CHAPTER VI

SUMMARY AND CONCLUSION

6.1 INTRODUCTION

The economic reform and privatization of companies have led to a great differentiation in the performance of individual companies. These differences have been increasing over time. The above study has analysed the factors, which are primarily responsible for sickness or corporate bankruptcy. The study has also analysed the distress prediction models developed in various countries. Based on the sample collected a new distress prediction model has been developed applicable to Indian environment. This is not only useful for the lending institutions but also to the investing public and other related industrial suppliers. The present study is important for the reason that it is the first ever distress prediction model developed in India with a large sample of 579 listed companies.

6.2 GROWING LEVEL OF INDUSTRIAL SICKNESS IN INDIA

With the launching of the new economic policy during the nineties, the protective barriers for the Indian industry started getting dismantled one by one. The average annual
growth rate of the industrial sector including mining, manufacturing and electricity
generation slumped to 0.6 per cent in 1990-91 as a short-term response to the reform
process. However, in a few years the overall rate of industrial growth gradually recovered.
It increased from 2.3 per cent in 1992-93 to 6.0 per cent in 1993-94, 9.4 per cent in
1994-95 and 12.1 per cent in 1995-96. Since 1996-97, however, there was a decline in
the growth rate of industrial production and it is less than 5 per cent during the financial

6.2.1 Identification of distress and development of sickness prediction model

There are three possible reasons why the firm can go into sickness. The first one,
extoclassical, is a result of a state when the allocation of assets is inappropriate. The
assets are usually industry specific and the bankruptcy is a mean of their re-allocation.
Within the neoclassical approach, the bankruptcy procedures are the inevitable way to
allocate resources efficiently. In this case the amount and size of distressed firms can give
a first insight on the speed of restructuring. This is the typical approach in the transition
literature to the bankruptcy as restructuring wheels.

The second reason for bankruptcy might be just financial. The firm has the right
structure of assets but its financial structure is bad with liquidity constraints. This means
that even if the firm is viable in the long run it has to go bankrupt in the short run. The
link with imperfection of capital market and inherited capital structure is the main driving
force in these cases. We cannot unambiguously determine whether the bankruptcy is good
or bad for the restructuring in this case. The last reason of bankruptcy might be that the
firm has the proper asset and financial structure but a bad management. The inefficiency is then driving the firm out of the market as a consequence of unsolved problems in corporate governance. Instead of wasting time till the net worth is eroded above fifty percent as required in the act, the owner just should fire the managers. Therefore, the state of sickness is definitely bad not only from the point of restructuring but even harmful from the point of social welfare. All these three issues and basic causes of distress or sickness are addressed with a competing specification in the empirical section. On the macroeconomic level we cannot distinguish these three states leading to the bankruptcy, the state of Chapter 11 or compulsory reference to BIFR. In this light, this study was carried out and the final conclusion was drawn. The present study has identified the potential sickness prediction variables and an appropriate strategy for restructuring has been offered.

6.3 SUMMARY OF FINDINGS

Since industries are an integral part of a nation’s economy, in a dynamic set up industrial units which are non-competitive, uneconomical and inefficient become sick and die out, as new and more efficient units come up to take their place. This process takes place in a cycle as a sequence of economic restructuring. The early stages of sickness can be detected if the signals which originate in the areas of financial, technical, and operational of an industrial unit are carefully noted and catalogued. It can be attempted through a process of monitoring the financial status of the firm in respect of working capital, cash losses, and erosion of net worth. Rehabilitation is possible if sickness is
reported at its incipient stage and not at the terminal stage. The criterion of distress has to be changed from negative net worth to an internationally acceptable yardstick of non-payment of debt dues. As Omkar Goswamy points out, all over the world, bankruptcy is defined in terms of debt default. The Banks and FIs in India are required to treat their loans as NPAs when there is a debt default of more than 180 days. It is, therefore, time to redefine industrial sickness on the basis of default in repayment rather than in terms of erosion of net worth. There is a need for a new look at the whole approach of dealing with the problem of industrial sickness in the context of the process of the ongoing liberalisation and globalisation of the economy.

Indian regulations and institutional setup are found to be inadequate to deal with industrial sickness. Several committees setup by the government highlighted the need for a major change in the regulations and institutional setup. Recent developments are right in the direction. Now that new Act and new machinery are in place, it is necessary to enforce the provisions of the Act to speed the process of revival of sick units and bring the economic resources back to use.

MDA and Logit models show high level of success rate in predicting the sickness one year ahead of the actual sickness. Among the several variables, cash flow variable is found to be relevant. Working capital, net profit, sales, and cash flow to total assets are found to be significant indicators of imminent distress. At the earlier stages, earning before interest and tax has also been found to be an effective indicator. The liquidity ratio, working capital to total assets, is statistically the most significant ratios to failure risk. This
is consistent with past studies of financial distress across different research designs and time periods in that, as this ratio increases, failure risk decreases.

An analysis of three BIFR cases shows how the new agency can deal with corporate bankruptcy and restructuring. A simple analysis of ratios and comparing the same with industry or representative non-sick company can be used to select appropriate restructuring package. If the sick firm has good comparable asset turnover ratio, then restructuring package should focus on cost reduction like waiver of interest. If the sick firm has poor asset turnover ratio, but good operating profit margin, then the restructuring package need to focus on merging the unit with others. If the sick unit reports lower asset turnover ratio and also lower or negative profit margin, then it is desirable to wind up the firm.

6.4 SCOPES AND LIMITATION OF THE STUDY

The study has centered on the factors causing distress, bankruptcy, or sickness to the corporate sector more from the financial and administrative angle. The major problem in bankruptcy research to date is that the nature of the dependent variable, "failure", is not a well-defined dichotomy as it should be for the types of modeling techniques that have traditionally been used to analyse it, e.g. logit analysis or multiple discriminant analysis (MDA). Recent studies have identified the macro and micro economic factors also contribute significantly to this state of affair. This has not been dealt in this study due to the non-availability of relevant data and the reforms are also in the offing waiting for the government assent in this field. Another limitation is that for distress prediction analysis
only companies from private sector have been chosen though there are many public sector undertakings, which are reeling in sickness. Similarly, this study excludes Small Scall Industrial units.

6.5 POLICY IMPLICATIONS AND RECOMMENDATION

The study shows that Indian regulation on industrial sickness is substantially different from that of regulations followed in other countries. The focus of the regulation should be bringing back the economic resources in use instead of protecting the interest of the borrowers. The new regulation to an extent aims to achieve this but its enforcement is critical.

The Rehabilitation Agency should have a basic framework for the kind of rehabilitation package that can be offered to the sick units. Today, the agency appoints some consultants or the lead bank to prepare restructuring package and considerable amount of delay on account of non-acceptance of the package by related parties. Instead of giving such kind of open-end task to the consultants or lead bank, the implementing agency has to examine the cause for sickness and accordingly propose appropriate restructuring plan. Financial restructuring by the way of writing off loans and interest accrued can be allowed only if the company is showing good asset turnover ratio and profitability is affected mainly on account of high interest liability. Similarly, asset restructuring in the form of merger or divesture can be considered only when the firm reports operating profit but its asset turnover ratio is poor. No restructuring plan can be allowed if the firm reports poor asset turnover ratio and profit margin and such cases has to be wound up.
Banks and other lenders need to use sophisticated model for predicting industrial sickness and initiate the restructuring plans well in advance. Our analysis shows cash flow variable is an important one in predicting of industrial sickness. Banks should insist periodical cash flow statements, like quarterly cash flow statements and examine such statement closely.

The functions of the BIFR is now taken over by the company law tribunal. Under the new set-up, a sick company will be one that has seen a 50 per cent erosion of its net worth over the last two years. Sickness, is often considered on a “total corporate basis”, and restructuring needs to be effected when certain symptoms appear. It is absolutely necessary to incorporate a default-oriented definition of distress and voluntary references to the regulatory mechanism. A clear time bound restructuring or rehabilitation without any legal hurdle is suggested to over come this situation. Bebchuk and Chang (1992) prove that the debtor in possession reorganization, the greater the time taken in bankruptcy, the higher the probability of equity extracting unwarranted value.

In western countries like U.S.A, Britain and France legal procedures for recovery of debt are simple, and decrees are awarded and executed quickly. The Indian legal system needs a complete and result oriented approach from the present dragging, and frustrating attitude. It is practically impossible to liquidate unviable firms and not a single liquidation decision of BIFR has been actually implemented. Since India is constrained by the lack of liquidation processes, the threat of takeover can be imposed by converting debt to equity, there by giving debt-holder the option of exit through the capital market.
6.5.1 Notify the names of defaulters for general reference

A fundamental problem of our scheduled banks and financial institutions is that they do not keep minimal track of the credit-worthiness of the promoters. Therefore, it is suggested that, in the first instance, all financial institutions should create a common information pool about firms that have defaulted on term lending dues, and list the names of promoters of such firms. In addition, all scheduled commercial banks should prepare a similar list of irregularities in cash credit and working capital repayment. This list can be ranked according to risk—the frequency and magnitude of defaults, and should be updated every quarter. This database, with its promoter risk ratings, should be available to all financial institutions and scheduled banks, and ought to form a basis for making lending decisions and project risk appraisals. It will be useful to have an independent and reputable credit rating organization like CRISIL to take up this task. The credit risk of promoters should be clearly stated in the prospectus of every company issuing shares or debt instruments in the market.

6.5.2 encouraging takeover mode of restructuring and tax incentives

The present act may be amended in such a manner that it will encourage takeover of potentially viable sick companies. The rules should also facilitate fresh investors to takeover such companies. If it is generally agreed that getting foreign exchange and foreign equity is in India’s national interest, then getting such funds to revitalize hitherto dormant companies must likewise be in the national interest. Further tax incentives and tax holidays can be offered to encourage restructuring of distress corporate.
6.5.3 Promoters exit on reference to regulating authority

The debtor in possession reorganization must be dispensed with and an expert committee as in British administrator system should do the restructuring of companies referred as sick. Under this system the erstwhile promoters will have to quit once the company is brought under national company law tribunal for restructuring or liquidation. This will give a clear signal to the promoters that any mismanagement will be expensive for them. It is also suggested that if a company is unable to repay its debt obligations over a period, instead of referring to BIFR. Fore Closure Laws may be brought in. A debt recovery tribunal will certify that a company is bankruptcy.

6.5.4 Fixing responsibility for audit firms

The audit report of corporates which is a statutory obligation in many cases do not reflect any indication to the imminent corporate distress. This view was authenticated in research studies. They simply say whether the company is referred to BIFR as sick or not as per Sick Industries Companies Act.. Based on the study it is recommended that it should be made as mandatory on the part of the chartered accountants to give the early warning or distress predicting ratios, net cash flow changes, earning before interest and tax variations for each year and outstanding interest dues towards financial institutions and the end of each quarter should be mentioned in the audit report. It is suggested that the Corporate Audit Firm may be entrusted with a statutory obligation of highlighting the present and future trend in their audit report. Statutory declaration based on the financial
predictive ratios, which will be a beneficial for investors, lenders and suppliers. The probability of the firm falling into sickness due to increase in debt and interest commitments may be projected. Earning of these corporates are to be keenly monitored and warning should be given in advance to the investors and lenders.

### 6.5.5 Restructuring through Merger and Acquisition

All over the world, mergers and acquisitions are dominant routes of industrial and corporate restructuring. There are large-scale economies, marketing and organizational synergies in mergers, and these will be exploited to an optimum level. India can be no exception. In fact, the successes of BIFR have been the merger cases under section 17(2), and not those sanctioned under section 18(4) rehabilitation. Given the importance of mergers, agencies responsible for rehabilitation have to play a more facilitating and positive role.

Merger proposals that are endogenously designed and passed under section 17(2) of SICA must let all the benefits from sections 41(1), 72A, 79, and 115J of the Income Tax Act. High Stamp Duties are major barriers to amalgamation and the government may consider reduction of these rates to facilitate large-scale mergers and acquisitions. Merger proposals and acquisition are found to be the cost effective form of restructuring.

### 6.5.6 Formation of asset reconstruction companies

Asset reconstruction companies may be established for relieving the financial institutions and banks from the mounting non-performing assets. The concept is that an
asset reconstruction company may be created with adequate financial resources so that it can buy or refinance against the idle assets of these distressed companies. The lending institutions need not block their advances and remain uncertain about the recovery. The national rehabilitation fund can be created by contribution from existing profitable corporate sector and tax incentives may be extended for this contribution. This will go a long way in creating a corpus for the distressed corporate sector.

6.5.7 SPEEDY IMPLEMENTATION OF NATIONAL COMPANY LAW TRIBUNAL

Though it is overwhelmingly announced in 2001, by amending the Companies Act of 1956, that the National Company Law Tribunal will replace the existing Sick Industrial Companies Act and The Board For Industrial and Financial Reconstruction, in reality till 2003 September all references are being made only to the outdated SICA. These sick industries are not bothered either for an early revival or repayment of loans. Hence it is recommended that the new Act be implemented immediately so that the enormous investments blocked in these distressed industries may be used for productive purpose and the non viable may either sold to some healthy units or liquidated so that further erosion may be halted.

6.5.8 INTRODUCTION OF BANKRUPTCY LAW WITH CROSS BORDER PROVISIONS

Indian Bankruptcy Law may be drafted based on the US Bankruptcy Act to draw on the American experience of early restructuring programme. It should be made as mandatory on the part of a corporate to disclose all adverse developments that can affect its cash position and profitability well before it turns sick.
The various trigger points for corporate to refer to an authorised consultant could be recording an operating loss, failing to service loan interest, plummeting working capital, default to suppliers. The suggestions by the consultant may be carried out under the supervision of institution and banks. Even though the committee reports have been submitted for the introduction of a new Bankruptcy Law in India on par with International standards, it has not seem the light till now. It is now recommended the early introduction of an effective Bankruptcy Law in India.