CHAPTER – V

SHORT TERM FINANCIAL STRENGTH

The short term financial strength refers to the ability to meet short term obligations, the short term obligations or current liabilities are those debts which are usually payable within a year. The necessity of analysing the short term financial strength arises from the fact that lack of liquidity affects creditors’ confidence, credit rating and in severe circumstances may cause liquidation of the company. On the other hand, excessive liquidity should also be avoided as it impairs the firm’s profitability. Therefore, the firm should avoid from both lack of liquidity as well as excessive liquidity.

For analysing the short term financial strength of SAIL following ratios have been used:

1. Current Ratio
2. Quick Ratio
3. Cash Ratio
1. Current Ratio

Current ratio indicates how much rupees of current assets are available for each rupee of current liability. The ratio is calculated by dividing current assets by current liabilities.

\[
\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}
\]

This ratio shows the margin of safety available to the creditors. Higher the ratio, greater the margin of safety to the creditors. A too high ratio may be desirable from the creditors' point of view but is not beneficial for the firms because a very high current ratio might be the result of excessive inventory or poor credit management in the form of overextended debtors.

Normally, the current ratio of 2:1 is considered satisfactory i.e. the current assets should be doubled the current liabilities. The basic philosophy of 2:1 is that if the current assets are reduced to half then also the payment can be made to the creditors in full.

The current ratio is a quantitative concept not a qualitative one because it does not show the composition of the current assets. A firm having current assets mainly in cash
and short term investments while another firm’s current assets consist of mainly inventory then both the firms may have the same current ratio but there is a sea difference between the liquidity position of the two firms.

2. Quick Ratio

Quick ratio is a more stringent test of liquidity because it indicates the relationship between quick assets and current liabilities. Quick assets are those current assets that can be converted into cash immediately or within reasonable time. According to Van Horne, “The ratio concentrates on cash, marketable securities and receivables in relation to current obligations and thus, provides a more penetrating measure of liquidity than does the current ratio.”

\[
\text{Quick Ratio} = \frac{\text{Cash} + \text{Marketable Securities} + \text{Debtors}}{\text{Current Liabilities}}
\]

"Inventory is not included in the list of quick assets because it must be sold first before it can be converted into cash. Since only cash, debtors after providing for bad and doubtful debts and short term investments are included in the list of quick assets, therefore, the danger of loss on realisation of assets is less and one to one ratio is indeed a very important index of
the short term solvency position\(^2\)." The ideal norm of this ratio is 1:1. As remarked by John N. Myer, "One-to-one quick or acid test ratio is supposed to be the indicator of the satisfactory liquid position of a business enterprise\(^3\)."

3. Cash Ratio

Cash ratio is the most severe test of the short term financial strength because this ratio considers the most liquid assets for meeting the short term obligations, that is, cash and marketable securities which can readily be converted into cash. The ratio is calculated as:

\[
\text{Cash Ratio} = \frac{\text{Cash} + \text{Marketable Securities}}{\text{Current Liabilities}}
\]

Table 5.1 on the next page shows the current ratio, quick ratio and cash ratio of SAIL and Tata Steel from 1999-00 to 2005-06.

From the table it is apparent that the liquidity position of Tata Steel was better than SAIL in the first four years 1999-00 to 2002-03 though current ratio of both the firms was below the norm of 2:1 but the acid test ratio of 1.14, 1.10, 1.03 and 0.93 of Tata Steel was quite higher than SAIL’s quick ratio of 0.72, 0.73, 0.63 and 0.74 respectively. The quick ratio of
SAIL was far below the norm of 1:1. The SAIL as well as Tata Steel had very low cash ratio during this period.

Table 5.1

Current Ratio, Quick Ratio and Cash Ratio of SAIL and Tata Steel

from 1999-00 to 2005-06

(In Times)

<table>
<thead>
<tr>
<th>Years</th>
<th>SAIL</th>
<th>Tata Steel</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Current Ratio</td>
<td>Quick Ratio</td>
</tr>
<tr>
<td>1999-00</td>
<td>1.64</td>
<td>0.72</td>
</tr>
<tr>
<td>2000-01</td>
<td>1.59</td>
<td>0.73</td>
</tr>
<tr>
<td>2001-02</td>
<td>1.47</td>
<td>0.63</td>
</tr>
<tr>
<td>2002-03</td>
<td>1.52</td>
<td>0.74</td>
</tr>
<tr>
<td>2003-04</td>
<td>1.34</td>
<td>0.83</td>
</tr>
<tr>
<td>2004-05</td>
<td>2.15</td>
<td>1.51</td>
</tr>
<tr>
<td>2005-06</td>
<td>2.14</td>
<td>1.38</td>
</tr>
</tbody>
</table>

Source: Annual Reports of SAIL and Tata Steel from 1999-00 to 2005-06.

The reason for lower quick ratio of SAIL than Tata Steel during the period 1999-00 to 2002-03 is that SAIL had more funds in inventory in comparison to Tata Steel. There is not much difference between the current ratio of SAIL and Tata Steel in the years 1999-00, 2000-01 and 2001-02 but the acid test ratio of Tata Steel is quite higher than SAIL, this denotes
that SAIL had more funds invested in inventory in these years and in the year 2002-03 the difference between the current ratio and quick ratio of SAIL is 0.78 whereas in case of Tata Steel it is 0.43 thus SAIL had higher inventory level in this year too.

In the year 2003-04 the current ratio of 1.34 of SAIL was higher than 1.03 of Tata Steel and quick ratio of 0.83 too was more than 0.57 of Tata Steel. The SAIL had cash ratio of 0.34 while cash ratio of Tata Steel was 0.09. Thus, in this year, the short term solvency position of SAIL was better than Tata Steel but was not sound as the acid test ratio should be 1. The current ratio of 1.03 indicates that Tata Steel did not have even margin of safety for short term creditors.

In the last two years 2004-05 and 2005-06 the ability of SAIL to meet short term obligations was quite satisfactory. The current ratio was 2.15 and 2.14 while the quick ratio was as high as 1.51 and 1.38 and the cash ratio of 0.93 and 0.76 too suggests sound short term solvency position of SAIL. The firm had excessive liquidity in these two years. On the other hand, in case of Tata Steel the liquidity position was very
weak as the current ratio was as low as 1.10 and 1.11 while quick ratio was 0.60 and 0.54 respectively.

**CONCLUSION**

The comparison of short term solvency position of SAIL with Tata Steel during the period 1999-00 to 2005-06 reveals that short term financial strength of Tata Steel was better than SAIL in the first four years of the study period i.e. 1999-00 to 2002-03. In these years the current ratio of SAIL as well as Tata Steel had been below the norm of 2:1 but the acid test ratio of Tata Steel was much higher than SAIL.

In the year 2003-04 the SAIL had better ability to meet short term obligations in comparison to Tata Steel. The current ratio as well as quick ratio of SAIL were 1.34 and 0.83 as against 1.03 and 0.57 of Tata Steel.

The liquidity position of SAIL was far better than Tata Steel in the last two years 2004-05 and 2005-06. The current ratio as well as quick ratio of SAIL were above the norm of 2:1 and 1:1 while in the case of Tata Steel the current ratio was 1.10 and 1.11 and quick ratio was 0.60 and 0.54 respectively.
Thus, out of the seven years under study 1999-00 to 2005-06, only in the last three years 2003-04 to 2005-06 the short term financial strength of SAIL was better than Tata Steel.
REFERENCES

