CHAPTER IV

ASSESSMENT OF THE BORROWER

Assessment of the borrower or the lessee falls within the purview of credit evaluation. Credit evaluation in leasing industry entails regulating credit policies and requisite procedures pertaining to leasing of credit. The main sources of credit information *inter alia* include client, bank references, trade references, credit rating agencies, company financial reports, media reports, stock market opinion etc. These sources are helpful in assessing the credit-worthiness of the lessee. The antecedents of the company, analysis of the financial information, reading of notes to accounts and other information etc., are various types of information that help in evaluating the creditworthiness of a lessee. An endeavour is made in the present chapter to critically examine all these and other related aspect to evaluate the creditworthiness of a borrower or a lessee.

Appraisement of the borrower or the lessee is a significant but uphill task that entails multiple steps of credit evaluation. Evaluating the credit-worthiness of the lessee falls within the ambit of credit management; hence its analysis can be better facilitated through an appraisal of credit evaluation. When it comes to a fund-based service such as leasing, credit-evaluation assumes paramount significance owing to various reasons. In the first instance, account receivables might form a certain percentage of the total funds employed of any company. But for a leasing company, the whole of its funds, owned as well as borrowed, are invested in accounts receivables. Working capital has the highest share in the total asset mix of a leasing
concern. Therefore, realisation of these assets is a key to its business. In a normal trading concern, credit is extended for a limited period, may be for 60 days or so. A leasing company extends long-term credit - running up to many years down the road. The rate of the return of the business as a whole depends on timely realisation of debts.

Eliciting information about normal trade customers is easy because they hail from the same trade. But a financial company would cater to the needs of clients at large, hailing from different trades and different regions. Therefore, even obtaining of critical information is so difficult. A trade customer will not normally default in payments in interest of his own future trade relations with the supplier. But in case of a financier, it is entirely different. There is no fear of discontinuance of further supplies or future support or a concern for general goodwill which may drive the customer to pay. Unlike a bank, a leasing company cannot even call back the asset unless the lessee fails to pay. That is, the lessor cannot go by apprehended risk.

Undeniably, credit management is a significant function in a financial company. However, the leasing industry in India today seems to be attaching little significance to credit management. Few of the companies have a standard credit sanction procedure, and hardly any of them have a credit department to look after this function. Credit risk is something which becomes known only as the industry comes of age, but prudence lies in projecting the future before it really begins to jell. Lessons may be learnt from banking brethren who after year of experience in lending business have become conservative and cautious. A good credit management lies not in laying down dogmatic procedures or fixing norms and asking for sets of documents - a
good credit management may be quick and yet effective, simple and yet critical. It may not have fixed standards and fixed procedures, yet it need not be entirely subjective. Credit evaluation is something like astrology- it is objective science with lot of objective art in it, but like astrology, it can hardly ever be definitely successful.

**FIXATION OF CREDIT POLICIES**

For a credit manager fixing a credit policy which in general determines the attitude of the company to its business is one of the most significant tasks. This would, *inter alia*, be concerned with broad questions like: company operating in totally risk-free cases or venturing into little riskier areas also, exposure of the company in different regions, the exposure of the company in different industries. Visualising the overall credit policy is the *sine qua non* for a leasing company. It may, at its option, decide to restrict its business only to absolutely safe cases, or cases which appear to be absolutely safe. On the other hand, it may delve into a little risky cases, or even riskier cases, which is what a company engaged in consumer financing or sales-aid financing does.

Companies having the 'risk-free' type of temperament deal only with the so-called 'blue-chips' and they have to operate on a very low rate of return. Of course, the rate of return moves along with risk, and so, those who maximise their returns are those who play with maximum risk. The developments in the leasing field which till now operated in a restricted safe sector, suggest that leasing companies have gradually got to become risk-receptive. Given the nature of their business and their cost of capital, they cannot afford to live on thin rates of return, and so, they have to combat risk and be able to absorb the incidence of bad debts which may be slightly higher.
in the risk-prone sectors. But the ideal policy for a leasing company should be not to avoid risk altogether- its policy must be to keep bad debts within affordable limits.

LAYING DOWN CREDIT PROCEDURE

A good credit procedure or the procedure of according approval and sanction to credit needs to be devoid of unnecessary time-consuming procedure, superfluous information, infructuous meetings and inflexible routines. Hire-purchase business on a large scale in India is conducted entirely with no credit procedures at all- the credit evaluation hardly depending on papers and going entirely by references and hunches work. Undoubtedly, one gains the difficult art of judging a person just on the basis of a gut feeling over the years. However, credit evaluation is not an easy task. There is nothing to under-rate the subjective opinion of the credit evaluator, but if that opinion is corroborated by objective details, it becomes all the more reliable. Credit procedures, therefore, need not be rigid, but they must not be dependent entirely on subjective opinions.

A good credit procedure must provide for security of a proposal for more than one person, to the extent possible. This has several advantages. It prevents opinion from being prejudiced and imparts to the process of scrutiny a thoroughness otherwise not possible. However, a collective scrutiny also means a dilution of responsibility, so that it may be possible that none of the scrutinisers really take their task seriously. To fix-up individual responsibility, a credit evaluation procedure may require the initial credit evaluation to be done by a particular person.
The collective scrutiny may appropriately be provided in form of a standing credit evaluation committee having representation from finance, marketing and secretarial departments. Such a committee may meet at regular intervals. To speedup the decision, relevant papers may be sent in advance to the committee members. A committee meeting may be combined with an interview of a representative of the proposed lessee, so that all the confusions or queries are disposed of immediately. Needless to say, speed is one of the most important attributes of leasing, and the committee must bear that in mind.

**SOURCES OF CREDIT INFORMATION**

Creation of a lease proposal prompts the credit department to commence collection of information about the proposed lessee. The marketing department may be made responsible for conducting an initial survey and giving a preliminary report, so that the primary sources of information, say, the client himself, may be contacted by the marketing people. After the preliminary work, attempt must be made to gather as much, still as relevant, information as possible. A variety of sources of information are always desirable so that the information obtained can be corroborated and individual biases may be scored out.

It is apparent that there cannot be any fixed norms regarding the sources from where to seek information. It would always depend on the skill of the collector. Marketing and credit wings of financial companies are always gathering information about possible clients. Where the scale of operations so permits, it may also be advisable to maintain a captive database of facts about, say, selected 500 corporations which matter in the country. This sort of
a database may be regularly updated on the basis of annual reports, press reports etc.

Viewed in a broad perspective, many sources can be tried for gathering credit references and these inter alia include client, bank reference, trade reference, competitors, credit rating agencies, published books, company financial reports, press reports, stock market opinion and charges registered etc. These are briefly appraised as follow:

a) **Client**

The client itself is the most important source of primary information. That is also the most original, comprehensive and by far the most trustworthy source. There is no scope for the belief that as a seeker of finance the client may tend to paint a rosy picture of its state of affairs. In fact the investigator has no reason to proceed with this sort of disbelief. He may proceed objectively and passionately collecting information and any over-estimations will become evident either in the process of interview or in course of third party references. As much relevant information as possible may be sought from the lessee. The range of information may cover the history of the company, nature of the company's business, the background of the promoters, the stake of the promoters in the company, trends in the industry in which the company is engaged, particulars of the competitors, sources of major raw materials (i.e., import component of total product cost), source of technology, technological advancements in the industry, the company's major customers, the company's major financiers, results of any public issue made by the company, dividend policy followed by the company, maturity composition of the company's current assets and liabilities etc.
The requisite information on above-mentioned points can be elicited either in the written form or verbally asking the factual details. Written statement is more passionate and carefully written and has less scope for bragging. Interview can be rather informal as well as probing. However, both the methods have their respective advantages and both can be used for eliciting information from the client. In order to ward off duplication the written form may be filled up before the oral interview is conducted and the interviewer may proceed on the basis of the proposal form. The interviewer needs to be polite and polished. Senior executives, particularly where the company is financially sound, may not be prepared to face probing questions. In fact, the interview must never be described as such. It may be described as just an informal meeting, in which interviewers may tactfully try to create a friendly and informal atmosphere and then seek the desired information cleverly but mildly.

b) Bank References

Information about the general financial health of the companies comes from the lessee’s bankers - not just the bankers with whom the company has an account, but really the bankers who might have lent to the company. Bank reference are normally oral, and preferably through the lessor’s bankers. Getting a reference through the lessor’s bankers makes it easy to get the correct information, and the lessor may really remain disguised. This is also quite important because it may be perplexing for the lessee when he gets feedback from several people where the lessor might have inquired.
c) Trade References

Trade reference, that is, references from the company's customers, suppliers etc., may be quite useful. Suppliers' information may be especially useful, because that would give an idea of the usual payment policies of the proposed lessee. Many a financially sound company follows a calculated policy of delaying payments, in which case, one need not be drawn back, but the rate of return must be calculated on the basis of the possible delay.

d) Competitors

Information gathered from a client's trade rivals or competitors is undoubtedly a potentially valuable source. If proof of this is needed, one has only to consider the wide use of credit interchange, as it is called in the USA. In the United States, under the aegis of the National Association of Credit Management, several groups of credit managers meet constantly to interchange opinions and experiences on conditions of and trends within their own client industries. The personal contacts so established create a near perfect environment for confidential exchange of information between credit managers who, although, might be working for competing industries.

e) Credit Rating Agencies

Credit rating is one the firmly incorporated professions in the developed countries, particularly the United States. In India, the professionally-run credit agencies are still at the nascent stage. ICICI had recently set-up an agency called Credit Rating and Information Services Ltd., (CRISIL), which will take up credit-rating for share issues and debentures issues to begin with. It would take quite some time for this sort of agency to be able to give credit references for leasing transactions, etc. Therefore, the need for credit rating
agencies in India is clearly visible. Enquiring through a credit rating agency has several advantages. Firstly, it may give ready and detailed information which might have been collected over the years. Secondly, due to the fact that the agency is in the market for all the time, it might be able to give more precise information than possible for anyone else. Thirdly, lessor may avoid perplexion for his client by keeping himself undisclosed and inquiring through a reporting agency. However, the reliability of information turned out by the agency would depend on the independence and thoroughness which the agency is able to provide to its reports.

f) Published Books

Preliminary and basic information about a company can be had from printed sources, that is, books. In India one can refer to the Stock Exchange Year Books published annually by various stock exchanges, or books like Corporate Path-finders' Data-base, Kothari's Industrial Yearbook etc. There are reputed books running into several volumes providing pertinent credit information about companies abroad. Dun & Bradstreet's Register is one of such books that pertains to UK and encompasses town-wise details of the trading concerns. A similar publication in the United States is Standard and Poor's Register. Information provided, of course, is quite basic such as name, address, trade, date of information, capital and registered charges, etc. The principal importance of such books will, however, lie in getting a basic information just to begin with. For instance, from a stock exchange yearbook, one may short-list clients who prima facie seem to be credit worthy.
g) Company Financial Reports

One of the most easy, convenient and commonly used tool of credit evaluation is the company's annual accounts which are statutorily prepared annually and laid before the shareholders. When a lease proposal emanates, a copy of the Annual Report of the proposed lessee may be had on request. It is also to be available for inspection and extracting at the Registrar of Companies' Offices. Apart from the annual accounts, a listed company has to publish half-yearly unaudited results in the newspaper twice a year. These are, of course, provisional and summary figures and it is difficult to make out much from these figures. The extent of reliability to be placed on the annual accounts is a factor to be judged by the evaluator based on individual merits. Several factors such as absence of or disregard for uniform accounting standards, tax on published profits under section 115J which continued up to Assessment Year 1990-91, effects of published figures on workers' and shareholders' expectations, general publicity policy of the company, etc., tempt the managements to fudge the figures either upwards or downwards. However, a skillful evaluator will not find it much difficult to sense such an attempt, and then, he may read the accounts accordingly.

h) Press Reports

The financial press comes out regularly with reports about companies. India's leading financial newspapers like Economic Times, Financial Express, Business Standard and Business Online publish some sort of periodic guides which give some key ratios and figures about well-known companies. These are, although, meant for an investor, a financial analyst may also find them useful for his data-base. Similarly, key indicators are available in financial
magazines. Apart from them, the press also comes out with company reports periodically. The financial press in India does usually publish investigative reports about companies. The company reports being published are, as a rule, based on the company's own press release, and are nothing except a publicity tool adopted by the companies themselves. Not much can really be gathered from these reports. But they are still helpful for analysis.

i) **Stock Market Opinion**

Although a stock market evaluates a company from investment point of view, which may not be congruent with a financial evaluation, yet a company's prospects, at least in the investor's perception, are best judged by the market opinion about a company. This market opinion also has an indirect impact on the company's health. Hence, a financier may also refer to shareholders or share dealers to know the market sentiments about a prospective lessee.

j) **Charges Registered**

Charges created on the assets of a company have to be registered with the Registrar of Companies. This information is available for inspection by paying a prescribed fee. A lessor may also like to check up this information which would indicate to what extent company's assets, present and future, are charged. Although a lessor does not give a loan, and hence a lessor is not directly affected by the company's charged assets, but in the event he seeks a collateral security, a charge inspection must be made as a routine. In any case, such an inspection gives a general idea of the extent to which the company has gone for secured borrowings.
TYPE OF INFORMATION TO SEEK

Selection of a criterion to judge the credit-worthiness of a client is perhaps the most difficult question to answer in credit evaluation. Moreover, how to get information is not a real problem - the real problem lies in identifying valuable and critical information. The question is so difficult because it is the natural corollary of more involved question - what determines the credit-worthiness of a client? What is it that indicates the strength of a company? What is it that might make the lessor feel safe? The best answer to this question is not to give any answer at all and say that a mix of factors which vary from industry to industry and even between firms, determines the credit-worthiness of a client, and that, the mix is too complex to be narrated in an essay in a book. The best way is, therefore, to shirk the question by passing some general remarks such as: it all depends upon the ingenuity of the evaluator as to what facts he enquires about a client, and what weight he gives to the information.

Perhaps nothing but a general answer to this question is possible - at least as far as the weightages to be assigned to the each of the facts collected go. No prefixed norms can be laid to weigh the relative significance of financial ratios, or qualitative information, or share-prices of general market sentiment, etc. Bad may the financial indicators about a company but still a lessor may feel himself to be safe with that company, may be because of influence the lessor is able to exercise on the company. Here, the influence factor gets more weightage than the financial ratios. Credit evaluation to a certain extent has to be subjective; that is, qualitative factors do play an equal role as qualitative information on a case-study of the prospective lessee rather
than on the basis of pre-determined 'ratings'. Credit evaluation in this respect is best comparable to a doctor's examination of a patient.

There is no instant formula approach to credit evaluation so as to suggest as to what information one should seek and what ratings should it lead to. But an evaluator must be advised not to seek too much redundant information- information which plays no role in the ultimate credit decision. Often, lease proposal forms and bank loan forms are full of such non-critical extraneous information. The answer to these proposal forms has usually to be a think binder containing a heap of papers- papers which are hardly read or respected. Some of the critical information which may be asked can contain following points, but again these points, as suggested below are neither exhaustive nor absolute:

a) **Antecedents of the Company**: How the company started and as to how it grew.

b) **Antecedents of the Promoters**: This aspect should contain information about other companies belonging to the group, its corporate standing, general group policy about its companies, whether there is flow of funds between the inter-group companies. It is worth noting that a positive answer to this question may mean that a good company in the group may turn bad because of a bad group company, or conversely, a bad company may still be safe because of group support), etc.

c) **Particulars about the Project**: This aspect should include information on the general state of the industry to which the project belongs- likely demand projections for the company's products, possibility of the
products facing threat from better alternatives. Does the project feasibility depend on tariff-protection? To what extent is the project dependent on the imported raw materials? Does the company have to pay highly in a foreign currency whose rates are going high? Does the project face competition from numerous small concerns (which may mean a price war particularly from the unorganised sector which may not pay any taxes or duties)? The dependence of the project on power supply and any captive sources available, etc.

d) **Financial Details**- This would incorporate information about growth in turn-over, market share, profits, taxes, dividends, net worth etc. The key ratios may be analysed, however, the ratios cannot be weighed on stochastic standards. Maturity composition of debtors and creditors may be asked for. A good company must be quick both in realising the debts and paying off its creditors. Inventory build-up can be seen as to whether it is in excess of the reasonable norms.

e) **Dividend and tax Payments**- Both dividend and tax payments are significant factors. A liberal dividend policy may mean that the company values shareholder satisfaction, and has further share issues in the coming period. A very conservative dividend policy may be financially prudent, but indicates that the company's shares are closely held.

f) **Company's Major Suppliers and Customers**- Information on this aspect will be useful in ascertaining the corporate standing of the company.
g) **Labour Relations** – Information on this aspect sheds light on labour-management relations that are crucial to the production and resultant growth of the company.

h) **General Qualitative Information about Management** – Ascertaining information on this aspect will be helpful in dealing with the key decision-makers of the company.

i) **Past Experience of Lenders, Inter-corporate Depositors, Fellow lessors** - Getting information in this regard would enable the investigator to know about the financial credibility of the company in the market.

j) **Company's Past Borrowing Records** - To get information about company's previous borrowing records would be helpful in ascertaining about its mode of financial dealings and to some extent its financial health as well.

While according credit-rating to a company, the CRISIL looks at the following various aspects of a company:

(A) **Industry in which the Company Operates**

i) Key factors for success in the particular industry in which the company operates (such as technological competence, capital requirements, bargaining power of buyers, suppliers etc.).

ii) Demand factors - growth rate of demand for the products, credit facility as a sales tool, et., - effect of changes in excise/customs tariff.

iii) Supply factors like raw materials, labour and power situation.
iv) Structure of industry - fragmented or concentrated, potential new entrants.

v) Pace of technology upgradation/change.

(B) Borrowing Company’s Position in the Industry
i) Marketing strength – ability to sell, selling and distribution arrangements, customers brand loyalty.

ii) Product and customer diversity.

iii) Technological competence, R & D efforts.

iv) Location advantages in terms of availability of raw material, power and other infrastructure.

v) Relations with labour.

(C) Management
i) Track record, goodwill earned.

ii) Its goals and philosophy.

iii) Strategic and financial planning.

iv) Stability and line of succession.

v) Financial policies, reliance on external debts as source of finance.

(D) Cash-flow Adequacy
i) Capital spending programme and financing pattern in the near future.

ii) Repayment schedules of existing debts/ other obligations.

iii) Variability of future cash-flow.

iv) Ability to raise finance under stress- company’s position in the capital market.
ANALYSIS OF FINANCIAL INFORMATION

Analysis of financial information, that is, information available from annual reports, can be classified broadly into four divisions- (a) ratio analysis, (b) Trend Analysis, (c) Inter-firm Comparison, (d) Reading of Notes to Accounts and Other information. These are briefly appraised below.

(A) Ratio Analysis

A ratio is a figure in the financial reports expressed in relation to another figure, and ratio analysis is the science of deriving certain conclusions by a study of such ratios. The rationale of ratio analysis is based on the simple logic that a plain reading of financial figures may not always convey the message – what is more relevant is the relative magnitude of the figures.

Before going to the merits of ratio computation, it is perhaps proper that their essential limitations be indicated, so that they are not mechanically relied upon. First, in order to be useful, a ratio must be properly defined and the definition may demand a change with changed industry characteristics as well as with changed objectives of the analyst. For example, the return on investments may mean a different thing for an investor, but different to a lender or a lessor. A lender may look at such a return before interest, and a lessor may look at it even before lease rent. Secondly, one need not depend on fixed or prevalent norms for seeing whether a ratio is too high or too low. A high D/E ratio may be justified in a particular industry or even for a particular company depending on the volatility of its earnings. Thirdly, mechanical reliance on the figures in published accounts must always be avoided and the real nature of the figures must be looked into. Of course, that is easier said
than done, and given the state of disclosure in accounts it is often difficult to
dig the reality buried in the published figures. But certain facts may be
apparent from the study of the accounts.

Some of the frequently-used ratios are as follow:

(I) **Balance-Sheet Ratios**

- Liability Ratios
- Asset Ratios
- Debtors/ Creditors Ratio
- Current Ratio
- Liquid Ratio

(II) **Profit and Loss Account Ratios**

- Rate of Gross Profit
- Rate of Net Profit
- Expenditure/ Sales Ratios

(III) **Balance-Sheet/ Profit and Loss Account Ratios**

- Stock Turnover Ratio
- Creditors/ Purchase Ratio
- Debtors/ Sales Ratio
- Working Capital/ Sales
- Net Return Ratio
- Return on Net Assets

(IV) **Lending Ratios**

- Interest Cover
- Debt Service Capacity
(V) **Additional Investment Ratios**

- Return on Equity
- Earnings Per Share
- Price/ Earnings Ratio
- Dividend Yield
- Dividend Cover
- Debt Ratio

(a) **Liability Ratios**

Liability ratios mean expressing each item on the liability side of the balance-sheet in terms of percentages—these percentages indicate the contribution of each of the sources of funds (i.e., liabilities) to the total funds employed. This would indicate the liability structure of the company and thereby, the financial leverage employed by the company. An important ingredient of the liability ratios is the popular D/E ratio or Debt/Equity ratio, which shows the proportion of debt to equity, that is, the proportion of long-term borrowed funds to proprietor’s funds, namely, equity and reserves. The extent of D/E ratio determines the financial leverage of the firm which indicates that it earns heavily for its equity when its rate of earnings is more than the cost of borrowed funds but it might go bankrupt when the return is lower than the cost. Highly geared firms are, therefore, risky.

Normally, financiers have been following a rule of 2:1 D/E ratio, that is, debt must not be more than twice the equity. However, the propriety of the D/E ratio depends entirely on the nature of business. A firm having reasonably secured returns shall not at all be concerned by a high amount of debt, and may go up to any extent trading on equity. A high D/E ratio would, therefore,
by itself mean nothing, but coupled with a low interest coverage ratio, it might mean disaster, unless there are very strong reasons to believe that the earnings are going to be maintained. A low D/E ratio means either that the firm has some constraints on borrowing as had been the case with the FERA companies, or the firm follows an extremely conservative approach to finance. One would find it hard to convince these firms to use external sources of finance, but they would normally prove to be good borrowers.

(b) Asset Ratios

Asset ratios, that is, the contribution of each item of assets to the total funds employed in the business, indicates the asset structure of the firm and its operative leverage. While there can at least be broad norms for liability structure, there is no general norm possible for the asset structure. What proportion of total available funds should be blocked in fixed assets so as to leave the balance as circulating capital is dependent entirely on the nature of business. The only thing to remember is that a business with inadequate working capital will always have poor returns as it will always be losing opportunities, buying materials in panic and paying high, selling stock for cash, and so, at low prices, foregoing customers who cannot afford to pay in cash, and all the more, it might have to distress borrowings at high cost. Clemens and Dyer (1977) have aptly compared fixed assets and working capital to the setting and the play in the theatre:

The fixed assets correspond to the stage setting and properties in a theatrical production, but the play is the thing. All the action and achievement of the business leading to progress and profits (other than capital profits) take place in the movement or turning over of the circulating assets. Against lavish background, a flimsy play, with poor direction and an ineffective cast, looks ridiculous. The current/ fixed assets ratio has for a finance director the same significance as the power/ weight ratio has for the automobile engineer. And that
business will progress fastest and farthest which has only the minimum of fixed asset dead weight to carry.1

(c) The Debtors/ Creditors Ratio

This is a ratio of trade receivables to trade payables, and is suggestive of the disparity in credit granted and credit enjoyed. It is obvious that if any trading business were to grant the same period of credit as it enjoys, it must have the trade debtors greater than trade creditors because included in debtors is an element of profit also. In a manufacturing business, debtors ought to be much more still, because of the value-added component as well as profit component of trade debtors. A low debtors/ creditors ratio may not prima facie be a reason for worry unless also accompanied by a fall in sales volume. A decline in debtors may be because of stricter credit policy followed or because of improved collections. An increase in creditors maybe because of the payment policy. But that itself may be a cause for concern for a financier, may not so much for an investor. This is once again to reiterate that the objections of an investor and a financier are different and so a ratio may not have the same meaning for the two.

(d) The Current Ratio

This popularly-used ratio indicates the relation between current assets and current liabilities. It is also known by the name of ‘working capital ratio’. It is computed as current assets over current liabilities, where current assets would mean those which are really encashable, and current liabilities as those which are really payable. The ratio is meant to indicate to what extent can the current liabilities be paid by the existing current assets. According to a prudent

financial practice called 'hedging', only short-term sources should be used to pay for short-term needs, and so, a firm which has a current ratio of less than one, that is, a negative working capital, will either have to borrow long-term funds to pay for the current liabilities, or will simply drive itself into a situation of 'technical insolvency', that is, inability to pay for the current liabilities although it has enough assets. This, however, does not mean that too high a current ratio is a sign of good health- working capital, of course, must be within the norms based on number of days of sale. Within that norm, the company should normally have a current ratio of at least 1:1.

(e) Liquid Ratio

Liquid ratio or acid test ratio or quick ratio is only an extension of the current ratio and calculates the relation of liquid current assets, that is, current assets excluding stock and works-in-process to current liabilities. This tests the firm's ability to pay its debts if the firm just stopped its business and could not liquidate its stock. Both in computation of the current ratio as well as acid test ratio, the figures of accounts receivables must be taken as those which are readily encashable. Doubtful debts, debts outstanding for more than 6 months, debts which are contested, etc., must be excluded. A similar understanding has to be applied to current liabilities also.

(f) Gross Profit Ratio

It is one of the frequently-used ratios designed to measure how much is the margin at which the firm sells, because it is this margin which determines the basic feasibility of any business. It is computed by taking gross profits as a percentage of sales- gross profits meaning profits before meeting any overheads, that is, after meeting only direct expenses. Now-a-
days, it is out of vogue for companies to prepare a manufacturing or trading account separately from the profit and loss account, and so, the gross profit rate may not really be ever known.

(g) Net Profit Ratio

Net profit ratio is the percentage of net profit to sales. Compatibility of net profits to sales may be questioned because it is the gross profits which have direct bearing with sales and not net profits, but since the general profitability of a business is expected to move with the volume of sales, the net profit ratio is of positive analytical significance. A low net-profits ratio as compared to the industry-average might mean an overhead-burdened company which may not remain profitable in time to come. A decline in the ratio might mean competitive pressures forcing the company to earn less, which may be, is compensated by an increase in volume.

(h) Expenditure to Sale Ratio

This is just a reciprocal of the gross profit ratio. It explains why the net profit ratio is high or low compared to the gross profit ratio. If the presentation of accounts so permits, the expenses could be classified into fixed, variable, and semi-variable, so that the position of the company at any given sales volume can be projected. This will also help ascertaining the 'margin of safety', that is, the decline in sales which the company may afford to suffer without going into losses. The expenditures to sales ratio is particularly useful in monitoring of a client, as an impending sickness is always indicated by an increasing materials to sales or wages to sales, or overheads to sales ratios.

(i) Stock Turnover Rate or Ratio
Stock turnover rate or ratio indicates the relation between inventory and sales. It is calculated as sales divided by inventory, but to afford better comparison, inventory is taken as the average inventory, that is, average of opening and closing figures, and the sales is taken at its cost, unless the stock is valued at market price. The result will indicate how many times the inventory has been turned over. For instance, if the average stock held was Rs. 100 and the sales were Rs. 1,200, it can be said that the stock was turned over 12 times, that is, the circle of stock-debtors-cash-stock had 12 rounds in a year. This would mean that on an average, the firm held one month’s stock. So, the number of days, the stock is held can be calculated as-

\[
\frac{365 \times \text{Average stock}}{\text{Cost of sales}}
\]

This, however, is a rather simplistic way of computing the number of days of stock held. An analyst would probably get a better picture by comparing item-wise sales, and compare what items were particularly slow moving. Further, he might like to compute separately the number of days for which raw materials, works in process, and finished stocks are held. The average stock need not necessarily mean average of opening and closing stocks- if a more representative estimate is possible, the same should be taken. A careful analyst will also inquire his clients about any redundant or non-moving stock included in the inventory figures, as in any organisation there always are defective, or mispurchased, or simply standby items which never move. The essential message is that instead of just working on the published figures, the analyst might query the lessee about the realistic figures to take.
(j) Creditors Ratio

Assuming that the trade creditors shown in the accounts are all currently payable, a relation between trade creditors and purchases will indicate the rate at which creditors have been paid. The ratio is computed as follow:

\[
\text{Trade Creditors} \quad \frac{\text{Trade Creditors}}{\text{Trade Purchases}}
\]

and the average number of days for which credit is enjoyed can be calculated as:

\[
365 \times \frac{\text{Total purchases}}{\text{Trade creditors}}
\]

Trade creditors may be taken on average basis, but to avoid the effect of year-end adjustments, it is better that a mid-year figure is taken. Further, the published figure will almost always include disputed liabilities, or liabilities long outstanding and no longer payable. These must be taken out from the figure of creditors.

The number-of-days-credit-enjoyed can be easily compared with the industry norm, that is, the prevailing terms of payment in the industry. A lower of days is not always desirable, as any prudent finance manager will always like to enjoy interest free credit to the extent possible unless he can get a better bargain by paying in cash. But where the credit period is higher than the industry average it must usually occasion an enquiry as to whether the firm has really followed a bad payment policy. That may be financially good for the company, but not certainly so for the lessor.
(k) Debtors Ratio

Similar to creditors ratio, one might also find out the average credit allowed to customers by calculating the debtors-turnover ratio, or the number of days credit allowed to customers as follows:

$$\frac{365 \times \text{Trade Sales}}{\text{Average Trade Receivables}}$$

Here again, a more reasonable ratio can be obtained only after weeding out the bad or doubtful debts, or debts which are long outstanding. The ratio will indicate how prompt the company is in collecting its debts.

(l) Working Capital Ratio

The working capital ratio establishes the relation between capital and sales, and is helpful in projecting how much a working capital will be needed to attain a particular level of sales anticipated. The ratio is computed as follows:

$$\frac{\text{Working capital, i.e., (Current assets - Current liabilities)}}{\text{Sales}}$$

Computation of the ratio is important for judging the sanctity of future projections, as many an ambitious expansion plan gets crippled due to working capital shortage.

(m) Net Return Ratio

Net return ratio or 'return on equity' (ROE) indicates what are the earnings on the shareholders' funds. As a tool for financial analysis, this is more important for the investor than the lender. It is calculated as under:

$$\frac{\text{Profit before tax}}{\text{Equity + Reserves}}$$
There is also a convention to the projects after tax for computing the ROE. From the point of view of an investing, this ratio is more meaningful.

The equity and reserves may be taken at their opening balances, but a more accurate picture will be had on the basis of average equity and reserves. A rough estimation of the average will be to add the equity and the reserves at the beginning of the year and those at the end of the year and divide the sum by two, assuming that the profits earned during the year were more or less at a uniform rate. In case there has been a share issue during the year, the exact time at which the proceeds of the issue were available to the company may be calculated and the average may be arrived at by giving appropriate weightages based on the number of months before and after the issue. Reserves would mean retained profits of the company. Capital reserves, such as subsidies, revaluation reserves, etc., do not represent retained profits, and so, should not be taken into account.

(n) Return on Assets

Return on assets or return on investments (ROI) is a similar ratio, but the rate being computed here is not only on the shareholders' funds but on all long-term funds employed by the company. This is a more realistic estimate of the company's ability to earn on the funds employed, because shareholders' returns are also affected by leverage. The profits to be reckoned for the purpose of ROI have naturally to be profits before interest. Since leasing is also a type of long-term funding source, in all fairness, the lease finance enjoyed by the company should be taken as a part of the funds employed and
the profits should be taken as before lease rentals. The calculation, therefore, will be as follows:

\[
\text{Profits before interest, lease rentals and taxes} = \frac{\text{Shareholders’ funds + Long-term borrowings + Lease finance}}{2}
\]

If the funds employed are to be taken as an average of the funds used for the year, as they should be, then, unless a more accurate estimate is possible by having monthly figures, etc., the opening and closing balances of the funds employed might be added and divided by two.

**Interest Coverage/ Lease Rental Coverage**

This is a ratio important for a lender, as it measures how many times the profits earned by the company are sufficient to pay the interest. This is a type of sensitivity measure, as it indicates the safety margin available. Say, if the earnings were four times the interest burden, that would mean that even if the company were to earn 75 per cent less than what it is earning today, it will still be able to pay the interest. The ratio is computed as follows:

\[
\text{Interest coverage} = \frac{\text{Earnings before interest and taxes}}{\text{Interest payable on loans}}
\]

A leasing company may want to make a similar computation as follows:

\[
\text{Lease rental coverage} = \frac{\text{Earnings after interest but before lease rentals}}{\text{Annual lease rentals}}
\]

**Earnings Per Share**

An earnings per share (EPS) is useful for investors. The EPS is the total earnings of the company divided by the number of shares, that is,

\[
\text{EPS} = \frac{\text{Profits after tax and after preference dividend}}{\text{No. of Equity Shares issued}}
\]
The ESP is used to find the fair value of a share by capitalising the earnings at an appropriate rate.

**Price/Earnings Ratio**

An investor will normally not look at just the earnings per share but also at the prevailing market price, because he would be able to buy the share only at that price. The price/earnings ratio, therefore, computes what are the earnings per rupee of the market price, or earnings per cent of market price. Hence, it may be computed as follows:

\[
\text{Earnings per share} \quad \overset{\text{-----------------------------}}{\times} \quad 100 \\
\text{Market price of share}
\]

It may well be computed in a reverse way, that is

\[
\text{Market Price} \quad \overset{\text{--------------------------------------}}{=} \\
\text{Earnings per share}
\]

which indicates what is the rate at which the market is capitalising the earnings per share.

**Dividend Yield**

Computation of the P/E ratio is not sufficient for an investor—he has to see the dividend being distributed as a percentage of the price, that is what the investor immediately gets on his investment. This is computed as follows:

\[
\text{Dividend per share} \times 100 \\
\text{Market price per share}
\]
Dividend Cover

Like interest or lease rentals cover, dividend cover also measures the sensitivity of the company's dividend paying capacity. It measures at what extent can the earnings fall still enabling the company to pay the present rate of dividends. The earnings here may be taken as earnings after the statutory transfer to reserves which any company wanting to declare a dividend of 10 per cent or more has to make. It is, thus, arrived at as follows:

\[
\text{Earnings per share after statutory transfer to reserves} \div \text{Dividend per Share}
\]

(B) Trend Analysis

Most of the ratios except some by themselves mean little. Their appropriateness or otherwise has to be seen by comparing them. The comparison may take two forms- intra-firm comparison, that is, review of the trend of the ratios over the years within the firm, and inter-firm comparison, that is, comparing the ratios with an industry average, or with those of a representative firm from within the industry. The trend analysis may even be related to absolute figures, such as growth in rates, net worth, etc.

The first question one is confronted with in trend analysis is the number of years to compare. Obviously, the trend becomes more clear with a longer number of years, but at the same time, that involves a lot of effort. If the resources available may permit that conveniently, for example, where a database is maintained, one may like to see the trend over as many years as possible. Otherwise, the number of years may fairly be large so as to indicate a trend- say, 5 years. It may be too cumbersome for the client to prepare the
ratios for 5 years and give it to the leasing company. So the lessor may just ask the client to supply the annual reports and do the calculations himself.

Unusual years, for example, a year which was affected by a major lock-out or a year where there was a general recession, etc., may be excluded from trend analysis. Similarly, other material changes in course of the year may be kept care of. The trend analyst, however, should not jump to conclusions just by looking at a particular behaviour of the ratios. He must enquire of the client and others knowing about the industry as to whether the particular behaviour of the ratios was just a temporary phase or is indicative of the direction in which the firm is moving.

Inter-firm Analysis

One of the most important uses of the ratios is for inter-firm comparison. The comparison must ideally be with the industry averages, which may be computed by taking average of the ratios of representative firms within the industry, or with the ratios of one or two representative firms. The industry averages usually are not readily available in India, but a leasing company in its own interest may do a little exercise and compute such rough averages which serve as a data-base.

When it comes to brass-tacks, inter-firm comparison may not be easy for a number of reasons. Firstly, many of the modern corporations are conglomerates engaged in diverse industries under one organisation. It is, therefore, not possible to apply any particular industry norm to these cases. The only solution possible is to obtain a break-up of the published financial figures as related to the different activities carried on (such sectional balance-sheets are also prepared for income-tax purposes, say, for claiming export
benefit of section 80-I benefits, etc.), and thereafter compute ratios for each type of business separately. The other possible solution is to compare the firm's ratios with a weighted average of the several industries in which the firm is engaged, the weightages being worked out on the basis of gross turnover of a more reasonable basis for a particular ratio of the company in each of these lines. The second difficulty is that the so-called industry average is only a myth because each of the firms in the industry has unique features of its own in terms of its business policy, client base, quality, size, etc. The stock-turnover ratio of a large-sized firm cannot be compared with a small-scale industry engaged in the same line, and so on. The solution to this problem is only to be worked-out by the analyst by just not dogmatically relying on the industry averages, but where necessary, looking at firm's special features, and then identifying a suitable yardstick to compare them with.

(C) Reading of Notes to Accounts & Other Information

No study of accounts is complete without critically examining the figures contained in them. It has to remembered that preparation of annual accounts is like posing before the camera, where one tries to make oneself as showy as possible. Similarly, the management knows too well who are going to be the readers of the annual accounts and what they going to lock for in the accounts. So, almost in all cases, every management tries to dress-up the accounts to give the best pose possible. Thus, various accounting policies are chosen, some acceptable, others not. All this need not reduce the reliability of the published accounts, because a careful analyst will be able to gauge the extent of fudging done by reading through the notes. Apart from the main body of the profit and loss account and the balance-sheet, an analyst may get
a wealth of information about a company from the other data available in the
Annual Report. These inter alia include notes to accounts, Director's Report,
Auditor's Report, and other data published in the Annual Report. These are
briefly appraised herewith.

i) Notes to Accounts

Basically, notes to accounts are supposed to give supplementary
disclosures, notes on accounting policy explanations to certain figures
contained in the accounts, and certain additional disclosures required by
Schedule VI of the Companies Act, 1956. However, as a matter of tradition,
the notes to accounts have assumed quaificatory character as whatever
remarks the auditors would like to give in their report are added in the notes
and the audit report merely makes a reference to these notes. A reading of
notes to accounts is, therefore, extremely necessary. Let us take some of the
issues connected with these notes one by one.

a) Accounting Policy and Changes therein

Some of the accounting policies which have a major impact on the
figures below the line are policies in respect of depreciation, valuation of
inventory, capitalisation of expenses, provisions for sunk investments or debts
etc. An analyst may take it as a matter of concern for him when the company
changes any of the accounting policies and tries to inflate profits or
performance. In the Indian context, although the best of the companies lay
play with accounting policies, which is what led to introduction of section 115J
in the Income-tax Act, but where a change in accounting policy is
accompanied by fall in turnover or decline in profitability ignoring the
accounting change, that may be sure sign of an internal weakness.
Depreciation

An Indian company might provide depreciation either on the straight-line method (SLM) or on the written down values (WDVM). Earlier, both these rates were dependent on Income-tax rates, but now, the rates of depreciation for accounting purposes have been de-linked from the Income-tax rates. As such depreciation in books may now be provided as per the rates given in schedule XIV of the Companies Act 1956. A company may choose either of the SL or WDV methods, but there has to be a well-defined philosophy behind such choice. A fundamental principle of accounting is matching of costs and revenues according to which the pattern of depreciation must match the pattern of the likely cash flows from the asset. If the cash-flows follow a declining pattern, as would mostly be the case, particularly in case of fast depleting items, WDV is undoubtedly a better method of reckoning depreciation.

Straight-line method is appropriate only for the assets which have a fairly long life and remain in almost equal working order throughout their effective life. Earlier, some of the companies used not to provide depreciation on extra-shift working but that has now been put beyond acceptance by Schedule XIV of the Companies Act, 1956. One must never be inclined to believe in write-back of excess depreciation provided earlier, when a switch-over in accounting policy is made. That is the best an accounting policy is made. That is at the best an accounting profit only, and in way affects the health of the firm. Hefty reserves that have been created earlier on account of under provision of depreciation should be eliminated in all financial analysis.
• **Valuation of Inventory**

Inventory must be valued at cost or estimated realisable value, whichever is less, and cost may be reckoned on the several bases possible, such as FIFO (first in, first out), LIFO (last in first out), average price, etc. The Institute of Chartered Accountants of India (ICAI) in Accountant Standard No. 2 on Valuation of Inventories has permitted either of these three methods to be followed to determine the cost of inventory in hand. But a switch-over from over of the methods to the other may cause a substantial effect on the accounts. For example, if in a period of rising prices; a company were to change from LIFO to FIFO method, that would book heavy profits because the inventory will be valued at the last prevailing price.

• **Capitalisation of Expenses**

Till recently, there was a curious accounting practice prevalent in India of capitalising interest on borrowing even after the production commenced. this was based on the ruling of a High Court in tax matters. This had led to large and reputed companies producing completely distorted figure of assets, depreciation, profits and interest. Fortunately, the tax ruling given by the High Court had already but overridden by subsequent amendments in the Income-tax law. But in some of the cases, that accounting practice is still being adopted, or at least the effect in the reserves being shown in the books of account is still there. There are clear opinions of the ICAI in this regard that interest can be capitalised in case of a new project only for the period prior to commercial production. In case of an on-going project, there is no question of capitalisation of interest or other expenses.
• **Sunk Investments etc.**

Some of the accounts receivables might have become bad or almost bad but may not have been provided for. The Notes to Accounts will often give information about such debts. The profits must always be read after writing-off such debts, whatever the management might feel about their recoverability. Similar sunken monies are often buried in loans and advances. The head 'Advances Recoverable in Cash or in a kind or for Value to be Adjusted' is often used as succour for hiding such sunk accounts. An analyst should detail of such advances and where the loanees are companies within the house, a copy of the balance-sheet of that company might also be obtained to see if the money is good. Similarly, unquoted investments and investments in subsidiary companies must not be taken at their face value. If the amount is substantial, effort must be made to value the investments.

Apart from the above, there are practices like accounting for expenses on cash basis, non-provision for disputed statutory liabilities, etc., which disguise the true strength or weakness of a company. A welcome step here is the new provision in section 209 of the Companies Act which provides that companies shall maintain accounts on accrual basis which term means that the accounts must conform to generally accepted principles of accrual-based accounting. As a weak management attempts to disguise the weaknesses of the company, many a good management may often try to disguise the strength of the company by reducing the profits. This could be attributed to various reasons like reduction of tax-liability under section 115 J. This is particularly so in case of closely-held companies. In such cases also, the analyst must be guided by the real strength of the company. It may be
mentioned that one or more the policy-distortions as mentioned supra may be 
used to reduce the profits as they are used to dress-up the balance sheet.

b) Quantitative and Other Information

Quantitative information is relevant for several purposes. This includes
(i) Break-up of quantity and value of all major raw materials consumed; (ii) 
Quantitative and value-wise break-up of stocks, turnover and purchases; (iii) 
For each item of goods produced, licensed capacity, installed capacity, and 
actual production. This will enable the analyst to get highly significant 
indications about the extent of use of installed capacity and the trend therein,
composition of raw materials so that the effect of the supply or price position 
of the key raw materials on the company's production may be projected, etc.
Apart from these, the balance-sheet shall also indicate the CIF value of 
imports made for raw materials, components and spare parts and capital 
goods. This again will give a very significant pointer to the import-dependence 
of the project. The projects which depend heavily on imports are susceptible 
to uncertainty on account of factors like duty changes, policy changes, 
exchange-rates changes, political conditions etc.

C) The Director’s Report

The Director's report can be helpful to the analyst in enabling him to 
have an overall picture of the state of affairs pervading the company. This can 
provide him a broad view about as to how did the company broadly fare 
during the year; what are the difficulties faced, if any; what are the future 
plans and prospects; how were the labour relations during the year; etc. Some 
of the reports give a fairly useful picture of the performance of various 
divisions of the company also. The summary information given in the
Director’s Report may be a starting point for the financial analyst, because he may probe into the various minute details after having a myopic view of the company’s affairs.

d) The Auditor’s Report

Unfortunately, due to the standard formats of audit reports prescribed, these reports hardly give what they should have given to the financial analyst. The audit reports are mostly technically worded, stereotyped and hardly give any information. However, it may be worthwhile to read the auditor’s comments on the internal control system, purchase of materials, etc., from related parties, delays in depositing provident fund dues and compliance with public deposit rules. The analyst must always insist on getting the latest audited report for the purposes of his analysis. If the audited accounts pertain to a period quite in the past, a provisional set of reports for the interim period may be asked. There is no harm in taking figures from provisional accounts—figures such as turnover, loans taken, etc., will remain mostly unchanged in provisional and audited accounts. But where the company is in arrears in accounting work, and has not prepared a balance-sheet that must have been laid before the AGM as per law, this must always give a negative point to the company, because prompt accounting is one of the many pre-requisites of efficient conduct of business.

Fixation of Credit Terms

The consummation of all the analyses and enquiries done, as appraised supra, lies in the credit decision. The first decision point of course, has to be yes or no, and if yes, the significant question to be decided is—how much, and for what period, the extent of exposure, that is, answer to 'how
much' has to depend on the client's requirements. But the credit manager has to carefully see if the client has not over-estimated or over-stated his requirements. The danger of over-estimation is always there unless the client fully well understands that what he is taking from the leasing company has got to be repaid along with interest. But the psychological illusion that the client does not have to pay for the asset leads many people to over-estimate their requirements. Further, the competitive bids taken by the client from the asset-suppliers must be seen. If the supplier is not too well-known an organisation, the supplier must always be taken into confidence to check spin-offs, which flow more often than usually realised.

Having estimated the client's real requirements, the analyst must see the repayment capacity of the client based upon his conservatively prepared cash projections. A margin of safety must always be maintained, and if the cash-flows are not sufficient to pay the lease rentals, the exposure must be curtailed. It is always the wise policy for the lessor to lay his eggs in different baskets, and so, diversify by placing limited exposures in different clients and different industries.

The question of 'how long' is one of the most crucial decisions to be made. Coming as it did from Western countries, the Indian leasing industry has started with a model lease period of 5 years, which, perhaps covers at least 75 per cent of the leases signed in the country. But there is no reason to accept five years as the standard lease period. In fact, there must not be any 'standard' period as such and the term of the lease must be decided in each case on the repayment capability and the risk-sensitivity of the case. The popular myth must be exploded that the lease term is a determinate of the tax
rate of depreciation or the rate of obsolescence of the asset. It is a
determinate of nothing except the risk involved in the deal. The tax rate plays
no role at all, because, under the new scheme of depreciation, whatever be
the resale value of the asset, there shall be no claim for the terminal
depreciation, and so, the question of WDV exceeding the terminal sale price
does not arise. The rate of obsolescence of the asset, of course, may tend to
limit the lease period. Thus, the period cannot be more than the economic life
of the asset, but the theory can never operate in the other direction.

The maximum every businessman understands by basic institution is-
the higher the pay-back period, the more the risk. So a longer lease period
means looking more down the road, and into unforeseeable future. Therefore,
if at all long-term leases have to be signed, the risk may be traded-off for
profitability and the lessor must look for a higher rate of return.

Securing

There is no ground for the popular notion that since the leased asset
belongs to the lessor, the lessor must not look for securities. A security is not
essential, but still desirable, and to the extent possible, the lessor must have
himself secured. This is more so when the company is new, or does not have
an established track record. In case of a house-managed or family-managed
organisation, personal guarantee of one of the people from the family must be
taken almost as a rule because the organisational entity in such cases is only
a myth. In case of new ventures or individuals, third party guarantee must also
be sought. The lessee's obligations may also be secured by a charge on the
assets of the lessee, apart from the leased asset, which, of course, belongs to
the lessor. In such a case, certain notable points are as follows:
• The assets may be inspected as to whether any charges are already created on it – by inspecting the charges registered at the Registry offices;
• The security must not be immovable, otherwise the charge has to be created by a registered conveyance;
• Even otherwise, the security must be easily movable and of general purpose, so that it may readily be removed and liquidated.

No security can be more valuable to the lessor than the cash-down or liquid security by way of a deposit. In the event of a lessee fails to pay the rentals and the lessor seizes the asset, the asset might in all eventuality actually yield less than the lessor's outstanding investment. Then the lessor can look to the security deposit. This deposit will also act as a deterrent for the lessee in failing to meet his obligations. Unfortunately, the leasing industry in India does not seem to have a tradition for such deposits, but the bankers, hire-purchase financiers, etc., have all realised in course of their experience that it is always proper to have the lessee invest in a part of the asset cost.

After-lease Monitoring

Leasing and lending are typical cases where the real problems begin only after a lease deal is signed. It is a continuing relationship which has to be maintained for the lease period, and the lessor has to keep a regular watch on the client as to how he is behaving. Speaking of banks, Donaldson says, "Banks rarely lose their money solely because the initial decision to lend was wrong. Even where there are greater risks than the banks recognised, they only cause a loss after giving warning signs. More banks lose money because
they do not monitor their borrowers properly, and fail to recognise warnings early enough, than for almost any other reason ".2 (Donaldson, 1986. p. 7.).

Here the leasing company will be in a slightly difficult position than the banks because the banker may terminate the loan and may get back his money. But a lessor, if he terminates the lease, gets back the asset only, which he may not find worthy of his investments, apart from the fact that unless the lease agreement empowers the lessor to do so on the basis of an anticipated failure, the lessor even cannot terminate the hiring without the actual, rather than apprehended, act of default. So the monitoring is significant only- (a) to prevent further exposure in the same client, for which he always approach if he is running into difficulties; (b) to put pressures on the lessee to secure that the forthcoming payments are made regularly; (c) to conduct regular inspections to see that the asset is properly maintained; (d) for lending management support, if necessary, to the lessee so that the problem can be overcome, etc.

Monitoring, therefore, is not entirely impertinent for a leasing company. The very concept of monitoring is to keep a regular watch on all the clients irrespective of whether they are performing good or bad. The prime purpose of monitoring is to identify weakness, not just to shut the stable door after the horse has run away. All financiers naturally watch companies in difficulty, but the main need is to review all the lessees and highlight early names of those whose quality is deteriorating. For regular monitoring, what is required is to have a regular flow of information. The bankers have realised the great significance of information and ask regular returns from their borrowers.

2 Donaldson
Leasing companies may not like to burden their clients with periodical returns, because it is where they say they are different from their banking brethren, but regular watch is nevertheless important. Whether the client is asked to give periodical accounts or whether the lessor himself sends his people to enquire about periodic performance of the lessees is a matter to be decided by the lessor. But the popular confusion needs to be shed that the lessee will be unduly burdened when asked to submit periodic information. In the age of information technology, most of the businessmen do prepare interim reports, or may very easily do so, and their reluctance to share the same with the lessor may only be because the lessor has himself not taken the requirement seriously.

Collection and Follow-up

The lessor must always be prompt in ensuring collection. A lousy collection machinery might even take a good client as bad. Secondly, timely collection of lease rentals is financially so important for the lessor because his intrinsic profitability depends on the projected cash-inflows being realised at proper time and re-invested immediately. C.P. De'Silva of Sri Lanka's Orient Leasing Company has offered following practical suggestions in this regard:

i) In all instances we try to obtain a Bank Standing Order from the client instructing his bank to make the monthly lease rental payments to us on the due dates. This is much safer from our viewpoint than to await prompt monthly payments direct from the client. Any delays on Bank Standing Orders are an unmistakable early warning of severe liquidity problems.

ii) When a rental becomes overdue it is essential to take speedy action. This is because the more over due an account becomes, the more difficult it is to restore it to its original current status. another reason is that when a debtor starts having liquidity problems he is likely to pay the creditor that puts the most pressure on him. It, therefore, pays to create fuss far in excess of what is warranted, the first time lessee falls into arrears.
iii) The first step is a telephone call in two days of the account becoming overdue.

iv) If this does not work, a polite letter must be written within a week of the account becoming overdue.

v) If this does not work, a second firmer letter should be written within another week.

vi) If this does not work, a marketing executive should visit the customer and go in-depth into his problem.

vii) If we find that there is a short term liquidity problem which the customer is confident will be corrected soon, we insist on a post-dated cheque, which he would find difficult to refuse if his confidence is genuine. I appreciate that the issuance of post-dated cheques may not be legal in some countries.

viii) If liquidity problem is longer term one, and we are satisfied that the situation will be eventually corrected, we could consider rescheduling the lease to give him relief.

ix) If we come to the conclusion that the customer is playing games, and is trifling with us, we threaten him with legal action.

x) If this threat proves ineffective, we inform the guarantors (if any) in writing, that we shall be having recourse to them.

xi) If all these steps fail, we send the customer a legal letter of Demand. We have found that this proves unusually effective. A letter from a lawyer has a psychological impact on all but the most hardened defaulters.

xii) If the letter of demand has had no effect, we take action to seize the asset if it is seizable.

xiii) If the asset cannot be seized, and all steps taken so far have failed we decide whether we should go to arbitration or to courts. Under our lease agreements we have the right to make that choice. Where we have the security of mortgages we go to courts, and in all other cases we would prefer arbitration because it is speedier.

CONCLUSION

It emerges from the foregoing analysis of the borrower's assessment that a borrower's assessment or creditworthiness of a borrower or the lessee is very akin to of credit evaluation. The concept of credit evaluation in leasing industry entails mechanism for fixing credit policies and procedures, etc. Client, bank references, trade references, credit rating agencies, company financial reports, media reports, stock market opinion etc., are the principal
sources of credit information. These are advantageous in evaluating the credit-worthiness of the lessee. Related aspects like the types of information sought from the antecedents of the company, analysis of the financial information, reading of notes to accounts and other information, fixing the credit terms, securing the lease, after-lease monitoring, collection and subsequent follow-up etc., are also significant factors that have been examined in the present chapter.

It is revealed that while fixing its credit policies, a company has to consider options like operating in the total risk-free areas or in little riskier areas, its exposure in different regions and the level of its exposure in different industries. A good credit procedure is less time consuming, devoid of redundant information and flexible. Collective scrutiny of credit proposals is regarded as a convenient via media for credit evaluation. It is observed from the above analysis that among the various sources of credit information, client is the most important source of primary information. Lessee's bank references are useful in ascertaining his or company's general financial health. Trade references acquired from company's customers and suppliers enable to get an idea of prospective client company's payment policies and general financial health.

An inquiry with prospective lessee's business rivals can also be helpful in eliciting information about the client. Besides, credit rating agencies (CRAs) too provide information about a company's financial standing in the market because the CRAs usually compile information about the companies spanning over years. It becomes discernible that yearbooks published by stockexchanges, business publishers and specialised agencies serve as good
source of information on companies seeking credit. The information culled from companies' financial reports, press reports, stock market opinions and Registrar of Companies etc., is equally useful in discerning the financial status of prospective client company seeking credit.

It becomes apparent from the above appraisal that the information being sought about the prospective client should include antecedents of the company and its promoters, particulars of the projects being handled, details about financial transactions, dividend and tax payments, company's major suppliers and customers, relations with the workforce, qualitative information about management, past experiences of lenders, inter-corporate depositors, fellow lessors, and prospective client company's own past borrowing records etc. Different methods used in analysing the financial information culled from a company's annual reports for various years have also been examined in this chapter. These methods *inter alia* include ration analysis of balance sheet and profit and loss accounts, lending ratios, liability ratios, asset ratios, debtors/creditors ratios, current ratio, liquid and gross profit ratio, net profit ratio, expenditure to sale ratio, stock turnover rate, etc.

The above-mentioned appraisal presents methods of calculating various ratios viz., stock turnover ratio, creditors ratio, debtors ratio, working capital ratio, let return ratio, return on assets, interest coverage, price/earnings ratio, dividend yield and dividend cover etc. While laying emphasis on financial information analysis through different methods prescribed therein in the chapter, the analysis stresses on going through notes to accounts appended to the balance sheet, accounting policies in respect of depreciation, valuation of inventory, capitalisation of expenses, provisions for sunk
investments or debts etc. The quantitative information comprising break-up of quantity and value of all major raw materials used, quantitative and value-wise break-up of stocks, turnover and purchases, licensed and installed capacity and actual production is of immense importance. It is further observed that Director's report is a profitable source of information about a company's financial status. Of equal significance is the auditor's report that provides helpful insights into financial dealings of a company.

The noteworthy aspect of fixation of credit terms is to ascertain client's requirements in terms of quantum and period for which credit is required. It is equally important to know the repayment capacity of the client. Emphasis is laid on after-lease monitoring the by ensuring regular payment of instalments, conducting regular inspection of asset's maintenance and to extend management support to the lessee to help the latter to overcome any difficulty being confronted by him in running or maintenance of the asset.