any default in the repayment of loan or payment of interest. These arrangements were peculiar in case of loans granted to Central government companies, having generally no counterpart in case of those granted to companies in the private sector.

Sixthly, loans were advanced to certain companies free of interest charges, or at concessional rates. This was specially true where loan capital was of significance. For instance Central Government allowed interest holidays on M.T.P. loans granted to Hindusthan Steel Ltd., upto 1961-62.

Fertilisers factories paid interest at the concessional rate of 3½% on their earlier loans. Borrowed capital free of interest charges in the capital structure of a company, is again a feature as already noted in one of the early chapters, that is not commonly found in the private sector companies.

There were also instances, where Central government companies have been allowed to convert their borrowed capital obtained from the Central Government into equity. For instance Praga Tools Ltd., a public limited company in the public sector, was allowed to convert its borrowed capital into equity to the extent of Rs. 17.75 lakhs in course of financial reorganisation.

35. Compendium of B.P.E. Circulars, New Delhi, p.64.
of the company. It is true that companies in the private sector also borrow funds by issuing debentures which may subsequently be converted into equity capital. Nevertheless, there is a basic difference in approach in this respect between the companies in the private sector and the Central government companies in the public sector. In the private sector convertible debentures are issued by the companies in order to get funds on easier terms which the lenders agree in the expectation of participating in the future prosperity of the company. But in the cases of the Central government companies, loans were converted into equity in order to pull out the companies from the oppressing burden of the fixed cost of their borrowed capital.

Last but not the least important feature of the Central Government's loan in the total borrowed capital of the Central government companies, is the mechanism of the notional recovery of interest on the borrowed capital of a company during the period of construction of the project. This was done by allowing their capitalisation provided the same had been indicated in the project report. The mechanism of the notional recovery of interest through its capitalisation is again a feature found to be dominant in the Central government companies. It may be said to be the outcome of the policy of financing the projects in the public sector,

39. Vide Circular No. F 7(4)/68 dated 10th June 1968 of the Ministry of Finance (Department of Economic Affairs) reported in the Compendium of B.P.E. Circulars B.P.E., New Delhi, p.64.
including those under the Central government companies, by maintaining a debt-equity ratio of 1:1. This meant that, unlike what is done in case of companies in the private sector, the decision relating to the use of borrowed capital was not related to their ability to pay for its cost out of the current revenue receipts. This practice of the notional recovery of interest through its capitalisation, as hinted at previously, had the effect of artificially making the capital structure of the Central government companies subject to over capitalisation in many cases. In view of the fact that the Central government companies cannot rule out profit as their objective especially in a developing country like India, there appears to be no logic in having borrowed capital in the capital structure of Central government companies before the profitability of these companies had been assessed in terms of their actual performance.

Analysis of the various features of loan from the Central Government as a source of borrowed capital of the Central government companies, which constituted more than $\frac{1}{4}$ (78.4%) of their total borrowed capital as at the end of 1969-70, establishes the fact that gearing of borrowed capital in their capital structure was dependent on a set of rules laid down externally by the Government and not by the management of the companies concerned. The rules were mainly directed, it appears, towards securing a so-called or an artificial uniformity of the terms and conditions of

the use of borrowed capital by the Central government companies. This does not, however, mean that the Central Government as a lender was averse to accommodate the individual problem of the company. The contrary was rather true. In many cases, as already observed, the Government granted interest holidays and facilities relating to the repayment of capital. In consequence, the basic objective of having borrowed capital in the capital structure of Central government companies was frustrated in them. Situation calling for the grant of interest holidays also suggests the hollowness of having borrowed capital with interest obligation in the capital structure of Central government companies right from their very inception in disregard to the accepted principles of corporation finance, both of the private and the public sector as mentioned previously.

Loan from Bank

Banks are one of the most common sources of borrowed capital to the commercial enterprises in general and the corporate undertakings in particular. Borrowings from the bank generally take three forms viz., loan, cash credit and overdraft. When a banker makes an advance in a lumpsum which cannot be automatically renewed wholly or partially after repayment is called a loan. If a customer repays the same, either wholly or partially, and wishes to have subsequent accommodation, the latter is treated as a separate transaction to be entered into between a banker and a customer on such

terms and conditions as the bankers may like to impose provided the banker agrees to grant fresh credit to the customer. Loan may be secured and unsecured.

As against loan, cash credit is an arrangement by which a banker allows his customer to borrow money up to certain limit against either a bond of credit executed by one or more as sureties or certain other forms of securities. Under cash credit system a customer need not draw at once the whole of the amount granted to him, but, can do so by instalments as and when required. He can put back any surplus amount which he may find with him for the time being. Interest is payable by the customer only on the amount to his debit at the end of each day's business. Although, in practice, clean loans on personal credit of an individual of undoubted means and character may be considered as safe and satisfactory as any other, Indian banks insist on having paper with at least two names as security for the advance.

Overdraft on the other hand is the temporary accommodation granted to a customer by a banker by allowing him to overdraw his current account usually against collateral securities. As on cash credit, a customer is required to pay interest on the daily balance of overdraft to his debit. The essential difference between a cash credit and a bank overdraft is that, the latter is supposed to be a form of

43. Ibid.
bank credit to be made use of occasionally; whereas the former is used for a long term by commercial and industrial concerns doing regular business.

The essential reasons for this difference seems to be the fact that cash credit is actually an overdraft guaranteed. But overdrafts are also on most occasions guaranteed. Furthermore, with the change of banking principles for granting credit from depending more on 'security' to depending more on credit worthiness the difference between cash credit and overdraft has actually been fading away in recent times. In any case the bank loans received by the Central government companies have been recorded in the name of 'cash credit' and there have been no cases of 'overdraft' which could have been treated as a "current liability forming a negative component of working capital."

In the cases of the Central government companies the role that the banks played as a source of borrowed capital of them can very well be observed from Table 23 of the present study. It shows that banks' contribution to the total borrowed capital of the Central government companies had never been significant in terms of its percentages except in the initial two years of 1960-61 and 1961-62, when the contributions of banks to the total borrowed capital of the Central government companies had been 21.5% and 17.1% respectively. In the year

44. Ibid.

1962-63 the percentage contribution of bank credit to the total borrowed capital of the Central government companies came down abruptly from 17.1% in 1961-62 to 3.8% in 1962-63. The fall was at the rate of 77.8%. In the year following three consecutive years, i.e. in the year 1963-64, 1964-65 and 1965-66 the contribution of the banks to the total borrowed capital showed an increasing trend with 5.2%, 7.9% and 10.2% respectively of the total borrowed capital. It means that over a period of three years the percentage contribution of bank loan registered an increase by 168.4% (from 3.8% at the end of 1962-63 to 10.2% at the end of 1965-66). From the year 1966-67 the contribution of bank to the borrowed capital of the Central government companies again showed a declining trend with 8.9%, 8.2%, 7.4% and 6.6% of the total borrowed capital respectively in the years 1966-67, 1967-68, 1968-69 and 1969-70. Thus, over a period of four years, the contribution of banks to the total borrowed capital of the Central government companies came down by 25.8% i.e. from 8.9% in 1966-67 to 6.6% in 1969-70.

In the cases of Central government companies, needless to mention, their borrowings from banks were needed because of the government policy regarding financing the capital requirements of public sector undertakings by loans. The Central Government's loan to the Central government companies was normally long term one and restricted to the financing of the long term capital assets of such companies. The government required the public sector undertakings, including the Central
government companies, to finance their working capital requirements by cash credit arrangements with the banks. The policy continued unchanged even in the year 1967-68 as the government again stated that normally public undertakings are expected to meet the working capital requirements by cash credit arrangements with the banks.

Central government companies borrowings from bank were also characterised by some special features. First of all, the companies themselves had no choice about the banks with whom they were to make the cash credit arrangements. It was the agreed policy of the government as well as of the Reserve Bank of India that the government companies in which the Central Government had a major share holding should have their banking arrangements with the State Bank of India and its subsidiaries. According to Professor Charles L. Prather, any arrangement of financing the working capital by borrowing should be preceded by a careful selection of the source to be

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*** The policy has now been changed. The Government has now extended the scope from State Bank of India and its subsidiaries to any of the 14 Nationalised banks (Vide Office Memorandum No.BPE/(49)Adv(F)71 dated 24th June, 1971, Second supplementary to Compendium of B.P.E. Circulars, p.22).
tapped for this purpose. But in the government policy of financing the working capital requirement of the Central government companies only through a particular bank directed by the former, this principle of financial management has hardly been respected.

Secondly, as against the practice of borrowing from bank by bank overdraft as done by the private sector companies, the government preferred to have accommodation from banks for the Central government companies in the form of cash credits. The cash credits were obtained against hypothecation of current assets such as stock of stores, raw materials, finished goods, works-in-progress etc. This implies that the loan received under the cash credit arrangements with the bank was intended to be secured one. It was also decided that if a company could not get the necessary cash credit from the banks because of the paucity of assets to be furnished as security, the company concerned could approach the government to stand as a guarantee so that it could obtain necessary cash credit from the State Bank of India. In this connexion the most common practice that was adopted by the banks for allowing the cash credit was to fix a certain credit line for each undertaking known


50. Compendium of B.P.E. Circulars, B.P.E., New Delhi, p.45.
as demand cash credit for which President of India had to give guarantee. The line differed from company to company on account of their difference in financial position, volume of transactions and credit requirements.

This does not, however, mean that unsecured cash credit was altogether unknown in the cases of the Central government companies over the decade between 1960-61 and 1969-70, though not availed of frequently. For instance, a reference to Balance Sheets of Hindustan Shipyard Limited shows that it had unsecured cash credit arrangement with the State Bank of India right from the year 1960-61 and in the year 1968-69 it had unsecured cash credit loan of Rs. 1.16 crores from the State Bank of India, against a guarantee by the President of India to the extent of Rs. 4 crores. The other instances were Hindusthan Steel Ltd. The State Bank of India allowed Hindusthan Steel Ltd. to have an unsecured cash credit of Rs. 7.14 lakhs and Rs. 507.01 lakhs respectively in the years 1964-65 and 1965-66. Similarly, Heavy Electricals (I) Ltd., Bhopal, arranged such loans to the extent of Rs. 30.5 lakhs in 1962-63, Rs. 0.1 lakhs in 1963-64, 1964-65 and 1965-66.

52. Ibid.
All these loans were guaranteed by the President of India. Needless to mention that the rate of interest payable by the borrowing company also differed according to the nature of the cash credit arrangement. A rate interests of 8.5% was charged in respect of unsecured cash credit against 7.33% in respect of secured one.

It was already been stated previously how borrowings from bank could not constitute a significant part of the total borrowed capital in the capital structure of the Central government companies except in the initial two years of 1960-61 and 1961-62 and how its share came down from 21.5% of the total borrowed capital in 1960-61 to 6.6% at the end of 1969-70. This decline in the percentage of bank loan to the borrowed capital and as such, in the capital structure of the Central government companies establishes the fact that, contrary to the government policy of working capital being financed out of bank loans, the Central government companies had less reliance on them for financing their working capital. And as such working capital requirements of these companies were met from some other sources. A reference to the individual balance sheets of some of the companies also established the same conclusion which will be evident from the data in Table 24 of the present study.
Table 24
Contribution of Bank loan (Cash Credit) to the Working Capital of some Central Government Companies between 1960-61 and 1969-70

(Expressed in terms of %)

<table>
<thead>
<tr>
<th>Name of Companies</th>
<th>Hindu-</th>
<th>Hindu-</th>
<th>Ferti-</th>
<th>Heavy</th>
<th>Heavy</th>
<th>Bhopal</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>than</td>
<td>than</td>
<td>iser</td>
<td>Engi-</td>
<td>Elec-</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Steel</td>
<td>Machine</td>
<td>Corp.</td>
<td>cal</td>
<td>neering</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Ltd.</td>
<td>Ltd.</td>
<td>Ltd.</td>
<td>Ltd.</td>
<td>Ltd.</td>
<td>Ltd.</td>
</tr>
<tr>
<td>Year</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1960-61</td>
<td>11.9</td>
<td>-</td>
<td>11.2</td>
<td>-</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>1961-62</td>
<td>13.4</td>
<td>29.3</td>
<td>0.0</td>
<td>0.0</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>1962-63</td>
<td>8.6</td>
<td>0.0</td>
<td>16.3</td>
<td>40.5</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>1963-64</td>
<td>0.2</td>
<td>22.4</td>
<td>6.2</td>
<td>26.2</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>1964-65</td>
<td>2.3</td>
<td>57.5</td>
<td>11.1</td>
<td>26.9</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>1965-66</td>
<td>10.9</td>
<td>54.2</td>
<td>55.6</td>
<td>45.2</td>
<td>-</td>
<td>18.0</td>
</tr>
<tr>
<td>1966-67</td>
<td>6.0</td>
<td>44.7</td>
<td>40.8</td>
<td>26.4</td>
<td>-</td>
<td>27.2</td>
</tr>
<tr>
<td>1967-68</td>
<td>7.7</td>
<td>41.1</td>
<td>23.8</td>
<td>40.6</td>
<td>-</td>
<td>17.0</td>
</tr>
<tr>
<td>1968-69</td>
<td>10.4</td>
<td>30.0</td>
<td>22.2</td>
<td>15.2</td>
<td>21.4</td>
<td>31.9</td>
</tr>
<tr>
<td>1969-70</td>
<td>11.6</td>
<td>29.5</td>
<td>18.1</td>
<td>25.1</td>
<td>18.3</td>
<td>35.7</td>
</tr>
</tbody>
</table>

Source: Annual Report of the Companies and other official records.
Computed.

The table shows that in the case of Hindusthan Steel, the percentage of bank loan of the total working capital finance of the company had been 0.2% to the minimum and 13.4% to the maximum. The same had been zero % to 57.5%, zero % to 55.6%,
zero % and 40.6%, 18.3% to 21.4% and 17% and 35.7% respectively in the cases of Hindusthan Machine Tools Ltd., Fertiliser Corporation of India Ltd., Heavy Electricals (India) Ltd., Heavy Engineering Corporation Ltd. and Bharat Heavy Electricals Ltd., over the decade between 1960-61 and 1969-70. The reasons for the relatively less significant role of the bank loan in the borrowed capital of the Central government companies over the period of this study are not difficult to trace. And these reasons were (a) The reluctance of the State Bank of India to provide fund to the required extent; (b) the unwillingness of the government to provide counter guarantee to the State Bank; (c) absence of urge among the borrowing companies to use fully the line of cash credit granted by the State Bank of India for reasons such as the absence of competitive rates, arduous procedures, unwillingness on the part of borrowing companies to expose their internal financial position, coupled with the irregular sales and faulty production programming.

Loan from Financial Institutions:

Borrowings from financial institutions by the public sector undertakings, including the Central government companies, were subjected to the government regulations right from December, 1961. The government policy in this regard had been that (1) industrial projects with more than 60% state capital

participation should not ordinarily be assisted by the Industrial Finance Corporation, (II) Projects with capital participation between 40% and 60% were to be considered for the said purpose on merits in exceptional cases, and (III) Projects with less than 40% capital participation were to be treated at par with projects in the private sector and thus considered eligible for assistance from the Industrial Finance Corporation. The issue was again reviewed in July 1967. It was held that the Industrial Development Bank of India and the Industrial Finance Corporation of India will not entertain any application for accommodation from Industrial concerns when the Central Government or any State Government individually or collectively own more than 50% of the equity share capital. The reasons adduced in support of this policy had been that public sector enterprises are owned by the government and therefore the responsibility for making available the long term finance to them should also be that of the same government. A procedural modification under which the funds were to be given first to the financial institutions which in turn would lend the same to the public sector enterprises, will not make any actual change in the over-all ways and means position of the government.


58. Ibid.
The aforesaid attitude of the government towards assistance to be granted from the financial institutions undergone some changes towards the end of 1967-68. It was felt that there was no reason why well established public sector enterprises should continue to be financed out of funds available from the budget of the Central Government. It would establish a healthy tradition if public sector undertakings also rely on such sources as are normally available to the private sector companies. Further, public sector enterprises seeking assistance from the financial institutions would have to subject themselves to the strict commercial scrutiny of their financial needs and their justifications by the institutions. This would go a long way in helping the enterprises to stand on their own feet. This would, it is believed, create in course of time a spirit of healthy competition amongst public enterprises to qualify for being classified as an enterprise worthy of being favoured with investment support from financial institutions. Such enterprises would also be able to receive sound advice on their financing schemes from the institutions which possess the necessary expertise in the field of industrial finance.

The Cabinet Committee on Prices, Production and Export, therefore, in its meeting held on 20th November, 1968, decided that there should be no objection to the financial institutions entertaining applications from the

59. Ibid.
public sector enterprises for financial assistance for their expansion programme provided that they have declared at least a maiden dividend and have sufficient internal resources and provided also that they do not come to the government for seeking financial help for future expansion programme. The financial institutions were also advised accordingly.

In the aforesaid circumstances it is quite natural, as will be evident from Table 23 of the present study, that loan from financial institutions formed a very insignificant part of the borrowed capital, as such, in the capital structure of the Central government companies between 1960-61 and 1969-70. It was 6.0% of the total borrowed capital in the consecutive two years 1960-61 and 1961-62. But, following the declaration of the government policy on financing the capital requirement of a project of the public sector undertaking in June 1961 its share came down to 2.6% in the 1962-63. Thus, over a period of twelve months, there was a fall in the portion of institutional loan in the total borrowed capital of the Central Government companies by 56.7%. The participation continued to be the same in the year 1963-64. In the year 1964-65 there was improvement in the position as its share increased from 2.6% in 1963-64 to 2.7% in 1964-65. But in the year 1965-66 the percentage of institutional loan came down to 1.6%. Thus a decline by 40.7%

60. Ibid.
was recorded in the participation of institutional loan in the total borrowed capital of the Central government companies in the year 1965-66. This declining trend continued barring 1966-67 and 1967-68. In these two years there was improvement in the percentage participation of institutional loan. But the position could not be sustained. From the year 1968-69, it again began to decline and by the end of 1969-70, the share of institutional loan in the total borrowed capital of Central government companies came down to 1.3% only. This implies that the change in the government policy on the question of financial accommodation received from financial institutions by the Central government companies had no immediate impact on the structure of borrowed capital of those companies. This lack of positive response from the Central government companies can perhaps be attributed to the rigid eligibility criteria for receiving the loan on the one hand and unwillingness on the part of the borrowing company to expose their internal financial position on the other.

Borrowings made by a company in harmony with its profit trend, no doubt, is accepted as one of the principles of corporation finance. But it is not clear at least from the standpoint of financial management, why dividend payment was made a criteria for the eligibility of being a recipient of loans from the financial institutions.

Recently the government policy on the financial assistance to public sector undertakings has been changed on the basis of the recommendations of the Industrial Licensing Policy Enquiry Committee. The government has now authorised the public sector financial institutions to entertain applications for assistance to the public sector undertakings which are incorporated as companies under the Companies Act subject only to the limitations imposed by the respective statutes under which institutions have been set up (Vide D.O.No. DPE/ 1(21)/Adv / Fin/ 68 dated 4th November 1971).
Other Sources:

These embrace the sources other than those discussed so far. Normally, therefore, it comprises borrowing from Indian and foreign companies, managing agents, secretaries and treasurers and directors and also deposits received from public. These deposits evidently consist of those which are not covered by current liabilities in the accounts of the companies. Borrowings by the issue of debentures to the public, not classified elsewhere, borrowings against the convertible notes, sterling debentures long term deferred payment credits and hire purchase liabilities are also included under these "other sources". It has already been observed that the modus operandi of the borrowings made by the Central government companies is under the rigid control of the Central Government. It has also been pointed out that, despite the authorities given in the articles of associations, there has been no instance of borrowings made by the issue of debentures to the investors by the Central government companies. An important aspect of the Central government companies in India had been that foreign exchange cost constituted a significant proportion of the total project cost in a number of such companies. For instance, foreign exchange cost constituted 47.5% of the estimated project cost excluding township, in case of Hindusthan Steel Ltd. It had been 40.5% in case of Bharat Electronics Ltd., 34.2% in case of Bharat Heavy Electricals Ltd., 41.8% in case of Heavy Electrical India Ltd.

and 44.9% in case of Heavy Engineering Corporation Ltd. Instances can be multiplied. The methods that were adopted to finance the foreign exchange costs of the projects were (I) Foreign private equity; (II) Project tied credits from foreign governments to the Government of India; (III) Foreign private long term credit as per specific projects; (IV) Deferred suppliers' credit and (V) Free foreign exchange resources of the government of India.

It will be recalled that foreign private investors evinced no interest in the participation of the equity share capital of the Central Government companies. In the circumstances foreign investment in the Central government companies had been in the form of participation in the total borrowed capital of such companies. Foreign loans, in fact, constituted 16.2% of the total borrowed capital in the Central government companies, other than promotional and financial ones, at the end of 1969-70. Project tied credits from foreign governments, it has already been indicated, were channelised through the Central Government remaining liable both in respect of the payment of interest and repayment of principal. As such it can be presumed that, at the individual company


level, such loans become a part of the Central government's contribution to the total borrowed capital of such companies. In the absence of information, it has not been possible to sort out in detail in the present study how much of the Central Government's loan to the Central government companies had been out of such project tied credit of the foreign government. Nevertheless, as one study has revealed, it was quite significant for the Central Government companies in the spheres of steel and engineering goods industries. Financing the foreign costs of the Central government companies out of free foreign resources of the Government of India is beyond the ambit of the present discussions and this source is a sort of a pool which, besides being constituted by the foreign exchange earnings of the country, includes other kinds of foreign exchange resources that can be used flexibly. In the circumstances it may be logically presumed that, so far as the Central government companies are concerned 'other sources' as indicated in Table 23 of the present study comprise foreign private long term credits and deferred suppliers'credit since loan from directors, managing agents etc. are out of question. Table 23, of the present study further reveals that their percentage on the total borrowed capital of the Central government companies had been on the increase with exception in the year 1962-63.

It was only 1.6% of the total borrowed capital in the year 1961-62. But at the end of 1969-70 it increased to 13.7% of the total borrowed capital. Thus over a span of nine years foreign private long term credit and deferred credit recorded a rise by 756.2%. This increase can perhaps be attributed to the increase in the number of operating Central government companies over the period coupled with the increase in the foreign exchange component of the project costs with the progress in the completion of the projects and enhancement of the rupee liability following devaluation of rupee in June 1966. In the absence of necessary details in the published data of the Reserve Bank Study on the Finance of Central government companies it is difficult to locate their exact proportion. Nevertheless, a reference to the analysis of the accounts of the Central government companies, other than Financial and Promotional companies, for the year 1969-70 contained in the Annual report published by the Bureau of Public Enterprises showed that deferred credit from foreign parties constituted 5.1% of the total borrowed capital and 31.3% of the total foreign loan to the Central government companies. Another interesting feature in respect of the foreign project tied loan and deferred credit has been that these were not taken into consideration in fixing the debt-equity ratio of 1:1. In consequence the loan content in the capital structure of

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the companies having foreign project tied loan and deferred credit had been higher than was contemplated under 1:1 ratio between debt and equity leading to the increase in project cost and also affected the profitability of the companies.

Debt-Equity Ratio in Case of Central Government Companies and its Appraisal:

The aforesaid role that borrowed capital played in the capital structure of the Central government companies it will be recalled, had been the outcome of the government's desire to have a uniform policy of providing funds to the public sector undertakings, by maintaining a debt-equity ratio of 1:1. It will further be recalled that government prescribed the ratio as an ideal to bring into record the true financial cost of a project at least partially. The other arguments in favour of the aforesaid ratio had been that it would bring a check on the operational activities of Central government companies in as much as they would exert themselves at least to meet the fixed cost of debts. Secondly, financing through uniform debt-equity ratio would make it difficult for the managers of the Central government companies in having an easytime making profit.

The prescription of 1:1 ratio between debt and equity uniformly applicable to all companies irrespective of their caste and creed is open to question. The ratio between debt

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69. Ibid.
and equity in a company should depend on its cash flow situation. This, in turn depends on level of production, nature of investment, in sale proceeds and in needs of replacement. It is only after taking all these into consideration that one could find how much of the surplus of a company would be available for the purpose of debt redemption. This is how the extent of debt equity mix in the capital structure of a company is to be determined. It may be argued that redemption of old debts may be possible by floating new debts. But, what has already been pointed out that many of the Central government companies had investment in township. Needless to mention, that, investment in the township was altogether a social overhead. There was no possibility of cash flow in the companies against the investment in the township which are shown as a part of gross block, at the enterprise level. Similarly, production level in many of the operating Central government companies in the period between 1960-61 and 1969-70 was also far from satisfactory. For example even at the end of 1969-70, capacity utilisation in the three units of Hindustan Steel Ltd. at Bhilai, Rourkella and Durgapur had been 74%, 64% and 51% respectively. It was 17% in case of Mining and Allied Machinery Corporation, 17%, 15%, 61% and 18% respectively in Mechanical lines, structural, castings and

forgings and in the machine tools shops of Heavy Engineering Corporation Ltd. There were other instances as well. In respect of sale proceeds it is to be noted that many Central government companies lacked the price cushion necessary for adjusting their financial results in as much as these companies had no freedom in fixing the prices owing to market competition, ensuring adequate surplus for servicing the total capital investments. For example, the price structure of Hindusthan Steel Ltd., was related to Tata's historical capital block of Rs. 1176 per tonne of salable steel and ignored that of itself that went over Rs. 2400 and thereby inflicted heavy losses on Hindusthan Steel Ltd.

The argument that a uniform debt-equity ratio in the capital structure of Central government companies would bring in check in the operational activities of these companies also does not appear to be convincing from the operational results of the companies. It has already been indicated in Table 17 (Chapter V) previously that gradual increase in the amount of borrowed capital in the capital structure of Central government companies effected for achieving the desired debt-equity ratio of 1:1 was associated with heavy accumulation of deficits in a number of those companies. It ended in causing thereby virtually an erosion of their capital. It

may also be recalled that earlier in this study, it was stated that, but for interest obligation of the Central government companies, their performance in terms of profit earned would have been much better. This is borne out by the fact that cost of capital as involved in interest payment amounted to Rs. 316.2 crores at the end of 1968-69, in respect of the public sector undertakings of the Central Government. If cost of capital, to the extent of this interest, was adjusted against the accumulated losses as at the end of 1968-69, instead of current losses there would have been a surplus of Rs. 267.30 crores earned by the running undertakings of the Central Government. In the circumstances, the desired ratio of 1:1 between debt and equity being sought to be uniformly applicable to all companies lost most of its flavour. An 1:1 or any other debt-equity ratio becomes commendable only up to the margin at which debt or equity becomes equally welcome to investors in a competitive market. A ratio at which the outcome is a loss to the equity holders or a return is earned at a rate lower than the rate of interest on borrowed capital, cannot evidently be tolerated by a financial manager. If profit cannot be increased, the proportion of debt, in that case, must be made to fall. In any case, the debt-equity mix in the capital structures of Central government companies as a whole had no doubt been approaching the desired ratio,

72. J. Satyanarayan - Deficits of Public Enterprises. All India Institute of Public Enterprises, Hyderabad, p.260.
since 1962-63, as could be studied from Table II previously. But it was possible only at the cost of allowing artificial inflation of the capital structure in many companies resulting from the capitalisation of interest, which the companies, as already indicated, had to practice for want of necessary revenue flow to pay the interest on their borrowed capital. Alternatively heavy operational losses had to be admitted. For example Hindusthan Steel Ltd. alone capitalised interest to the extent of Rs. 13 crores, and to that extent inflated its capital structure and the overall operational loss in the company had been Rs. 151.96 crores for the period of ten years between 1960-61 and 1969-70.

Further, it is also doubtful whether the contemplated pressure on the management of Central government companies under the uniform debt-equity ratio of 1:1 in their capital structure, would actually work when, as already told, certain companies were given loan by the Central Government free of interest charges or against interest at concessional rate.

The behaviour of the debt-equity ratio of the Central government companies as a whole covering all industries between 1960-61 and 1969-70 and the unit-wise behaviour of the said ratio in case of 13 leading Central government companies was as follows:

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companies controlling 93.8% of their total paid up capital at the end of 1969-70, equity first being taken at their nominal values and then at their current values could be guessed respectively from Table 25 and 26 below for

Table 25

Debt-Equity Ratio (equity taken at their nominal value) in the Central Government Companies between 1960-61 and 1969-70.

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of Companies</th>
<th>Ratio between Debt and Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>1960-61</td>
<td>26</td>
<td>1:2.42</td>
</tr>
<tr>
<td>1961-62</td>
<td>28</td>
<td>1:2.19</td>
</tr>
<tr>
<td>1962-63</td>
<td>31</td>
<td>1:1.16</td>
</tr>
<tr>
<td>1963-64</td>
<td>32</td>
<td>1:1.22</td>
</tr>
<tr>
<td>1964-65</td>
<td>33</td>
<td>1:1.28</td>
</tr>
<tr>
<td>1965-66</td>
<td>39</td>
<td>1:1.08</td>
</tr>
<tr>
<td>1966-67</td>
<td>44</td>
<td>1:0.91</td>
</tr>
<tr>
<td>1967-68</td>
<td>49</td>
<td>1:0.81</td>
</tr>
<tr>
<td>1968-69</td>
<td>55</td>
<td>1:0.76</td>
</tr>
<tr>
<td>1969-70</td>
<td>58</td>
<td>1:0.79</td>
</tr>
</tbody>
</table>

Debt-Equity Ratio (equity taken at their current values) in the Central Government Companies between 1960-61 and 1969-70

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of Companies</th>
<th>Ratio between Debt-Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>1960-61</td>
<td>26</td>
<td>1: 2.77</td>
</tr>
<tr>
<td>1961-62</td>
<td>28</td>
<td>1: 2.59</td>
</tr>
<tr>
<td>1962-63</td>
<td>31</td>
<td>1: 1.11</td>
</tr>
<tr>
<td>1963-64</td>
<td>32</td>
<td>1: 1.99</td>
</tr>
<tr>
<td>1964-65</td>
<td>33</td>
<td>1: 1.25</td>
</tr>
<tr>
<td>1965-66</td>
<td>39</td>
<td>1: 1.06</td>
</tr>
<tr>
<td>1966-67</td>
<td>44</td>
<td>1: 0.86</td>
</tr>
<tr>
<td>1967-68</td>
<td>49</td>
<td>1: 0.73</td>
</tr>
<tr>
<td>1968-69</td>
<td>55</td>
<td>1: 0.65</td>
</tr>
<tr>
<td>1969-70</td>
<td>58</td>
<td>1: 0.65</td>
</tr>
</tbody>
</table>


Central government companies taken as a whole, and from Table 27 and 28 in case of Central government companies taken unit wise. It will be observed from Table 25 and 26 that debt-equity ratio could hardly reach the dead level of 1:1 in case of the Central government companies over the decades between 1960-61 and 1969-70. Table 27 and wherein unit-wise behaviour of the debt-equity ratio of 13 companies has been depicted establishes the fact that, even when considered individually, the ratio between debt and equity...
had not been found to be at the uniform level of 1:1 in all the years between 1960-61 and 1969-70.

For instance, the ratio of debt in relation to equity in the Hindusthan Steel Ltd. had been 1.02:1 and 1.16:1 in 1960-61 and 1961-62 respectively. Thus, the debt-equity ratio in the Hindusthan Steel Ltd. was very near to the desired ratio of 1:1 in the year 1960-61. But in the year 1961-62 it was more than the said desired ratio. It came down to 0.80:1, 0.68:1 and 0.86:1 in the subsequent three years, viz., 1963-64, 1964-65 and 1965-66. In the years between 1966-67 and 1969-70, debt-equity ratio in the said company improved and was very near to the desired ratio of 1:1. In case of Bharat Heavy Electricals Ltd., the debt-equity ratio had been much higher than the desired ratio of 1:1. It was 1.19:1 in 1967-68, 1.49:1 in 1968-69 and 1.67:1 in 1969-70. As revealed in Table 27, the lack of uniformity in the debt-equity ratio could be noticed in the same way in the cases of other companies also.

Though the position changes materially, the fact that uniform debt-equity ratio of 1:1 could not be secured by the companies, either collectively or individually over different years remains unaltered even if equities were taken at their current values. This will be clear from Table 28 of the present study where debt-equity ratio of 13 leading Central government companies other than Bokaro Steel has been shown from the year 1964-65 to 1969-70. The aforesaid analysis goes to corroborate the observation made earlier in chapter III that despite government's desire for having 1:1 ratio between debt and equity in the capital structure of Central government companies hardly any company could reach the target in its entirety in the period between 1960-61 and 1969-70.
The question of maintaining uniform debt-equity ratio of 1:1 among the different companies as a desired one, for reasons already indicated, came up for consideration subsequently by different expert bodies. The Committee on Public Undertakings opined that there cannot be one common ratio applicable to all the undertakings. Similarly for the same undertaking also one ratio cannot be made applicable for all times. Thus, it was ultimately recommended that rigidity in this regard should be avoided. The committee also observed that if any undertaking plead for altering the ratio, the government should give it due consideration. The Administrative Reform Commission also considered the issue of uniform debt-equity ratio and made recommendations similar to that of the Committee on Public Undertaking. The government accepted these since September 1968. The National Commission on Labour also examined the issue of investment in public sector undertakings in their proper perspectives, suggested that investment on township associated with the projects in the public sectors should be a charge against a separate fund instead of that of the undertaking. The government considered the recommendation.


carefully and ultimately took a decision as late as in November 1970 to treat the expenditure on township as a part of equity investment in public sector enterprises. It also issued instruction to reorganise the capital structure of existing enterprises on the basis that entire expenditure on township is financed by the government by the equity and the balance of the capital outlay is financed partly by way of equity and partly by loan by and large in the ratio of 1:1.

From the aforesaid discussion it is clear that government revived its earlier stand on uniform debt-equity ratio of 1:1 with the exception that the same would be applicable only in respect of the financing of the assets of companies other than investment in township. This leads one to comment that though the present debt-equity ratio policy is an improvement over the original one immunciated in June 1961. Nevertheless, its rigidity is not lost. Determination of debt-equity ratio in the Central government companies has not been left to the internal management of such companies, to be determined in accordance with respective objective condition. It has been pointed out previously that the prescription of


a uniform debt-equity ratio of 1:1 in case of the capital structure of Central government companies was not the outcome of a desire for optimility in the capital structure of Central government companies ensuring a minimum cost of capital. In the situation what is needed is the assessment of debt-equity ratio, in each individual case of Central government companies, on merit and allowing the internal management to decide the said debt-equity mix.