APPRAISAL OF TERM LOANS

(Report of the Working Group on the Appraisal of Applications for Term Loans)

RESERVE BANK OF INDIA

BOMBAY

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PREFACE

In the years since Independence and particularly during the last decade of planned development, several specialised institutions such as the Industrial Finance Corporation of India, Industrial Credit and Investment Corporation of India and the State Financial Corporations have extended a growing volume of medium and long-term credit to industry. Some of the large scheduled banks have also, of late, been taking interest in making formal medium-term loans to industry, assisted partly through facilities available from the Refinance Corporation for Industry Ltd. The criteria of assessment and methods of analysis for appraisal of term loan applications are materially different from those normally adopted by banks in dealing with applications for short-term credit from industrial companies. In view of the increasing importance of term loans in industrial expansion during the Third and subsequent Plans and the need for improving as well as disseminating more widely techniques of appraisal of term loan applications, it was considered useful to pool existing experience in this field and prepare a brief Report outlining some of the general principles followed by financial institutions specialising in term loans. Accordingly, the Reserve Bank set up a Working Group consisting of a representative each of the concerned financial institutions as under:

1. Shri K. N. R. Ramanujam (Chairman),
   Director, Banking Division,
   Economic Department,
   Reserve Bank of India,
   Bombay.

2. „ R. S. Pochkhanawala,
   Managing Director,
   Bombay State Financial Corporation,
   Bombay.

3. „ N. H. Bhatt,
   Industrialist,
   A, 8/254, Sardar V. P. Road,
   Bombay.

4. „ V. P. Varde,
   Director, Industrial Finance Corporation of India,
   C/o Messrs. R. R. Nabar & Co.,
   31, Dalal Street,
   Bombay.
   (Shri C. V. Desai attended the meetings.)

5. Shri V. G. Mahadevan,
State Bank of India,
Central Office,
Bombay.
(Shri P. C. Malhotra attended the meetings of the Group subsequent to the transfer of Shri V. G. Mahadevan to Calcutta.)

6. „ S. S. Mehta,
Technical Adviser,
Industrial Credit and Investment Corporation of India Ltd.,
Bombay.

7. „ V. V. Apte,
Joint Director of Industries (Small-Scale Industries),
Government of Maharashtra,
Bombay.

(Shri B. L. Pandharipande,
Deputy Director of Industries (S. S. I.),
Directorate of Industries,
Sachivalaya Annexe, Bombay,
was subsequently nominated in place of Shri V. V. Apte.)

8. „ M. G. Parikh,
Manager,
Bank of Baroda Ltd.,
Bombay.

9. „ K. Vasudeva Rao,
Deputy Chief Officer,
Industrial Finance Department,
Reserve Bank of India,
Bombay.

10. „ Y. V. Sivaramakrishnayya (Secretary),
Industrial Finance Officer,
Industrial Finance Department,
Reserve Bank of India,
Bombay.

2. The Report of the Working Group was presented at the Eighth Annual Conference of the representatives of the State Financial Corporations which met in Madras on November 24 and 25, 1961. As the approach to term loan applications and the methods of appraisal discussed in the Report are likely to be of interest to all financial institutions engaged in term lending, it was considered worthwhile to publish the Report. Owing to

the nature of subject-matter, this may be regarded, however, as the first attempt at exposition in a rather intricate and difficult technical field and is designed to elicit comments of the institutions and individuals specialising in this field.

3. The Bank wishes to take this opportunity to record its gratitude to the institutions which have co-operated in this work by making available the services of their members to the Working Group and also to the members of the Group. In particular, the Bank desires to express its appreciation of the valuable assistance given by the Industrial Credit and Investment Corporation of India and the Bombay State Financial Corporation in this regard.

4. The views expressed in the Report are those of the members of the Working Group in their personal capacity and should not, therefore, be associated with the institutions which they represent.

Reserve Bank of India,
Central Office,
Bombay.
Dated the 8th May 1962.

B. K. MADAN
Executive Director

CHAPTER I

THE INSTITUTIONAL SET-UP FOR TERM CREDIT TO INDUSTRY—BANKS AND TERM LOANS.

With the quickened pace of economic development under the impetus of the Five-Year Plans, the most striking change in the Indian economy has been the initiation of an industrial revolution. Production in the organised sector of industry practically doubled during the period of the two Plans, the general index of industrial production rising from 100 in 1950-51 to 194 in 1960-61.* Further, over the past decade, there has been a deepening as well as a widening of the industrial structure. Not only have the established industries increased their installed capacity and output but a wide range of new industries has also come into being. Thus, in the field of capital and producer goods industries, units manufacturing such items as machinery and machine tools, electrical and engineering equipment, heavy chemicals, locomotives, etc., which provide the foundation for a self-sustained growth of the economy, have been set up; amongst consumer goods industries, units producing such items as bicycles, sewing machines, plastic products, etc. are forging ahead. According to the Third Plan, the general index of industrial production is expected to reach the level of 329 in 1965-66 as against 194 for 1960-61.

2. These developments have brought to the fore the importance of provision of various categories of finance to industry, namely, for short, medium and long-term requirements. In industrially advanced countries, this is the function of the group of institutions called financial intermediaries which consist of commercial banks, insurance companies, investment trusts and finance corporations and the various appurtenances of a capital market such as stock brokers, issuing houses and underwriting agencies. By mobilising savings and channelling them towards productive investment such intermediaries play a prominent and vital role in assisting industrial growth.

3. In recent years, the institutional set-up in India for the provision of long and medium-term credit for industry has been broadened. The Industrial Finance Corporation of India was established in 1948 under a separate statute for the primary purpose of providing medium and long-term finance to industry. It is empowered to subscribe to the debentures and shares of industrial concerns and grant and guarantee loans repayable within 25 years, underwrite stocks, shares or debentures of companies and guarantee deferred payments on imports of capital goods and their purchase in India. It also provides loans in foreign currencies. The Corporation functions as a *marginal* lender providing assistance to applicants who may not find it possible to approach the capital market. It assists only public limited companies and

* It is likely that the index, which does not cover new industries set up after 1951 understates the real rate of growth.

co-operative societies incorporated in India. Loans and advances or guarantees of loans and advances can be granted by the Corporation against certain acceptable tangible security or the guarantee of the Central Government, a State Government, a scheduled bank or a State Co-operative Bank. Also, the Corporation generally requires collateral valued at not less than twice the amount of the loan. Upto June 30, 1961, the Industrial Finance Corporation had sanctioned loans to the extent of Rs. 105.82 crores, of which Rs. 57.35 crores had been disbursed and Rs. 42.23 crores were outstanding.

4. The State Financial Corporations have been established in all the States under central legislation to serve the needs of medium and small-sized industries on a regional basis. In structure and mode of operations, they are broadly similar to the Industrial Finance Corporation. Their loans are granted against the first charge of fixed assets, such as land, buildings and plant and equipment. They grant loans generally for about 50 per cent of the net value of the fixed assets offered as security. The fifteen State Financial Corporations operating at present (including the Madras Industrial Investment Corporation Ltd. established as a joint stock company) sanctioned upto March 31, 1961 loans aggregating Rs. 30.73 crores of which Rs. 21.93 crores had been disbursed.

5. The Industrial Finance Corporation can augment its resources upto a certain limit by issue of bonds, by borrowing from the Reserve Bank of India upto 18 months against specified collateral and also from the Central Government on such terms and conditions as may be agreed upon. The State Financial Corporations Act has been recently amended to enable the Corporations to borrow from the Reserve Bank upto 18 months and also from the concerned State Government or any notified financial institution such as the Refinance Corporation. For the proper co-ordination of the activities of the Industrial Finance Corporation and the State Financial Corporations, these institutions observe a convention under which the Industrial Finance Corporation would not normally entertain individual loans for amounts less than Rs. 10 lakhs which was the maximum limit upto which the State Financial Corporations could give loans to individual units. The limit has since been raised to Rs. 20 lakhs in respect of public limited companies and co-operative societies.

6. The Life Insurance Corporation of India also participates in the financing of industries by purchasing the shares and bonds of the Industrial Finance Corporation of India and the State Financial Corporations and also by the purchase of shares and debentures of joint-stock companies. In recent years, the Life Insurance Corporation's holdings of these investments have shown a steadily increasing trend. The Corporation also participates in underwriting activity.

7. The National Industrial Development Corporation was established by the Government in October 1954 with a view to promoting

certain types of industries in association with the private sector, wherever feasible, and for providing loans to the machine tool industry and for the rehabilitation and modernisation of the two industries of national importance namely, jute and cotton textiles. The National Small Industries Corporation set up in February 1955, though not primarily a financing institution, undertakes the supply of machinery to small-scale industries on an instalment payment system and is empowered to guarantee loans to small-scale units made by banks and other financial institutions. There are counterparts to these all-India institutions at the State level also. Some of the State Governments have established Industrial Development Corporations. The scope of the activities of these Corporations is fairly wide and includes the extension of loans and grants to industries as also the subscriptions to the shares and debentures of industrial concerns. Special corporations to assist small industries have been established in several States to provide assistance—technical, managerial as well as financial—to small-scale industries. Besides these Government agencies, the various State Governments are empowered under their respective State Aid to Industries Acts/Rules, to provide financial assistance to industries in the form of loans and guarantee of loans from banks. Recently, co-operative banks (State and Central) too have been extending term credit to industry, but to a very limited extent.

8. Yet another special financial institution, with a somewhat extensive range of loan and other operations, is the Industrial Credit and Investment Corporation of India Ltd. The I.C.I.C.I. also gives loans in foreign currencies. Further, this is the only private institution which undertakes, on a fairly large scale, the underwriting of shares and debentures of industrial companies. The minimum amount of loan which the Corporation normally provides is Rs. 5 lakhs. Upto December 1961, the I.C.I.C.I. had a total financial commitment of Rs. 42.71 crores of which Rs. 18.41 crores had been disbursed.

9. The total loans disbursed by the various financial corporations since their inception are of the order of Rs. 100 crores. Undoubtedly, their operations will continue to expand and grow in importance in the future. Nevertheless, a further strengthening and broadening of the institutional set-up to cater to the financial requirements of industrial development seems necessary. The overall requirements of industry and mining in the private sector for fixed investment during the Third Plan are placed at Rs. 1,350 crores; of this, Rs. 1,250 crores are estimated to be available from various internal and external sources, including 'institutional agencies' the share of which is expected to be Rs. 130* crores (against Rs. 80 crores provided by them in the Second Plan). Side by side with these requirements of the private sector in respect of finance for fixed investment, the demand on the resources of commercial banks to provide for working capital to this sector will continue to

* Vide *The Third Five Year Plan* p. 464.

grow in pace with the growth in industrial production. Everything considered, banks and other lending institutions will have to play a larger role in the sphere of industrial finance.

10. Although the primary role of the commercial banking system in relation to industry is to cater to its short-term requirements, banks no doubt take some indirect interest in the long-term financing of industries in several ways. Thus banks have contributed to the share capital and debenture issues of special financial institutions such as the Industrial Finance Corporation, the State Financial Corporations and the Industrial Credit and Investment Corporation. In addition, they subscribe to a limited extent to the shares and debentures of industrial concerns and make advances against such shares and debentures. Of late, banks are also increasingly participating in underwriting the issues of debentures and to some extent the ordinary shares of joint stock companies either singly or in association with other banks and institutions such as the I.C.I.C.I., I.F.C. and the Life Insurance Corporation of India. Even the short-term credit provided by the banks to industry becomes in fact long-term through being "rolled over" for periods of more than one year. Interest in formal term lending as such is, however, small and confined mostly to major Indian banks. In order to induce banks to take greater interest in term lending, the Government and the Reserve Bank set up the Refinance Corporation for Industry in 1958. Upto December 31, 1961 the total of loans sanctioned by the Refinance Corporation for Industry to financial institutions was Rs. 16.49 crores.

11. The Corporation provides facilities of refinance against medium-term loans granted by banks and other financial institutions to medium-sized industries (with paid-up capital and free reserves normally not exceeding Rs. 2½ crores). Originally, the facilities of the Corporation were extended to only fifteen member banks and each of them was allotted a quota depending roughly on the amount of the bank's deposits as on January 25, 1957, upto which refinance facilities could be obtained by it.

12. According to the original requirements, loans eligible for refinance by the Corporation were to be for periods between 3 and 7 years, with the amount not exceeding Rs. 50 lakhs for an individual industrial unit. The interest rate to be charged by the member banks on their loans to industrial units was not to be more than 6½ per cent. The Corporation itself charged interest at 5 per cent per annum on its loans to the banks. It was further required that the borrowing industries should be those included in the Second Five Year Plan and other subsequent Plans.

13. In October 1960, these requirements were relaxed substantially. The facilities of the Corporation are now available to forty-three commercial banks in addition to its member banks and also to the State Financial Corporations (including the Madras Industrial Investment Corporation Ltd.) and 3

State Co-operative Banks. Loans granted by banks for periods upto 10 years are eligible for refinance in exceptional cases. However, loans by State Financial Corporations upto 10 years are as a general rule eligible for refinance. The financial institutions are allowed to charge an interest rate based on the creditworthiness of the borrower and are not necessarily required to adhere to the maximum rate of 6½ per cent although the Corporation continues to charge 5 per cent on its loans to the financial institutions. However, the Corporation can review the lending rates of financial institutions seeking its assistance if in its opinion they are unduly high. Loans to industries other than those listed in the Plans are also eligible for refinance provided they are in general conformity with the purposes of the Plan.

14. The extension of the scope and the relaxation of requirements of the Corporation notwithstanding, banks move with caution in extending their term-loan commitments, as generally they consider such loans as non-liquid and hence risky. However, banks with large resources, with their close contact with industrial units in the sphere of short-term finance and their large branch net-work throughout the country, are well suited to extend term credit.

15. Term lending is not uncommon even in a country like the U.K. where banking is considered to have developed on conservative lines. The granting of what are known as "character loans" to individuals in commerce and industry for fairly long periods is not an uncommon practice among the larger British banks. The clearing banks extend to a limited extent export credit for periods of over one year. In the United States, there has been a more formal re-modelling of banking practices. Even as early as in 1935, the U.S. Banking Act required the Federal Reserve Banks to extend credit to Member Banks against "any acceptable assets". This was in recognition of the changing needs of the times; the depression had left the commercial banks with vast excess reserves and a dearth of profitable avenues of investment. It was not that the demand for credit was insignificant. Rather, the needs of industry emerging from the depression were such that loans for a longer duration than were generally granted by banks were required. Their competitive position was further endangered by the growth of life insurance companies and other non-bank lenders. The objections to capital or medium-term lending by banks broke down under these circumstances. In the 1930s, the U.S. banks, especially in the larger cities, began to extend credit for periods generally ranging from one year to five years and in exceptional cases upto eight years; such credit has come to be known as term loans. By 1941, term loans constituted a third of the business loans of all Member Banks. The proportion has subsequently remained more or less at that level. The 1957 Survey of Business Loans of Member Banks revealed term loans as forming 38 per cent of the business loans of all Member Banks, with half of the term loans having a maturity of over 5 years. In certain areas, however, the importance of term loans is even greater. Among the New York City

banks, for instance, the ratio of term loans to all *classified business loans* was about 55 per cent in June 1960.*

16. At first sight, it might appear that term loans cannot satisfy the canon of liquidity which is the major consideration in all bank loan operations. Since a large part of banks' liabilities consists of demand deposits, the tenets of "sound" banking require the distribution of assets in such a manner as to provide for their easy conversion into cash to meet the regular demand and predictable increases in it as also unexpected but limited withdrawals. Hence, according to the traditional view, banks should provide loans only for short periods and for operations which result in the automatic liquidation of credit in such periods. By these standards, loans to meet the working capital needs of industry and commerce are the only acceptable type of credit, since the financing of the processing of goods or their movement from the producers to the consumers results in the quick realisation of the funds lent. The liquidity criterion is satisfied by the fact that the borrowers are in a position to repay the loans, with the completion of the productive process or sale transactions.

17. It might well be that, at certain times, an individual bank desiring to increase its cash may not like to wait until the completion of the process of production or marketing for the repayment of its short-term loans. In such an event, the liquidity of loans is not jeopardised so long as commodities or items covering the loans can be sold in the market or transferred to other institutions. There is, however, a distinction between liquidity (understood in the sense of easy realisability without any loss of capital) as it applies to an individual bank and to the banking system as a whole. While an individual bank may be able to effect sales or transfers of such assets with ease, a similar attempt by all banks cannot obviously be successful. A simultaneous move on the part of all banks to "pass on" the advances made to a large number of borrowers might even precipitate a recession and destroy the very basis of liquidity of such credit. For the maintenance of the liquidity of the entire banking system then, an outside agency to whom all assets can be finally shifted is necessary. The central bank of the country fills this role and the ultimate liquidity of the short-term credit depends in fact on the extent to which it accepts assets covering the loans and acts as the lender of the last resort. If the central bank is willing to make advances to commercial banks against their medium-term loans, such credit is immediately endowed with liquidity. The amendment of the U. S. Federal Reserve Act in 1935, for instance, which allowed Federal Reserve Banks to make advances to Member Banks on their longer-term notes, conferred liquidity on this type of bank credit although so far there has been no instance of a Member Bank re-

* Loans classified as "commercial and industrial loans" (or business loans) constitute the most important single item in the loan portfolios of U. S. banks. At the end of 1956, the total outstanding loans of commercial banks was $ 91·9 billion, of which business loans amounted to $ 38·7 billion or 42 per cent of the total. In New York City, however, business loans of banks will bear a still higher proportion to their total.

discounting such loans with the Federal Reserve Banks. The fact that liquidity was conferred by the Federal Reserve System on all eligible medium-term assets constituted an important factor for the development of term lending in the U.S.A. The crucial consideration in the loan operations of the banks in the U.S.A. came to be the *soundness* of assets rather than the duration of the loan. The supervisory authorities of banks in the country also interpreted the concept of "sound assets" broadly making it dependent on their quality rather than on the duration of the loans.

18. The traditional concept of liquidity as a feature exclusive to short-term credit thus requires to be modified. Loans can be liquidated not only by the sale of goods which they finance but also to an extent by shifting them from the lending bank to another holder. The measure of liquidity is thus the ability of the bank to transfer the assets to other buyers at prices involving no loss of capital. This "shiftability" criterion, however, has its limitations since it is not applicable to a bank's unsecured commercial loans which cannot be readily sold in the open market or transferred to other banks. As bonds and stocks can be considered as liquid by this standard the development of the corporate form of business has enhanced the scope for banks for acquiring liquidity under this concept and for that reason it is more applicable to bank practices in advanced countries than underdeveloped economies like India. As regards Indian banks at present, the only "shiftable" assets held are Government and other trustee securities, usance bills eligible under the Bill Market Scheme and medium-term loans eligible under the scheme of the Refinance Corporation.

19. Neither the traditional concept of liquidity nor the criterion of shiftability can be applied to term loans. These loans, according to the U.S. practices, are extended for periods ranging from one year to about eight or ten years. The crucial point about term loans is that the proceeds of these loans are generally used for what are broadly known as 'capital purposes', that is, expansion in plant capacity, or strengthening the working capital of an existing industrial unit or the establishment of a new one. Their repayment is usually scheduled over a period of time. The resultant strengthening of the industrial base increases physical output, lowers costs and hence raises profits. The loan is intended to be repaid over a period of years, out of this enhanced profit as also out of the proceeds of depreciation reserves. Hence, the liquidity of such loans is said to depend on the 'anticipated income' of the borrowers.

20. This argument in itself could possibly give rise to some distrust of term lending inasmuch as the liquidity of term loans is connected with the long-run success of the borrowing unit. In other words, repayment will flow in smoothly only if the income of the borrower increases as anticipated. It might be felt that in these conditions, the usual guides to business lending such as the record of an individual unit and the efficiency of its management

cannot be relied upon since extraneous factors may affect the income of a unit, regardless of its own efficiency. The liquidity of term loans depends ultimately on the stability of the economy or the continued consumption by the public of the goods and services produced by the term loan borrowers. A bank might hesitate to make this broad assumption and hence abandon term lending as too risky. However, the hazards of economic fluctuation affect short-term loans as well. A sudden and sharp decline in prices might impart a high degree of risk to a commercial transaction and impair the liquidity of a loan financing the transaction. This type of risk is hard to avoid, regardless of the maturity date of the credit.

21. While it is true that in India *formal* term lending is yet to be undertaken on any significant scale, loans which are formally short-term but extended to a longer period are made by Indian banks in one form or other. In other words, they do not always necessarily adhere to the traditional canons of short-term liquidity. Personal loans to individuals not in business and loans against stocks and shares, insurance policies and real estate are now fairly common. Also, it is well known that Indian banks "roll over" a substantial portion of their short-term credit. That is to say, short-term loans or overdrafts and cash credits once granted, are repeatedly renewed or, if recalled, reloaned immediately. In effect, if not in form, this amounts to medium-term lending. This is not, by any means, an exclusively Indian practice. Even in the U.S.A., before term lending came to be widely accepted, loans which were ostensibly short-term were in fact used for more permanent purposes, with a tacit understanding between borrowers and lenders that, under normal circumstances, the short-term notes would be renewed upon their maturity.

22. Thus, some medium-term credit is currently being extended by Indian banks, though not on a formal basis, without adversely affecting their liquidity position. While the "rolling over" practice common to banks every where is bound to continue, its continuance would by no means provide the same facilities to borrowers as formal term loans by banks, since the scope and objective of the latter differ fundamentally from those of the former. Under term loans the borrowers secure funds at a specified rate of interest for a specific period of time, during which period apart from amortisation payments they have no obligations to repay in full; these facilities, may not be always available under the "rolling over" practice. On the other hand, in most cases renewal of short-term loans is more or less automatic provided other conditions remain unchanged. The tacit assumption is that if conditions affecting the loan should undergo any change, the lending bank would have the opportunity to review the credit and recast its terms. This, however, is no substitute for the scientific appraisal usually required to be made *prior* to the grant of a term loan.

23. An important aspect of term loans which is sometimes lost sight of is that they are not as illiquid as they are supposed to be. In fact, there

is a degree of liquidity in the provision for regular amortisation of term loans more than in some of the so-called "demand loans" which are renewed from year to year. Another important point which is sometimes overlooked is that term finance disciplines both the banker and the borrower as long-term planning is required to ensure that cash inflows will be adequate to meet the instalment repayments and allow an active turnover of the bank's loan portfolio. The adoption of the formal term loan by at least the larger banks would thus introduce a needed type of flexibility in the operations of the Indian banking system.

24. The present conditions in India are especially favourable to the adoption to a limited extent of the practice of formal term lending by the larger banks. The formation of the Deposit Insurance Corporation may contribute to a reduction of "panic withdrawals" and add to the strength and stability of our banking system. The climate for term lending in the U.S.A. was vastly improved by the establishment of the Federal Deposit Insurance Corporation in 1934 providing for insurance of deposits of member banks.

25. At the same time certain limitations concerning the ability of the Indian banking system to extend the scope of banks' activities in this field should also be noted. Already the liquidity ratio of commercial banks is under pressure, partly due to the upsurge of demand for industrial credit and to the relatively slow rate of deposit growth. Indian banks will find it increasingly difficult to enlarge their sphere of operations in industrial finance unless they take adequate steps to mobilise deposits on a much larger scale than hitherto. Consistent with their requirements of liquidity and subject to the general credit regulation of the Federal Reserve Board, the U.S. banks extend term credit. The Indian banks may not always find such an adjustment easy of implementation. In India, with demand deposits of banks comprising only a third of money-supply (as against 75-80 per cent in the U.S.A) and with a money market not so well integrated and developed as in the U.S.A., the instruments of credit control are not so efficacious.

26. Moreover, term lending cannot, by any means, be adopted by all Indian banks. The extension of term loans is necessarily a specialised business. It involves an element of risk since in a dynamic economic environment, changes in the conditions affecting the borrower and the lender are bound to occur before the loan is fully amortized. A bank making such a loan has, therefore, to assess the situation and estimate likely changes in the future. Not all banks are well equipped to make such appraisals or undertake such risks. Only those banks which possess a certain minimum level of resources, personnel and organisation will be in a position to undertake extension of term loans to industry.

27. Even for an individual bank qualified to grant term loans, such lending will have to be upto a certain limit, depending on its overall financial

position. Various indicators may be used to gauge the strength of a bank and hence its capacity to grant medium-term credit. These include the structure of the bank's deposits, i.e., the size of its term deposits in relation to its total deposits, its capital funds ratio, i.e., the ratio of its paid-up capital and published (and secret) reserves to its deposits and the general level of its advances-deposits ratio. To the extent refinancing facilities are available for these loans, the capacity determined on the basis of factors mentioned above will be increased.

28. It is indeed difficult to lay down hard and fast rules regarding lending practices in general and term lending in particular which may be followed by banks. The circumstances conditioning loan applications can never be uniform. The approach, procedure and terms—and even the decision whether the loan is to be granted or not—will depend on various factors affecting the conditions of the industry concerned and the earning potential of the borrower. The final decisions are based on the judgement of the financial institutions for which the analysis of these factors is only the starting point. Lending is an art and not a science, and does not conform to set rules. However, to the extent that it is based on adequate information, analysis and judgement, banks and other financial institutions are enabled to take what are known as "calculated risks".

CHAPTER II

SPECIFIC ASPECTS OF APPRAISAL

29. The distinctive characteristics of term loans set them apart from short-term credit granted by banks, and it becomes necessary, therefore, to adopt a different approach in examining the applications of borrowers for term credit. An element of risk is inherent in any loan, short, medium or long, because of the uncertainty of repayment. It is as a safeguard against such risks that generally banks demand adequate collateral or otherwise satisfy themselves of the creditworthiness of the individual or the business unit requiring the loan. The longer the duration of the credit, the greater is the attendant uncertainty of repayment and consequently the risk. The liquidity of term loans depends not so much on the short-run saleability of the goods and commodities, the movement or temporary stocking of which is financed, as on the increased income of borrowing units resulting from a higher level of utilisation of existing installed capacity and/or additions to it. Hence, the primary task of a lending institution before granting a term loan is to assure itself that the anticipated rise in the income of the borrowing unit would materialise thus providing the necessary funds for repaying the loans according to the terms of amortisation.

30. For purposes of assessing the risks involved in loans of longer duration, the normal criteria used for judging the "soundness" of short-term loans are often unreliable and inadequate. Banks extend short-term credit on the basis of examination of the general creditworthiness of the borrower and an examination of his financial position, especially his current assets and current liabilities. For term loans, the area of investigation has to be extended and a comprehensive set of criteria for assessment established. In fact, the standards to be adopted and the methods of analysis required for appraisal of term loans are more appropriate to investment decisions than short-term lending. While a static analysis of the balance sheet position would suffice for a short-term loan, appraisal of term loans requires a dynamic approach, involving as it does, among others, a projection of future trends of output and sales and estimates of costs, returns and flow of funds.

31. Since appraisal of term loans depends to a large extent on estimates and forecasts, it is likely to be vitiated by the margins of error in these projections and can at best be considered as a reasonable approximation. The purpose of an appraisal, however, is not to set down a categorical statement of the long-range prospects of an industrial unit but only to provide broad guidance to the financial institution in forming its judgement regarding the future prospects of the particular borrowing unit and to work out the terms of the loan.

32. In India, the practice of making appraisal of term loan applications on modern scientific lines has not made much progress. This is partly due to the fact that such loans are given mainly by the larger banks to highly creditworthy constituents and hence no elaborate enquiry is considered necessary. But the need for such appraisals will come to be increasingly felt as term lending expands. Banks and other lending institutions have to focus attention therefore on the task of a scientific examination of term loan applications making use, to the extent permitted in the Indian context, of criteria adopted by financial institutions in other countries.

33. There can be no fixed or standardized approach to appraisal. Numerous and diverse elements enter into the process, and it is difficult to have a cut and dried formula with the help of which a loan proposal can be adjudged straightaway as acceptable or unacceptable. While broadly the same set of factors is taken into consideration in the scrutiny of individual applications, the weightage given to the several factors varies from case to case. The more important factors among these are the type of organisation and activity of the borrowing unit, the nature of its product and its market potentiality, its size, the quality of its management and soundness of financial position, the amount and term of the loan required and its repayment schedule.

34. As between loans for new projects and those for the expansion or modernisation of existing units there are certain important differences in the scope and nature of the appraisal. For the latter, a good deal of data concerning their past performance, efficiency and quality of management would be readily available. Thus, the degree of risk could be assessed with relative ease. A similar assessment is difficult for new concerns in the absence of any past record. Since appraisals are to be made on the basis of a projection of future trends in output and income, the risk element is generally, though not necessarily, greater for the new concerns.

35. In extending term loans, financial institutions would be inclined naturally to adopt primarily the criterion of profitability rather than that of "development". That is to say, they will be concerned mainly with the commercial profitability of a project as determined by the level of prospective profits and its ratio to invested capital of the borrowing unit and not with its broad economic significance or importance in the development of the resources of the economy. Since the benefits of a project to the economy may not always be reflected in its financial prospects, its value to the economy as a whole could well be greater than its commercial profitability. Projects which offer extensive employment opportunities, reduce regional imbalance or strengthen the foreign exchange position through an increase in exports or production of import substitutes could come under this category. Also, commercial profitability could sometimes be more apparent than real. The extent of State support and the manner in which it is made available *e.g.*, import controls, protective duties, subsidies, tax rebates and other con-

cessions have considerable bearing on the profit prospects of certain industries. To the extent that the profitability of a project is conditioned on the continuance of such support, appropriate allowance has to be made by the lending institution in the appraisal of the project. For, a change in the extent of State intervention or its removal would change the picture correspondingly

36. In India, with capital a scarce resource at present, it is important to allocate it in such a manner as to maximise the return on capital but with due regard to broader development considerations. Hence, the criterion of commercial profitability may have partly to be tempered by the wider development objective. In the nature of circumstances, however, commercial profitability is likely to remain the predominant criterion as far as the lending institutions are concerned. Special financing and risk-bearing arrangements have therefore to be made for certain preferred sectors such as small-scale industries. Government loans and the Credit Guarantee Scheme of the Government of India operated by the Reserve Bank of India in favour of small industries are instances in point. As regards the operations of the financial institutions, the broader development criterion impinges more specifically through Government guarantees of repayment of loans on behalf, for instance, of co-operatives or other industries considered essential or vital to development generally or in backward regions.

37. An appraisal of a loan application begins with adequate back ground knowledge of the current developments in the economic policy of the Government. In general, the expansion of industry in India has to be in accordance with the Industrial Policy Resolution of April 1956, which spells out the roles accorded to the private and the public sectors. The Third Five Year Plan gives the accepted priorities in industry as also the industrial development programmes with the proposed targets of physical output and financial investment. The fact that an applicant unit has secured the necessary industrial licence should normally serve to indicate that the industry conforms to the priorities established by the Government. However, a number of other aspects of state policy such as taxation, transport rates, prices and wage limits, import control, export promotion, exchange regulations, tariff protection, etc. also affect the establishment as well as the day-to-day functioning of an industrial unit. Lending institutions should therefore maintain adequate and up-to-date information on these aspects.

38. There are four broad aspects of appraisal, namely, technical feasibility, economic feasibility, financial or commercial feasibility and managerial competence. For lending institutions in particular, financial appraisal is the most important and hence is dealt with comprehensively in Chapter III. The other aspects are discussed below.

39. *Technical Feasibility:* The examination of this aspect consists of an assessment of the various requirements of the actual production process.

It requires a detailed estimate of all the goods and services needed for the project—land, housing, transportation, raw materials, supplies, fuel, power, water, etc. Broadly speaking, the financial institution will have to satisfy itself that these requirements are matched with availability. Where the resources are not domestically available and have to be imported, conditions in the foreign market as well as Government policy at home and the question of availability of foreign exchange call for a review. Since at present bottlenecks or unexpected shortages of vital requirements are common, and as a result, the progress of projects is often held up, a careful enquiry will have to be made into the availability, accessibility and quality of the goods and services required. The location of a project is highly relevant to its technical feasibility and hence special attention has to be paid to this feature. In fact, the accessibility to the various resources has meaning only with reference to location. Inadequate transport facilities or lack of sufficient power or water, for instance, can adversely affect an otherwise sound industrial project. The requirements of the proposed project should be studied individually with reference to this factor and special care taken for projects in remote areas.

40. An important feature of technical feasibility relates to the type of technology to be adopted for the project. Sometimes, new technical processes are adopted from abroad without due regard to the differences in conditions. A new technology will have to be fully examined and tried before it is adopted. The dangers of hasty adoption of new techniques are especially great in an under-developed country. At the same time, obsolete processes are also to be avoided as they will affect productivity adversely. It is desirable for lending institutions to employ persons with technical competence in engineering, chemicals, etc. so as to assist them in the engineering and other technical aspects of the projects or alternatively, wherever possible, make use of the services of consultants in the respective fields.

41. The labour requirements of a project need to be assessed with special care; though labour, in terms of unemployed persons, is abundant in this country, there is a shortage of trained personnel, not only of technicians at the intermediate and lower levels but also of managers at the top. The quality of labour and the training facilities made available by the borrowing unit will have to be taken into account. For certain projects, foreign experts or foreign training for local staff may be essential and here again, the problem of foreign exchange needs and availability comes up.

42. *Economic Feasibility :* This aspect of an appraisal has reference to the earning capacity of the project ; since earnings depend on the volume of sales it is necessary to determine how much of the output of the new unit, or the additional production from an established unit the market is likely to absorb at given prices. The first step in this direction is to consider the current situation, taking account of the total output of the product concerned

and the existing demand for it with a view to establishing whether there is an unsatisfied demand for the product. For certain branches of industry, e.g. light engineering, the potentialities of the export market also should be taken into account. Two general indicators of the existence of unsatisfied demand are the price level and the prevalence of controls. Where demand is greater than available supply and there are no controls, prices would be at high levels in relation to production costs, yielding abnormal profits to producers. Similarly, if price controls, rationing or like measures are enforced in respect of certain items, they are obvious evidences of the fact that all demand is not being met by current production. However, care should be taken to verify whether all producing units are working at full capacity for it is not impossible for idle installed capacity to co-exist with unsatisfied demand. Bottlenecks in production, such as raw material or power shortage, could be responsible for such a situation. Difficulties with labour or deliberate restriction of output by producers might be other causes. It could also be that the excess capacity is more apparent than real, the machinery and plant of the units in the industry being obsolete and hence easily displaced. In any case, it is necessary to know specifically whether the unsatisfied demand is ephemeral or genuine, that is to say, arising from a lack of productive capacity. If the latter is found to be the true cause of unsatisfied demand, it would be safe to conclude that the immediate sale prospects of an increase in the volume of total output are good.

43. However, the study should go beyond immediate prospects. Possible future changes in the volume and pattern of supply and demand will have to be estimated in order to assess the long-run prospects of the industry as well as earning capacity of the unit. In fact, a thorough market analysis is an essential part of a full appraisal. On the side of supply, the competitive position of the unit in question should equally be examined. It would be necessary to obtain details, as far as possible, of the other units in the industry in regard to capacity, production, age of plant and equipment, technology adopted, profitability, the scope for expansion, etc. The purpose is to determine whether and to what extent the project being appraised would have cost advantages and disadvantages, compared to existing and potential competitors.

44. Projection or forecasting of demand is a complicated matter but one of vital importance. It is vital for the reason that without it, no valid estimate can be made of the probable sales revenue of a unit, which would determine the levels of its profits and its capacity to amortise the loan. It is complicated because a variety of factors affect the demand for a product at a given time, and it is difficult to take account of all these. For instance, changes in demand would follow changes in the geographical distribution of the population. Thus, with increasing urbanisation, demand would rise for certain products but decline for some others. Structural changes in the economy might have a similar effect. Technological innovation could bring

substitutes into the market, while changes in tastes and consumer preferences might cause sizeable shifts in demand. While it is not possible to quantify these influences on demand, an appreciation of these factors is necessary in any demand projection. Generally, however, the demand for any product is fairly responsive to changes in price and income. Thus, people will reduce their consumption of a commodity which has risen in price and increase their consumption of a commodity which has declined in price. Similarly, as individual incomes rise, more expenditure on consumer goods may be expected though not proportionately. Quite obviously, the degree of response in demand to changes in price and income cannot be the same for all commodities or articles. The demand for some basic necessities, for instance, might continue to remain more or less stable, regardless of changes in the variables. On the other hand, demand for luxury goods might go up relatively sharply with a rise in incomes or a fall in price and contract sharply when the conditions are reversed. If information concerning the demand for a product in the past is available, projections of demand over a period of years can be made on the basis of assumptions concerning future trend of prices and incomes. In the case of consumer goods this problem presents less difficulties.

45. The projection of demand for intermediate goods—that is, goods used as inputs for further production—and capital goods is more complicated as the demand for such goods is affected by changes in incomes and prices but only indirectly, through the change in the demand for the final commodities in the production of which these goods are utilised. Often, intermediate and capital goods have multiple uses, being needed in several lines of production, and hence it is necessary to take into account inter-industry relationships also.

46. In calculating the future demand for intermediate goods, it is thus necessary to take into account the probable expansion of the industries using such goods and the growth of new industries requiring them. In the case of capital goods, in addition to structural changes in the economy and technological developments leading to expansion in installed capacity, some other factors have also to be taken into account. The degree of obsolescence of existing plant is a relevant consideration, as also the extent of capacity utilisation. When idle capacity exists, it would be possible to increase the output of final goods without causing a new demand for capital goods. Demand projections for intermediate and capital goods thus require information on the whole range of technical inter-relationships and substitution possibilities.*

47. Estimations of demand can never be wholly accurate or absolutely reliable; they can at best be considered as approximations.

*For a full discussion of the practical aspects of demand projection, see the United Nations *Manual on Economic Development Projects* (1958), Chapter II.

Even in advanced economies, where adequate data exist to enable calculations being made with the help of the most advanced statistical methods, the forecasts can be stated only in terms of a range of values which are most probable. In a country like India, where the economy is undergoing rapid changes and where the basic data available are inadequate for this purpose, the resultant margin of error is considerable. Nonetheless, it should be possible to determine with more or less approximation the range over which the demand for any product will move over a given period.

48. When the product is partly or wholly oriented to an export market, conditions in the foreign market need to be analysed. Special care has to be taken in estimating the competitive position of the industry concerned. Details of the world market and production costs of substitute commodities should be studied.

49. *Managerial Competence :* To a large extent, the lending institution's confidence in the repayment prospects of a loan is conditioned by its opinion of the borrowing unit's management. Where the technical competence, administrative ability, integrity and resourcefulness of the management are well established and its continuity is also fairly certain, the loan application will naturally get the most favourable consideration. In a dynamic economic environment, the capacity of an enterprise to forge ahead of its competitors depends to a large extent on the relative strength of its management. Hence, it has been remarked that appraisal of management is the touchstone of term credit analysis.

50. What has been described in the preceding paragraphs represents the *maximum* scope of an appraisal. Not all term loans require consideration of all these aspects. Nor need all lending institutions follow uniformly all the criteria listed above. A project can be obviously profitable and advantageous, in which case only a general consideration of the borrower's position may be necessary. Again, where a product has a "captive market" *i.e.*, an assured market, a demand analysis may not be called for.

51. Even in instances where a fairly comprehensive enquiry appears necessary, it would be neither possible nor necessary to attach equal importance to all aspects of appraisal. Some enquiry into the technical, economic, financial and managerial aspects of the project would no doubt be necessary but in the final analysis, the situation should be viewed as a whole, with the strong points set against the weak. The countervailing factors revealed by one aspect of the appraisal may more than offset weaknesses or disadvantages in others. Thus, outstanding financial strength may outweigh the average calibre of the management or economic prospects which are not highly attractive. Contrariwise, sound management and excellent economic prospects could more than compensate for some weakness in the financial posi-

tion. Negative factors might predominate in some instances. Managerial ability could be so low as to surpass all other considerations.

52. Although the scope of an appraisal depends on a number of factors and the need for a full-fledged enquiry may not exist in all cases, banks and other lending institutions should be aware of the importance and the nature of this type of credit investigation and be in a position to adapt it to suit the varying requirements of the situation. A comprehensive check-list, designed to facilitate the task of project appraisal is given in Appendix I. All the aspects of appraisal are taken into account in the list and hence all items included in it would not be relevant to every case. The purpose of the list is only to give a general idea of the types of information that would be useful to term lending institutions. The information actually called for would depend on the circumstances of each case.

CHAPTER III

FINANCIAL APPRAISAL

53. The general approach of financial institutions to the appraisal of projects as lenders is not dissimilar to that of investors although by no means identical to it. Naturally, the former are concerned with the type of security and/or guarantees offered for the loan as also other safeguards available in order to satisfy themselves that the payment of interest and repayment of the principal amount of the loan will be made as agreed to. The emphasis of their analysis of the prospects is, therefore, on the possibility of a reasonably high level of earnings and their overall stability rather than on rapid development of profitability of the project leading to capital appreciation—a typical investor criterion.

54. *Objective of Appraisal :* A comprehensive appraisal of an industrial project, as stated earlier, should cover technical, economic, managerial and financial aspects; the first three have been covered in Chapter II. The financial appraisal, by and large, is designed to seek answers to the following:

(1) whether the estimates of the cost of the project fully cover all items of expenditure and are realistic;

(2) whether the sources of finance contemplated by the sponsors of the project will be adequate and the necessary finance will be available during the period of construction as per their schedule;

(3) what is the likely impact of the project on the level of production, sales, net earnings, borrowings, costs, etc. of the borrowing unit, with special reference, for new concerns, to the stage when the project may be expected to break even (with earnings offsetting expenditure) and start yielding profit?

55. This leads to a further step in the appraisal, *viz.*, fixing the time when repayment should start and the total period of repayment in the light of the financial capacity of the borrower stemming from increased output and income. Thus, the magnitude of the available surplus and other cash accruals to meet the interest and principal repayments, customarily referred to as debt service coverage (this point is dealt with in detail later under ratio studies) is an essential point for investigation in deciding on the period of amortisation. For this purpose, it is necessary to review the financial position of the concern over a period of years during the currency of the loan. For obtaining a proper perspective of the financial position of the concern, it is not sufficient to judge merely on the basis of a single year's performance as revealed in the balance sheet and profit and loss account. Whether it is an entirely new project or an expansion of an existing concern, a dynamic view will have to be taken of the organisation in the next few

years. For example, for an entirely new concern, all figures of the *pro-forma* (estimated) balance sheet come from the cash-flow, and the validity of the estimates deserves attention. For existing concerns, however, balance sheets and the cash-flows during the past five years or so may be studied in order to secure an insight into their past performance. As regards the estimates during the period of the loan, the starting point is the latest balance sheet of the concern to which figures of cash-flow estimates are added. Such a review of a projected picture of the concern may disclose unsatisfactory features which need be taken into account for deciding whether the loan is to be sanctioned or not. It will also help in determining the terms and conditions under which the lending institution would be prepared to finance the project.

56. Term lending institutions, abroad and in India, follow different methods in obtaining the necessary data for dealing with the proposals of their prospective borrowers. Some institutions use comprehensive application forms calling for particulars of different aspects of the projects presented for financing. Others use a simple preliminary application form to judge whether the scheme of the applicant is *prima facie* feasible. In respect of applications which are regarded as worthwhile, this is followed up by a comprehensive form. Some others, however, avoid the 'questionnaire' appearance of their forms but obtain, in effect, even more detailed information through notes setting out the salient features of the project and forms calling for the requisite financial data. Quite often, the lending institutions adopt the interview method for eliciting as many details and particulars of the scheme as possible, as it is exasperating to the borrower if the gamut of questions is to be covered in an initial application form. Whatever be the approach, lending institutions should seek to create, as a matter of business strategy, a friendly and cordial atmosphere while negotiating the loans thus removing any possible inhibitions in the minds of the borrowers.

BASIC DATA :

57. The basic data required for a financial analysis can be broadly grouped under the following heads:

(i) Cost of the project (whether additional or new).

(ii) Cost of production and profitability.

(iii) Cash-flow estimates (sources and application of funds) during the currency of the loan.

(iv) *Pro-forma* balance sheets.

(i) *COST OF THE PROJECT :*

58. A comprehensive and critical review of the capital cost estimates of the project of a borrowing concern is necessary. It may be facilitated considerably by comparisons with similar projects entertained earlier by the lending institution in regard to which full appraisals would be readily available. The object of such a review is to ascertain whether the various estimates submitted by the concern are realistic and sufficiently flexible; whether proper arrangements have been made to secure various types of finance for the project taken as a whole and whether the project is generally acceptable as a sound financial proposition or would require certain modifications before it can be entertained. In obtaining particulars of cost of the project, the following *pro-forma* may be useful :

COST OF THE PROJECT

Period required for completion.....

	Already incurred		To be incurred		Total Rupees and Rupee equivalent
	In Rupees	In Rupee equivalent of foreign exchange	In Rupees	In Rupee equivalent of foreign exchange	
Land (including development expenses)					
Buildings					
Machinery and Plant					
Spare Parts					
Insurance, freight, duty and transportation to site ..					
Erection charges					
Technical know-how/ consulting/engineering fees ..					
Intangibles					
Preliminary expenses					
Pre-operative expenses (upto start of normal production)..					
Interest during construction ..					
Allowance for unforeseen costs					
Total					
Net Working Capital requirements					
Grand Total					

Note.—(1) Details and/or supporting documents should be furnished wherever possible.
(2) Information may be furnished on the phasing of the expenditure on the project *over a period of years* in a separate statement, if necessary.

Notes on items: *Land* should include payments for land, legal expenses and taxes and expenses for basic improvements.

Buildings should also include various site facilities e.g. wells, reservoirs, water mains, sewers, fencing, roads and outdoor lighting.

Machinery and Plant—Estimates for the major items in this category should be supported by quotations from suppliers. They should also cover machinery foundations, installation, testing, electric lines and wiring, etc.

Technical know-how/consulting and engineering fees—These should include fees for technical men (foreign experts, if necessary) for construction of the project, training the staff and operating the plant.

Intangibles may include patents, licences, payments for goodwill for a going business, trade marks, trade names, copyrights, etc.

Preliminary expenses etc. should include legal expenses, brokerage, commission, etc.

Pre-operative expenses should include the promotion expenses, working expenses, expenses for training personnel, interest on borrowings, guarantee charges, etc. up to the stage of reaching commercial production.

Interest during construction has to be capitalised and regarded as a capital cost of the project.

Allowance for unforeseen costs—It is absolutely essential to include an allowance for contingencies to take care of the errors, omissions, price increases, and additions. This may be taken at 5 per cent of the cost or more depending on the circumstances.

Net Working Capital—i.e. the difference between the current assets and the current liabilities may be estimated as indicated in paragraph 59.

The feasibility of the project needs to be examined with particular reference to the following which affect its successful implementation:

Location : As the success of the project is dependent on its proper location yielding the advantages of nearness to the sources of raw materials, labour, power, etc. or markets and adequate transport facilities, the lending institution will have to satisfy itself in regard to these aspects.

Land and Buildings : As regards the land acquired or proposed to be acquired, the main point for consideration is whether it would be sufficient, having regard also to the future expansion of the concern. The lending institution should also examine the full particulars of the construction of existing or proposed buildings including various site facilities.

Machinery and Plant : Complete details of the existing machinery and plant should be obtained and the position regarding spare parts ascertained. It has to be ensured that the cost of equipment is based on proper quotations etc. from suppliers and that suitable provision has been made for insurance, freight, duty and transportation to site, erection charges and allied expenses.

Adequate provision separately for spare parts is essential, particularly if they involve imports from abroad. Where the schemes are for renovation or modernisation, it may be desirable to have a full-scale survey carried out by technical experts in the relative industry.

Technical competence : The lending institution has to ensure that suitable technical personnel are available and necessary arrangements have been made for training the staff. The cost of the project must, therefore, provide for fees for technical men including foreign experts, if necessary, for construction of the project and for running it in the initial stages before regular staff are trained and also for training such staff.

Raw materials and stores : The success of a project depends very much on the firm arrangements made for a regular supply of raw materials and stores, having regard to the Government's policy on imports, price and regulation of supplies thereof. Any anticipated difficulties deserve attention.

Adequate supplies of power, water and labour : No project can succeed without adequate power supply at reasonable cost. Industries such as heavy chemicals require steady and economical supply of electric power in the absence of which they will be handicapped. In the case of industries like glass where the process of manufacture is continuous, it has to be ensured that the necessary stand-by arrangements for power have been made, as otherwise their production will be gravely affected. In the case of individual projects, it is necessary to ascertain that no difficulty will be envisaged in getting additional power for further expansion. Similarly, the availability of the right quality of water in adequate quantities is important. It is an advantage if both skilled and unskilled labour is available near about the work-spot.

Working capital requirements :

59. A reasonable proportion of the working capital which is required on a long-term basis should be included in the cost of the project. There may be a general tendency either to ignore this item or under estimate it, resulting in difficulties due to shortage of working capital. A safe estimate of the working capital has to be made having regard to the nature of the business, the rate of turnover of its stocks and the business practices in the particular industry concerned. For example, the requirements of working capital will be larger for industries relying on imported raw materials and stores or on indigenous agricultural commodities subject to seasonal trends in output, since sufficient stocks of these have to be maintained for a comparatively longer period. It cannot be expected that the working capital requirements would be fully met by bank advances and suppliers' short-term credits. Commercial banks naturally look for a minimum margin requirement and do not generally advance to the extent of the full value of stocks of raw materials and finished goods, while suppliers may not similarly extend credit if the

current liabilities of the concern are as high as the current assets. The requirements of working capital may be estimated as below:

Current assets:	Rs.
————————months' stock of raw materials and stores	
Value of goods in process	
————————months' stock of finished goods	
————————months' value of accounts receivable, if any.	
Cash on hand	
Others (specify)	
Less	————————
Current liabilities :	
————————months' credit available against purchase of raw materials and stores	
Others (excluding short-term loans)	————————
Total requirements of working capital	
Less	
Met by short-term bank loans	
Others, such as deposits, etc. (specify)	————————
Net working capital required to be financed by term loan	

Generally a ratio of 2 : 1 between current assets in relation to current liabilities may be considered satisfactory but a lower ratio may also be acceptable in most cases because of the difficulties of obtaining long-term capital.

Means of finance :

While considering the estimated cost of the project, (including a part of the working capital requirements), it is necessary to ascertain the manner in which the project is proposed to be financed and that proper arrangements have been made for funds. The usual sources of finance are as under:

(*a*) Share capital ;

(*b*) Reserves and surplus ;

(*c*) Retained earnings ;

(*d*) Long-term borrowings ;

(*e*) Deferred payments ; and

(*f*) Other sources

(*a*) *Share capital :*

The existing as well as the proposed capital structure of the concern has to be examined. In India, at present, capital issues of over Rs. 10 lakhs require the prior approval of the Controller of Capital Issues. The stipulations, if any, laid down by him while granting the permission should be noted. It is also necessary to look into the arrangements proposed to be made for marketing the shares such as commission, brokerage, underwriting by financial institutions, etc. Further, what portion of the capital has been or proposed to be issued for consideration other than cash, say, for the supply of machinery, know-how, etc., may be taken note of. The amount raised by way of capital and its appropriate relation to other long-term sources of finance is of particular significance. A strong equity base will reduce the concern's need to borrow from other sources and to that extent lessen the burden of payment of interest and loan instalments. On the other hand, a disproportionately high equity capital tends to make the issue less attractive from the point of view of the investor. For much the same reason, the amount of preference capital should not be unduly high, say more than 20 per cent of the equity capital, though in exceptional cases it may be permitted to go up to 40 per cent.

(*b*) *Reserves and surplus :*

For existing concerns, internal resources such as reserves and surpluses created out of past profits may be available to finance a part of the cost of the project. Their composition should be examined to ascertain whether they will be readily available in the form of cash when required to meet the expenses.

(*c*) *Retained earnings :*

Well-managed concerns, by following prudent and cautious policies are often able to build up substantial amounts by way of depreciation on fixed assets, development and taxation rebates, etc. These can also be utilised for financing the project, provided they are available in the form of liquid assets realisable in cash without capital loss.

(d) *Long-term borrowings :*

It is necessary to take into account the composition and nature of long-term borrowings, existing and proposed, other than the loan applied for, in order to assess the impact of the payments of interest and instalments of principal on the ways and means position of the concern.

(e) *Deferred payments :*

Due to the acute shortage of foreign exchange, Government may require the concerns to secure deferred payment terms for importing their requirements of plant, machinery, etc. To the extent such facilities are available, they ease the financing problem for a certain period of time, until their re-

payments start, when they will have an impact on the available flow of cash resources.

(f) *Other sources :*

It is usual for some industrial concerns to rely on borrowings by way of loans or deposits from their directors, managing agents, etc. The terms on which such funds are received should be examined to see that they are not likely to cause undue strain to the concern financially. Further, where such borrowings are intended to meet part of the cost of the project, it may be desirable to stipulate that these loans or deposits should not be withdrawn until the project is completed or till the term loan is discharged.

60. After ascertaining the estimates of the total cost of the project, the working capital requirements, and the proposed means of financing it, it is necessary to determine the phasing of the project so that arrangements can be made to raise the funds required from time to time for the project. Where the project is to be financed partly by share capital, it is necessary to ensure that either the requisite amount has been raised or active steps are being taken for the purpose. Similarly, before the disbursement of the loan, the lending institution will have to satisfy itself that the borrowing concern has created sufficient capital assets to provide the required margin for the loan. Where the proposed loan is intended to be utilised say, for construction of buildings, purchase and installation of plant and machinery etc., the borrower will not need the entire amount within a fairly short time after the loan is sanctioned. A time schedule of disbursement of the loan will, therefore, have to be drawn up so as to synchronise with the different payments to be effected by the borrowing unit. This will also have the added advantage of avoiding a possible diversion of the funds for other uses. Financial institutions may also follow the practice of making payments directly to machinery suppliers, contractors, etc. of the borrowing concern.

(ii) *COST OF PRODUCTION AND PROFITABILITY :*

61. The next step is the assessment of the earning capacity of the project. For this, it is necessary to ensure that the products manufactured will be in demand and that the concern is in a position to manufacture them at costs and sell them at prices which allow adequate profit margin even in a competitive market.

62. There is a general tendency to under estimate the cost of production because of which the project may appear highly attractive initially but it may turn out later to be of doubtful commercial value. In order that none of the important elements of cost is overlooked, data regarding each component of the total cost of the product on the basis of various levels of output are essential. The profitability of an enterprise depends on the sales

and the total cost of production. Before estimating sales in money terms, it is necessary to estimate the physical volume of sales which are likely to be made not for one year, but for three or four years ahead. The volume of sales is influenced by a variety of factors the most important of which relate to the quality of the product and general market conditions. Sales may be valued on the basis of current price trends or more conservatively at a lower level of prices than prevailing at the time of estimation. Sales value estimated according to the second alternative would provide a suitable basis for this purpose. A number of variable factors also enter into the cost of production and all these point to the need for care in preparing alternative estimates of output and revenue for each year after production is to commence. For existing concerns, the impact of the project on the total production, sales, earnings, etc. has to be carefully studied.

63. The estimate of earnings will have to be made upto the time the unit is expected to establish itself in the market and reach a satisfactory level of production at normal costs. It is particularly important that the estimates should be worked out till the special tax benefits expire in order to assess the normal profitability. The following form sets out the manner in which data regarding cost of production and profitability may be obtained for both new concerns and expansion projects of existing concerns.

COST OF PRODUCTION AND PROFITABILITY

	Construction*			Operation		
	First year (1)	Second year (2)	Third year (3)	First year (4)	Second year (5)	Third year (6)
	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.
Production (Grade & Quantity): (Production in the initial period should be assumed at a reasonable rate of utilisation of capacity, increasing gradually to attain estimated full capacity in subsequent years).						
Raw materials (separately for each item of raw material indicating also the quantity required per unit of finished product and price at which it will be obtained).						
Power and fuel. ..						
Consumable stores. ..						
Repairs and maintenance.						
Labour.						
Factory supervision and overheads...						

Administrative overheads (viz., office salaries, insurance, rent, travelling and other expenses, etc.). ..	
Selling and advertising expenses.	
Interest—(indicate also rates).	
(*a*) On bank borrowings for working capital.	
(*b*) On medium and long-term borrowings. ..	
Depreciation (rates also should be given for all items).	
Managing Agents' /Managing Directors'/ Secretaries and Treasurers' Remuneration—(indicate also rate).	
Other expenses.	
Cost of production	
Sales—(indicating prices for each product line). ..	
Other income.	
Operating profit. ..	
Less	
Taxation	
Net profit	
Ratio of sales to total capital employed	
Ratio of operating profit to sales	
Ratio of profits (before taxes with interest on long-term debt added back) to total capitalisation, i.e. long-term debt plus equity.	

Note: Details and/or supporting documents should be supplied wherever possible and particularly regarding the source and rate of raw materials, power, fuel, etc., labourers and other personnel employed, and the basis for the selling prices assumed.

* In the case of an existing company in operation existing sales, etc. will continue till new operations start.

64. The cost of production and sales estimates are designed, among other things, to work out various ratios (which are discussed later) and the stage at which the project will "break even" (i.e. when the income from sales would cover the costs including interest, and amortisation of long-term debt) and start yielding a profit. The calculation of the "break-even" point is elucidated in a separate section later. This point will indicate the minimum

level of output, usually expressed as a percentage of full capacity, at which the project can stay in business. In order to appreciate its staying power and its vulnerability to declining prices of the products, it is necessary to work out the extent of price-fall which can be absorbed without incurring losses by the project at a given level of production. This is revealed by the ratio of profits to sales.

65. Sales may be studied in relation to total capital employed for obtaining an indication of the economy and efficiency in the use of capital. Similarly, a study of profitability in relation to sales provides a measure of the efficiency of production. An examination of profits as a percentage of total capitalisation, viz., total of owned funds and long-term debt reveals the return on investment and the financial efficiency of the concern. These aspects are also dealt with in detail in a subsequent section.

(iii) *CASH-FLOW ESTIMATES :*

66. In addition to the cost of the project and its profitability, the lending institution must ascertain when the project will need money for different purposes and the different sources for such funds. This will ensure sound financial planning and a reasonable assurance of the availability of cash to meet the requirements of the project from time to time such as for acquisition of fixed and other assets during the construction phase and for initial working capital when operations are to commence. Repayment of instalments of loans is also arranged according to the cash accruals shown in the cash-flow statement. Several of the term lending institutions in India have already arrangements to secure data in this regard. The point to be emphasized here is that it is not enough, for example, if the estimates show profit; it should be available in the form of cash and in right time to meet the operational requirements of the project as also for the repayment of the loan.

67. The cash-flow estimates (which may be made quarterly or half-yearly as may seem necessary) may be obtained in the following form:

CASH-FLOW ESTIMATES

(Quarterly/Half-yearly estimates may be given during construction period)

	Construction			Operation		
	First year (1)	Second year (2)	Third year (3)	First year (4)	Second year (5)	Third year (6)
Sources of funds:	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.
Net profit (before taxes with interest added back but after depreciation and development rebate reserve)						
Share capital increase ..						

Increase in long-term borrowings		
Increase in short-term borrowings		
Depreciation provisions ..		
Development rebate reserve		
Others (specify) ..		
Total		
Application of funds:		
Fixed assets and capital expenditure		
Current assets (such as book debts, closing stock, bills receivable, etc.)		
Repayment of long-term borrowings (including deferred payments)		
Repayment of short-term borrowings		
Interest		
Other assets		
Taxation		
Other expenses..		
Total		
Opening balance of cash ..		
Surplus/deficit between sources and application of funds..		
Closing balance of cash ..		
Debt service coverage ratio. ..		

68. The cash-flow estimates in respect of a new concern will be on the basis of the prospects for the project under consideration. For existing concerns, however, the estimates take into account the cash-flows arising from their current business as well as those emanating from the expansion under consideration in their entirety. The cash-flow estimates will show for any given period, during the phase of construction and for a few years subsequently, the sources of funds including those arising out of profits and depreciation. They will also reveal the application of funds for different purposes such as payment of interest and instalments on long-term debt. A study of the figures will indicate the adequacy or otherwise of financial arrangements made by the borrowing unit. The 'debt service coverage ratio' mentioned at the end of the statement is arrived at by dividing cash accruals comprising net profit (after taxes with interest on long-term debt and depreciation added back), by total interest charges and loan instalments; this will indicate whether the cash-flows would be adequate to meet debt obligations

and also provide a sufficient margin of safety to the lending institution. This ratio as also the cash-flow estimates would serve as an invaluable guide to the lender for determining (1) the time when repayment of the loan should commence and (2) period of repayment of the loan, and imposing restrictions on the utilisation of funds where so warranted. In drawing up the terms of the loan, the principal consideration should be that they should not impose any strain on the concern and provide a reasonable measure of certainty for its financial viability while, at the same time, allowing a margin of safety to the lending institution.

(*iv*) *PRO-FORMA BALANCE SHEETS*

69. There is a difference in the financial appraisal of new ventures or new projects and expansions of existing concerns. In the former case, assessment is based on estimates and conjectures, while in the latter, past records and future forecasts based on previous performance are available and the established techniques of financial analysis can be applied to facts—not to only expectations as in the case of new ventures. What can be learnt by such an approach may tell far more about the quality of management, the financial strength of the concern, the market situation for the product, etc. than one could know about a new project. It is, therefore, desirable as a first step in the financial appraisal of existing concerns to study their balance sheets and profit and loss accounts for the past five years or so. The second step would be the preparation of estimates of the cash-flow statements for the next four or five years. The third step involves the working out of the estimated balance sheets for a similar period of four or five years, the figures of cash-flow statements providing the link between the balance sheet of one year with the next. For a new project, all the necessary figures must come from the cash-flow estimates. The preparation of *pro-forma* balance sheets is facilitated to the extent cash-flow estimates are available during the period of the loan. The following form may be used for compiling the *pro-forma* balance sheet estimates :

PRO-FORMA BALANCE SHEET ESTIMATES

	Construction			Operation		
	First year (1)	Second year (2)	Third year (3)	First year (4)	Second year (5)	Third year (6)
Capital & Liabilities	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.
Share capital						
Reserves and surplus						
Long-term debt						
Current liabilities						
Total ..						

Assets	
Gross fixed assets ..	
Less: Depreciation ..	
Current assets	
Investments	
Intangible assets	
Others	
Total	
Debt-equity ratio:	
Current ratio:	

70. As stated earlier, the cash-flow statements constitute the links between consecutive balance sheets and provide a dynamic picture of the concern as it progresses from period to period. The estimated balance sheets at different points of time provide the financial structure of the project as it has evolved and are helpful from the lender's point of view in assessing, for example, the adequacy of debt-equity ratio and the current ratio. These are explained in detail under ratio studies. It will suffice to say here that the former ratio indicates the balance of the capital structure as between the owned and borrowed funds, and the latter ratio indicates the coverage of the current obligations and the extent to which the business can withstand shocks by the strength of its liquid assets. Both these considerations are of major importance to the lending institution and as such may be useful for prescribing restrictive covenants, if necessary, in the loan agreements.

71. The preparation of the various statements would, no doubt, involve both time and effort. A proper understanding of the requirements of the lending institution and co-operation on the part of the borrowing concern would make the appraisal work easier. The borrower may require a step by step guidance in furnishing all the relevant data. Although information called for from the borrower may be rather detailed and the job of furnishing it somewhat exasperating, the borrower would sooner or later realise that the object of the enquiry is to establish the financial feasibility of the scheme and to see whether there is scope for modification for the mutual benefit of both the parties concerned.

72. No term lending institution can afford to ignore a comprehensive financial appraisal, except at its own risk. There may be a tendency to examine merely the latest balance sheet and profit and loss account of a concern and on the basis of some profit appearing in the accounts to take a favourable view on the loan proposal. In other words, there may be a temptation to appraise term loans, applying the criteria adopted for short-term loans; this, however, must be scrupulously avoided. Whereas investigation of the means and integrity of the borrower may suffice for short-term

accommodation, for term loans, it is essential for the lender to make sure of the viability of the proposed project i.e., technically, economically, financially and managerially. A banker providing short-term loans for working capital has to ensure, for example, that the loan will be repaid from the sale proceeds of the products for the manufacture of which raw materials, etc. are purchased with the help of the loan. In case of default, the loan can be readily realised by the sale of goods which normally have a ready market. But in the case of industrial loans against fixed assets, recovery is to be expected only out of profits earned from the use of the fixed assets and not from their sale, which do not ordinarily have a ready or regular market. No lender can, therefore, afford not to examine the essential requirements of a term loan, in the proper perspective.

73. It is not enough to know with reasonable accuracy what the project will cost and its expected costs and revenues when it starts normal production. The period before the commencement of the normal operations is crucial and in the absence of proper data, it would be difficult to arrive at realistic estimates of earnings which would in turn affect the cash-flow estimates. It is, therefore, desirable for the lending institutions not only to see that the forms of application for loans prescribed by them provide for the requisite information but that material information is not withheld by the borrowers on the plea that it is not readily available. As stated earlier, the lender should provide all possible assistance to the borrowers in preparing the relevant statements. On the part of the borrowers, there is sometimes a feeling that lenders enquire into various aspects of the financial position which are considered private. Such an attitude is obviously not justifiable as the lending institution cannot but be concerned with the project if it has to finance it.

MINIMUM FINANCIAL CRITERIA :

74. Term lending institutions have to critically analyse the data obtained from the borrower to ensure that the projects meet the following minimum financial criteria :

(1) The estimated cost of the project is reasonable and complete and has a fair chance of materialising.

(2) The financial arrangement is comprehensive without leaving any gaps and ensures cash availabilities as and when needed.

(3) The estimates of earnings and operating costs are as realistic as circumstances permit.

(4) The borrower's repaying ability as judged from the project operations is demonstrable with a reasonable margin of safety.

RATIO STUDIES :

75. In the financial statements (balance sheet, profit and loss account and cash-flow statements) over a period of years, one can study the trends or patterns in financial structure, and inter-relationships between financial facts. The study of past financial pattern usually provides the basis for projections regarding the future and enables one to focus attention on the inter-relationship of certain items or a group of items with certain other items or groups of items so as to pin-point the weaknesses, if any, in the financial position. Keeping the purpose of the study in view, the appraisal will have to be confined to items of major significance. Ratio studies are regarded as an essential part of the equipment of the financial analyst. Ratios are useful as indicators, but they suffer from the inherent limitation that when there is a variation in them over a period of time, it will not be possible to say without reference to the basic details whether the change has been brought about by either one of the factors or both. At best, they indicate the possible weaknesses calling for further investigation in the proper direction.

76. On the basis of the financial statements furnished to it, the lending institution has to satisfy itself about the solvency of the concern, its probable continued solvency during the currency of the loan and its ability, meanwhile, to meet its obligations. Consequently, the judgment of the overall financial position of a concern would depend on an assessment of the structure of its capital position, its earning capacity and the profitability in relation to its sales and capital invested, and, finally, the ability of the concern to meet its obligations as and when they mature—a matter of primary importance to the lender. Ratio studies of the financial statements are specially useful in this regard. Some of the basic ratios and their significance from the point of view of the term lending institutions are discussed in the following paragraphs :

(i) *Debt-equity ratio :*

77. From a lender's point of view, the financial structure of a project should reveal a satisfactory balance of "owned" funds i.e., equity, and "borrowed" funds i.e., debt. Debt includes all debt and debentures maturing within more than one year ; maturities even in respect of term loans becoming due within one year should, therefore, be omitted as they become current liabilities. Equity consists of the entire share capital (ordinary, preference etc.), premium on issue of the shares, free reserves and surplus, discretionary provisions for contingencies, etc. and like items which represent the interest of the owners in the concern. Equity should also include the development rebate reserve. In this context, redeemable preference shares with less than twelve years to run may be taken under debt while those with longer period may be categorised under equity. It is generally

desirable that the owners have a substantial stake in the project so that the enterprise is free from the burden of paying interest on borrowed capital in the earlier years. The debt-equity ratio can be computed by dividing debt by equity expressed as a percentage. There cannot be a rigid rule as to the relationship between these items ; a debt-equity ratio of 50 : 50 may generally be considered good in respect of industrial enterprises. However, if the project is considered risky because of uncertainty of the market or other factors, the lending institution may consider it necessary to expect a more favourable ratio and conversely, higher proportion of loan funds may not be regarded as unsatisfactory if the concern is well-managed and produces basic products for a favourable market. The composition of debt itself is an important factor to be considered ; for instance, if a substantial part of the earlier debt matures for repayment and overlaps with the instalments of the proposed loan, it may impose an unduly large burden on the concern. A prudent lender will have to judge the risk and also consider the composition and nature of debt in order to appreciate the debt pressure on the concern. The ratio may be useful in prescribing the repayment clauses of the loan agreement.

(ii) *Current Ratio :*

78. The next important aspect to be studied from the balance sheet is the relationship between current assets and current liabilities which reflects the short-term financial position. Current assets include stocks of raw materials, stores, work-in-progress and finished goods, book-debts and other receivables, pre-paid expenses, cash and investments which can be readily liquidated ; in other words, all assets which are in liquid form or which can be converted into cash within a year. The current liabilities cover all short-term obligations which must be met within a year. The relationship between current assets and current liabilities is termed the current ratio which is obtained by dividing the former by the latter. Its purpose is to indicate whether the concern can pay off the current liabilities as they mature and whether it can withstand sudden reverses by the strength of its liquid position.

79. A current ratio of 2 : 1 is generally considered satisfactory. However, taking into account the condition of our money market as well as the business custom of relying rather more heavily on short-term borrowing, a lower ratio of, say, 1.5 : 1 may be acceptable. The ratio will vary with different industries ; for example, a company whose turnover is quick will not require as much working capital as its counterpart with a slow turnover. The current ratio indicates only a quantitative coverage and by itself does not give an indication as to the quality of the current assets and current liabilities. The adequacy of the ratio should, therefore, be judged by an examination of the composition and the quality of components of these assets and liabilities. Consideration of factors such as the valuation of stocks,

duration of the sundry debt and borrowings and the marketability of the investments would substantially assist in determining the quality of the ratio. If a scrutiny of the current assets reveals that they contain slow moving stocks of raw materials, work-in-progress and finished products and debts whose collection is slow and if these are pitted against current liabilities requiring urgent attention, even a high current ratio cannot be deemed adequate as the concern's solvency might be affected. Similarly, a sudden fall in the prices could shrink the value of stocks thereby narrowing the margin of safety to the creditors. Therefore, it is necessary to make a further analysis of the current ratio and not take it at its face value.

(iii) *Sales and Profitability Ratios :*

80. In order to determine whether the borrowing concern is in a healthy financial condition, the scrutiny of the balance sheet has to be supplemented by an examination of the profit and loss account. The level of sales and the resulting profits studied in conjunction with the connected items are often revealing, and the relative ratios are briefly discussed below:

Sales Ratios :

(a) *Ratio of sales to total capital employed :*

81. This ratio is usually referred to as turnover of total capital employed and is calculated by dividing sales by total tangible assets i.e., assets minus the fictitious items. Capital is employed in fixed assets which are used for manufacturing goods and in current assets for meeting manufacturing expenses. Manufacturing activity can be maintained only if sales are good and increased sales mean increasing profits. This ratio is, therefore, a broad indicator of the economy and efficiency observed in the use of capital.

(b) *Sales to receivables ratio :*

82. This ratio is obtained by dividing sales by receivables (book-debts) and is capable of disclosing collection problems of credit sales. As an illustration, a ratio of 12 : 1 may imply that the book-debts are equivalent of sales of one month. A fall in the ratio is considered unfavourable as it may amount to a longer collection period and reflects on the quality of the book-debts. Thus, if the ratio is 3 : 1 showing four months' uncollected debts and if the business custom is to extend, say, only one month's credit, the collection of book-debts would seem to be considerably slow and the matter would have to be investigated.

Profitability ratios :

83. The profitability of a company can be examined from different view points. The main approaches are (a) profit on sales, (b) profit on total capitalisation and (c) profit on equity.

(a) *Profit-sales ratio :*

84. The profit-sales ratio is of primary importance as profits accrue only from sales. It is computed by dividing operating profit (before deduction of taxes and excluding income from investments outside the business) by sales. The ratio provides a yard-stick of the efficiency of production and a measure of margin on sale price.

(b) *Profit to total capitalisation ratio:*

85. The profit to total capitalisation ratio is worked out by dividing profit (before taxes with interest on long-term debt added back) by total capitalisation (i.e., equity plus long-term debt, both referred to earlier under debt-equity ratio). Profits are taken before taxes as taxes vary over a period of years ; profits after taxes may not therefore be quite comparable. As the intention is to measure the earning power of both "owned" and "borrowed" capital, it is necessary to add back to profits the interest paid on borrowed capital ; otherwise, the ratio will not give the correct picture.

(c) *Profit to equity ratio:*

86. This ratio provides a measure of the return on the investment of equity shareholders and is calculated by treating net profit after taxes as the numerator and using equity alone as the denominator. This is really an investor's criterion as it enables him to ascertain the dividend-paying capacity of the concern. A higher ratio is indicative of brighter prospects of attracting new capital.

(iv) *Debt service coverage ratio:*

87. The debt service coverage ratio, also called debt coverage ratio, provides a measure of the ability of a company to pay the interest due on its entire long-term debt and also serves as a guide to determine the period of repayment of instalments thereof. This is calculated by dividing cash accruals by total of interest on long-term debt and principal instalments, for a given year. Cash accruals, for this purpose, should comprise net profit (after taxes) with interest on long-term debt and depreciation provision added to it. The denominator should be the total annual interest on all long-term debt and the annual repayments of principal. This ratio is valuable in that it indicates the margin of safety which exists for the lenders, and is, therefore, appropriately included in the cash-flow statements, each year. The ratio may vary from industry to industry, but one has to view it with circumspection when it is less than two.

(v) *Break-even point :*

88. "Break-even" point is expressed as a percentage of full capacity production and is that at which the plant may be said to cover its costs including full debt service (interest and amortisation of long-term debt). At this point, customarily, losses cease and beyond it profits are realised. A good project is supposed to have a break-even point not higher than 70 per cent, but acceptable break-even points vary over a wide range. The break-even point, calculated after making allowances for price fluctuations, would be more meaningful as it would reveal how much fall in prices can be absorbed by a project at a given level of production without incurring losses.

89. The basic ratios discussed above may, by and large, be sufficient to get a feel of the general condition of financial health of a company and diagnose any possible maladies.

90. The trends of important items in the financial statements as well as the different ratios computed on the lines suggested earlier would enable the financial analyst to appreciate the long-term financial position of the company, and whether its operational and financial efficiency would improve. The application of financial analysis internally, i.e., within the company, provides a basis for judging its financial strength through a period of years. The use of external comparisons, on similar lines, is a convenient means of studying the company's position in relation to its competitors and this shows whether the concern is ahead of its competitors or is likely to lag behind.

91. *Pre-sanction Inspection :* For existing concerns, if a study of the basic data furnished by the borrowers reveals that a basis for considering the loan proposals exists, it would be prudent for the lending institution to depute an officer to inspect them with a view to verifying the correctness of the information furnished by the borrowers and supplementing it where necessary through investigation, etc. Such an inspection may bring to light certain features which would not have normally been revealed by a mere study of the balance sheets and profit and loss accounts of the concerns. With this end in view, the inspecting officer is expected to go behind the figures, to find out, for example, whether the assets, especially those comprising security, exist and are owned by the concern. The inspector has also to check up the valuation of assets and the depreciation policy adopted by the concern. Further, he may ascertain whether all the liabilities and claims, admitted as well as in dispute and contingent, have been disclosed by the concern. This is an aspect which is likely to escape the attention of the lending institution but has to be noted carefully. The report of the inspector will focus attention on the unfavourable aspects or weaknesses, if any, of the financial policies followed by the concern and the quality of its management. On the other hand, it may also show favourable features and throw light on the competence of the management.

92. *Follow-up :* A well designed follow-up of loan proposals is as important as the pre-sanction financial appraisal. As the lending institution is concerned with the success of the project, it is necessary for it to keep a close watch on the progress of the project during the currency of the loan—to see that the construction schedule is adhered to, that the plant and machinery and other equipment are received according to the promised dates of delivery from the suppliers, that generally the expenses of construction and operation of the plant are within the estimates and that after production is started, the sales and profits of the enterprise compare favourably with the original estimates, and so forth. The causes and circumstances which delay or impede the realisation of the targets will have to be investigated promptly and remedial action taken before it is too late. The follow-up and supervision of the loans thus form an essential part of the work of lending institutions—these are in essence an extension of financial appraisal. It is usual for lending institutions to stipulate that the borrowing concern should submit periodical progress reports and furnish such other information as may be considered necessary. The nature of information called for in regard to various projects varies according to the circumstances of each case. However, the information concerning the following aspects may be called for periodically (quarterly or half-yearly) for the above purpose.

(1) *Construction :*

(*i*) Progress made in the acquisition and development of land, construction of buildings and site facilities.

(*ii*) Finalisation of orders for plant and machinery, their delivery according to schedule and the progress made in their installation.

(*iii*) Availability of foreign technical know-how and engineering services.

(*iv*) Progress of plans regarding the training of labour and supervisory cadres overseas and in India.

(*v*) Statement of expenditure already incurred and yet to be incurred indicating the availability and sources of funds.

(*vi*) Deviations or changes in the financial plans requiring revision of the financial estimates with reasons for the changes.

A final report on the project at the end of the construction may be called for indicating the cost, sources of funds and the major changes from the original plans.

(2) *Production and Sales :*

(*i*) Production (indicating nature of product):
(*a*) quantity.
(*b*) cost.

(*ii*) Sales (indicating nature of product):

(*a*) quantity.

(*b*) value.

(*iii*) Cost of products sold.

(*iv*) Reasons for deviations from the earlier estimates of production costs and profitability.

(3) Position regarding employment of labour and technical personnel and whether wages and salaries have been paid on the due dates.

(4) Particulars of additions, if any, to financial resources of the concern.

(5) Changes, if any, in the value of security and in the financial position or means of guarantors.

(6) *Pro-forma* balance sheet and profit and loss account for the period ended—(quarterly/half-yearly as may be desired).

(7) Other particulars and explanations having a bearing on the progress of the concern not covered under any of the above heads.

(8) Details of insurance cover held against the assets charged as security:

	Type of risk covered	Amount. Rs.	Date of expiry of the policy
(*a*) Buildings			
(*b*) Plant and Machinery ..			
(*c*) Others (specify)			

(9) Position regarding income-tax—whether necessary provisions have been made and outstanding liability, if any.

(10) Position regarding rent, rates, taxes—whether they have been paid on the due dates.

93. *Inspection :* The different financial estimates made originally may require revision in the light of the progress reports. Where serious handicaps are revealed, the causes must be properly investigated. Generally, the progress reports provide clues in respect of possible irregularities which may be examined more closely by periodical inspections at least once a year. These inspections should be capable of supplementing or even substituting the burdensome reporting requirements on the borrowing units by requiring the inspectors to gather information on all essential aspects not covered by the periodical reports, returns, etc. submitted by the units. Attention will have to be paid during inspections to the following aspects, in particular :

(1) actual use of the loan as against the purpose for which it was intended ;
(2) implementation of the terms and conditions of the loan, particularly the restrictive covenants ;
(3) progress made in construction and operations ;
(4) reasons for changes in plans or estimates ;
(5) change, if any, in the value of security ;
(6) verification of the inventory ;
(7) financial position of the concern with particular reference to the following :

(*a*) reasons for changes in capital, if any ;
(*b*) the reason/purpose behind increase or decrease in reserves ;
(*c*) whether adequate reserves for taxation, bad debts, etc. have been created ;
(*d*) whether any fresh charge on assets already mortgaged has been created ;
(*e*) increase or decrease in borrowings and the rates of interest thereon ;
(*f*) any abnormal increase in liabilities ;
(*g*) nature and size of contingent liabilities ;
(*h*) schedule of capital assets and the valuation thereof ;
(*i*) nature of investments of the concern and their effect on its liquid position ;
(*j*) extent of interlocking of funds.

(8) reasons for defaults, if any, or delayed rep. ,ments of the instalments of the loan ;
(9) production and sales record ;
(10) availability of raw materials, power, etc. ;
(11) position regarding insurance ;
(12) any factors impeding or threatening the progress of the concern according to plan.

In order to remedy the defects that may have come to light during the inspection, the lending institution may give suitable directions or guidance to the concern as may be considered necessary in the circumstances. Further, if the conditions so warrant, the lending institution can also exercise the right usually retained by it while granting a loan, of nominating a person on the Board of Directors of the borrowing concern. Such a course is intended to safeguard the interest of the lending institution as its nominee will remain in touch with the affairs of the concern and help it to follow appropriate policies and implement the directions given by the lending institution.

94. What is sought to be emphasised here is that the maintenance of a constant and close contact with the borrower is the best guarantee for the security of the credit and its regular redemption. Sometimes the project

may face difficulties such as poor management and planning, sub-standard production due to technical defects or frequent breakdown of machinery due to improper handling, inadequate supply of raw materials, power and skilled labour, and absence of suitable transportation facilities. In all such cases, the reasons for the difficulties have to be carefully investigated. The lending institution with its knowledge of conditions in many industries which it finances could provide expert advice to its borrowers even on matters not connected with credit. For example, when a borrower experiences financial or operational difficulties, he could be helped to overcome them by timely advice or securing for him the services of a technician or an experienced partner or director or, where such a course is justified, providing additional finance. Thus, the lending institution should not consider that its interest has ended with the sanction or disbursal of the loan. It should closely follow the progress of the project and whenever occasion warrants, advise the concern suitably keeping in view their mutual interests. The handling of these aspects of loan transactions is indeed a matter which calls for full appreciation of the circumstances of the loanee concern and exercise of sound judgment.

95. *Rate of interest :* On the basis of a thorough financial appraisal, the lending institution determines the feasibility of the project and works out the terms and conditions of the loan. An important question which is to be decided at this stage is the rate of interest to be charged by the lending institution and the periodicity of its application i.e., monthly, quarterly, half-yearly, etc. The rate of interest on term loans should normally be higher than the rates for short-term accommodation in view of the larger risk involved and should be related to the cost of raising the funds by the lending institutions. The rate of interest in an individual case would depend among other things on the financial standing of the borrowing concern, the integrity of its management, the period of the loan and the degree of risk involved in the project itself. Other things being equal, a well-managed concern of sound financial standing should be able to secure funds at a more favourable rate than one which is not of the same rating. Similarly, undoubted integrity of the management or a lesser degree of risk may tip the scales in favour of a slightly lower rate and *vice versa*. It is the general practice with some of our term lending institutions to charge a uniform basic rate of interest in respect of all loans regardless of the type or size of the borrowing concern and the degree of risk involved. Under this system, a project for expansion in a well-established line and another which is a venture into an entirely new and uncharted field are set on the same plane. The present practice makes for uniformity of treatment and avoids charges of discrimination ; it is hoped that in course of time the rates of interest will be varied according to the risks involved in financing the concerned projects.

96. *Restrictive covenants :* Sometimes, the project may be approved subject to certain financial restrictions. Such restrictions which may take different forms and are usually incorporated in the loan agreements, are

intended to protect the interests of the lending institution and generally to ensure the maintenance of the soundness of the financial position of the concern. For example, the borrower may be required to agree that the loan in question will receive the highest priority for repayment. At times, provision may be made that the borrower should not borrow further sums on a long-term basis without the consent of the lending institution, or a stipulation may be made that the debt-equity ratio should not exceed a stated limit. Sometimes, the agreement may specify conditions regarding the maintenance of minimum working capital so as to possess enough cushion for withstanding unexpected financial shocks such as through fall in prices, etc. At other times, in order to ensure that the borrower is not short of funds for meeting his current obligations including the servicing of the loan, it may be provided that the selling commission or the managing agency commission, if any, will not be disbursed during the currency of the loan except after meeting the interest on and instalments of the loan. Similarly, the borrower may be required not to declare dividend for specified periods or beyond an agreed rate. The lending institution can rely on other types of restrictions as may appear necessary (Vide item 110 of the Check-list in Appendix I). A few restrictive covenants as indicated above would be necessary in case of a term loan which runs over a period of years for ensuring protection to the lender, lest the borrower should be tempted to dissipate resources to the detriment of the interests of the lending institution.

97. The Working Group wishes to record that the methods of financial appraisal as well as follow-up and the role of guide, philosopher and friend which financial institutions should play vis-a-vis their term loan customers, as set out in this Chapter, are based on practices studiously followed by such institutions in the U.S.A., Japan and West Germany. They are also based on current practices of Indian institutions such as the Industrial Finance Corporation of India and Industrial Credit and Investment Corporation of India Ltd.

98. *Illustrative Example :* An illustrative example of a loan appraisal is given in Appendix II of the Report.

99. *Need for publishing financial data on industries :* As suggested earlier, comparison of the financial data of the concern seeking finance with those of other units engaged in similar lines is a useful tool in the hand of the financial analyst. However, this confronts lending institutions with the problem of procuring financial data in respect of specific industries. Due to the paucity of suitable published data, the financial institutions have to obtain balance sheets of other concerns of 'comparable size and circumstances' for a purposeful comparative study. The publication of financial data for each industry, as also the data relating to companies grouped by size (large, medium and small) would be worthwhile. The Department of Statistics in the Reserve Bank of India which is already engaged in the analysis and publica-

tion of balance sheet data, may consider undertaking this work in collaboration with the Industrial Finance Department of the Bank. Two points may be stressed in regard to this work : firstly, the coverage of industries has to be as wide as possible, and secondly, the data will have to be published as speedily as possible. The Reserve Bank may also consider bringing out special dossiers on the various aspects of major industries. These publications would prove of great value to a variety of interests, viz., Government, industrialists, investors, financial institutions, planners, research workers and so on.

100. *Training in industrial finance :* Term lending institutions should have on their staff persons with adequate qualifications and experience who can be entrusted with the work of appraisal. To this end, attention will have to be given to recruitment and training of qualified and experienced staff. Each such institution should have a minimum complement of one team consisting of trained and experienced persons from each of the three fields, viz., engineering, industrial economics and accounting, at a fairly senior level who could provide the necessary guidance. It will be an added advantage, if the technical experts are able to advise on groups of industries in a general way so that reference to outside experts with specialised knowledge of particular industries may be minimised. When a full complement of competent basic staff and sufficiently qualified consultants are not available, there is a danger of emphasis being laid on one or two aspects of the appraisal in which the staff are experienced, and neglecting the other equally important aspects. From the point of view of financial appraisal, it is necessary that an intensive course in industrial financing covering both theoretical and practical aspects spaced over a period of six to nine months is organised in the Bankers' Training College conducted by the Reserve Bank for the benefit of the officers of the term lending institutions. The present *ad hoc* course for 8 weeks is good as far as it goes. These facilities should be valuable in the context of the increasing number of financial institutions, particularly banks, taking to term lending. The Working Group attaches great importance to the training aspect ; there is no substitute for providing the proper basis for correct thinking, right approach and solid experience.

CHAPTER IV

SECURITY AGAINST TERM LOANS

101. Security considerations, which assume prime importance in short-term credit operations in India, appear significant for term loans also. It is essential that there should be adequate asset protection behind a term loan to provide against loss resulting from errors of judgement in appraising the loan There may also be occasions where security considerations assume greater importance. For example, a lending institution may have to consider a proposal which relates to a project in an industrially backward area; similarly an industrial concern may propose to enter into a new line of production which is important from the point of view of development of resources of the economy but the soundness of which is not immediately certain. Security considerations are also of particular importance in less developed countries where information on the character, integrity, and creditworthiness of the borrowers is not readily available and much groundwork has yet to be done in the establishment of credit information bureaux. A prudent term lending institution should, therefore, secure its loan by adequate collateral and, where necessary, guarantees and, in order to safeguard its interest and to ensure that the ability of the borrower to discharge the loan out of future earnings is not impaired, also embody in the loan agreement, suitable protective and restrictive covenants such as maintenance of certain minimum financial standards, supplying to the lender adequate financial information, earlier repayment of loans under certain conditions, restriction on the payment of dividend and any other payments, e.g., managing agency or selling agency commission, etc. Taking of adequate security would also have the effect of infusing the necessary responsibility in the borrower. There is, however, a general tendency among term lending institutions in India to depend more on the collateral for the repayment of loans than on the integrity and ability of the management and the borrowing concern's past and prospective earnings. To a large extent, this seems to be due to an inclination on their part to associate the repayment of the loan with the sale of the security. Frequently, the assets given as security such as specialised machinery, etc. are difficult to dispose of as they do not ordinarily have a ready or regular market; the worth of these assets which is estimated on the basis of a "going concern" largely depends on the earning potential of the project, as a whole. The greater reliance on security may also sometimes be due to inadequate financial appraisal which in its turn may be due to non-availability of the necessary data. However, as financial assessment is the very keystone of a project's appraisal, the security cover of the loan should not be regarded as a substitute for such an assessment. Nevertheless, considerations of security form an important basis of lending and are thus a necessary adjunct to financial appraisal. The lending institutions should therefore examine loan proposals from the point of view of both commercial profitability and the nature of security offered.

102. The size of asset protection will depend firstly on the quality of the assets and secondly, and more importantly, on the concern's past record of operations, its managerial competence, its reactions in the past to adverse economic conditions and reputation for straightforwardness and financial responsibility. There is certainly scope for relaxing the margin requirements say from 50 per cent (normal) to 40 or 35 per cent according to the earning potential of a concern. The following paragraphs briefly deal with the current practice, in general terms, of Indian term lending institutions in the matter of securing their advances.

Types of Security:

103. By and large, the types of security generally accepted by the term lending institutions are the existing industrial assets as well as those to be acquired from the loans to the concerns. Quite a few of them also accept non-industrial assets (such as land and residential buildings of the directors or partners) as part of the main security in cases where industrial assets are not sufficient, or as collateral. Although, in principle, industrial assets are by far the best security for industrial loans, non-industrial assets could also be accepted as supplemental security and for new ventures, as an interim measure, till sufficient industrial assets are created to cover the loans. In such cases, it is often the practice to stipulate a higher margin. Agricultural land, however, is generally not accepted or is accepted only to a limited extent because it raises a number of problems stemming from land legislation, etc.

104. Most financial institutions also obtain, as a measure of abundant caution, the personal guarantees of the directors/managing agents. As the future of the concern is largely dependent on the standard of the management, joint and several guarantees obtained from persons responsible for directing its affairs may be of particular value. However, the rule need not be applied so rigidly as to render the absence of such guarantees a disqualification. For instance, they may not be considered necessary in the case of concerns having a good record, reputation and standing. On the other hand, where relaxations or concessions are made in the other terms and conditions of the loan such as the reduction of margin requirements etc., a greater emphasis may be placed on personal guarantees.

Statutory and Other Provisions Governing Security Requirements :

105. A term lending institution in India may either be a company incorporated under the Companies Act like the Industrial Credit and Investment Corporation of India Ltd., Madras Industrial Investment Corporation Ltd., and Refinance Corporation for Industry Ltd. or a banking company (also governed by the Banking Companies Act, 1949) or a statutory body like the Industrial Finance Corporation of India or the State Financial Corporations. It may be useful to refer to certain important provisions governing the types of security for loans contained in the respective Acts. So far

as the Companies Act, 1956 is concerned, it does not contain any specific provision either about advances or security and any stipulations in this regard are governed by the memorandum and articles of association or internal rules and regulations of the company. For example, the Refinance Corporation does not take any direct security but relies on the standing of the primary lending institution and accepts a declaration of trust by it in respect of security taken by the institution from the industrial concerns. The Banking Companies Act, 1949 does not prescribe any stipulations in this regard except that a banking company is prohibited from making advances against its own shares or unsecured advances to its directors or firms, etc. in which it or any of its directors is interested. A general power is conferred on the Reserve Bank of India under Section 21 of the above Act to issue directives with a view to controlling advances. Subject to this, commercial banks are free at their discretion to secure their term loans in the manner they deem fit. The State Bank of India and its Subsidiary Banks are authorised to make loans to approved industries upto seven years upon such security (including immovable property) as the State Bank may deem fit (vide Section 33(xixb) of the State Bank of India Act and Regulation 46(b)(ii) of the Subsidiary Banks General Regulations). Section 23(2) of the Industrial Finance Corporation Act, 1948 as well as Section 25(2) of the State Financial Corporations Act, 1951 provide that no accommodation shall be given by these Corporations unless it is sufficiently secured by a pledge, mortgage, hypothecation or assignment of Government or other securities, stocks, shares or secured debentures, bullion, movable or immovable property or other tangible assets in the manner prescribed by regulations or unless it is guaranteed as to the repayment of principal and the payment of interest by the Central Government, State Government, a scheduled bank or a state co-operative bank. Apart from the fact that these Corporations are prohibited from making loans or advances against their own shares, there is no specific restriction in these Acts on the type of security, margin, valuation, etc. The regulations of these Corporations which are framed by their respective Boards of Directors after consultation with the Reserve Bank of India and with the approval of the Central/State Government concerned; usually leave the conditions regarding the type of security, margins to be maintained and factors to be taken into consideration in deciding the margin, etc. to the discretion of the Boards/Executive Committees of the Corporations. It would be seen that the onus of choosing the right type of security and the responsibility of valuing it and fixing a margin on it, etc. is placed on the institutions themselves. No doubt, the Corporations have also to follow the directives, if any, received in this regard from the Central/State Governments concerned.

Nature of Charge :

106. The nature of charge for industrial loans is usually a mortgage on the fixed assets which may be reinforced by personal guarantee as stated earlier.

It may be considered whether the principal charge should be in the form of a legal mortgage, or an equitable mortgage created by the deposit of title deeds. The obvious advantage of a legal mortgage is that since the deed is executed and registered, it becomes possible for the lender to deal with the security in the manner set out in the deed without the intervention of the Court of Law, subject however to the provisions of Section 69 of the Transfer of Property Act, 1882. As against this advantage, a legal mortgage attracts high stamp duty while an equitable mortgage does not. There is also the factor of delay in getting the document registered. In certain cases, particularly when the period of the loan is relatively short, equitable mortgages might be more economical and suitable. The Transfer of Property Act recognizes equitable mortgages as equivalent to legal mortgages; an equitable mortgage by deposit of title deeds takes priority over subsequent legal mortgage. In view of this, equitable mortgages should normally find greater favour. In practice, however, equitable mortgages are accepted by some of the financial institutions subject to the memoranda of deposit being registered only to a limited extent for interim loans pending completion of legal mortgages, and also for short-term loans for periods upto about 18 months. The following are among the reasons for the relative unpopularity of equitable mortgages. Firstly, they cannot be created in places other than Presidency Towns, *viz.* Bombay, Madras and Calcutta and such other towns as are notified by the concerned State Governments and are, therefore, of limited availability. Secondly, the property mortgaged by deposit of title deeds cannot be sold except with the intervention of the Court. To overcome these limitations, the Seminar on Financing of Small-Scale Industries in India held at Hyderabad in July 1959 had suggested the desirability of amending the statute to allow the creation of equitable mortgages also in taluka towns and the sales of properties under such mortgages without the intervention of Court. These suggestions deserve consideration.

107. The creation of a legal mortgage involves heavy expenses by way of stamp duty and registration charges and if the loan is required for a relatively short period of five years or so, taking of equitable mortgages would be economical from the borrower's point of view and not so risky from the point of view of the lending institution. However, equitable mortgages are not suitable for long term loans and it will be safer and desirable to insist on legal mortgages so that in case it becomes necessary, the mortgage could be enforced without intervention of the Court. Further, the total cost of borrowing will not be burdensome to the concern as the stamp duty and registration charges are spread over a larger number of years unlike in the case of medium-terms loans.

108. Another suggestion made by the Hyderabad Seminar was that plant and machinery, which are treated as 'immovable' in certain circumstances *e.g.* if they are fixed to the premises should, in all circumstances, be treated as movable property so that they can be hypothecated instead of mortgaged,

No doubt, a hypothecation of movable property will not prevail over a subsequent charge taken without notice of hypothecation. But in the case of companies, since Section 126 of the Companies Act, 1956, lays down *inter alia* that the registration of a charge would constitute notice of the charge to every person who may later come to acquire any interest in the subject matter of the charge, a subsequent charge or transfer would not get priority over the rights of the person whose charge is previously registered. To offer the same degree of protection in the case of hypothecation advances to individuals and firms—who are the main borrowers in the small-scale sector—the Seminar had recommended legislative amendment making registration of such charges with the Registrar of Assurances compulsory. Both these recommendations of the Seminar also deserve consideration. Pending an amendment of statute, the State Governments may consider allowing reduction in the stamp duty and registration charge on loan documents. These concessions will be of considerable psychological value to the borrowing industries. The revenue foregone by the State Governments on this account is not likely to be significant and is expected to be more than compensated by the beneficial effects of industrial development on employment and income, which would ultimately result in additional revenue.

Valuation of Security :

109. An assessment of the sufficiency of the security offered as cover for the loan implies a proper valuation of assets. These assets may be valued on the basis of their book value, current market value, or replacement value less depreciation for the number of years the assets have been in use. In applying any one of these bases of valuation the lender might either become too conservative to the detriment of the borrower's interest or become too liberal against his own interest. For instance, a rigid application of the book value to an asset which has been written down considerably though its market value is high, might not be equitable to the borrower. Similarly, adherence to the market value at a particular time might not afford a proper basis of valuation in the context of term loans ranging over a period of years during which a variety of factors might affect the market value prevalent at the time the loan was sanctioned. The replacement value might prove in particular cases to be an over-estimate. It would hence be expedient to combine one or more of the above methods depending on the type of the asset so that the valuation finally adopted might safeguard the interests of the lending institution and also be equitable to the borrower. A further point to be noted is whether the assets of the borrowing concern have been revalued earlier at any time; if so, it would require a careful probe into the matter. Similarly, if the business of the borrower was purchased as a going concern, it would be necessary to examine how the assets were valued at the time of their acquisition.

Land:—Land is sometimes valued at cost; but generally a preference is shown for assessing land at market value. In arriving at the market value

of land, it is desirable to take into account the locality, recent sales in the neighbourhood, proximity to roads, markets and other centres, possibilities of fluctuations due to development, present and anticipated future income, etc. One of the financial corporations utilises the services of retired revenue officials for the purpose of valuation and some such arrangement would be of advantage.

Buildings :—The valuation of buildings is generally entrusted to architects or engineers and detailed instructions are sometimes issued by lending institutions in this regard. The value of the buildings may be arrived at on the basis of replacement cost less depreciation for the number of years the buildings have been in use or market value, whichever is lower. The area, the type of construction and the nature of materials used, the age of the building, the nature of maintenance and the condition of the building, etc. have to be taken into consideration while assessing the value of a building. In computing the replacement cost, reasonable allowance has to be made for the engineers' and architects' fees and the building contractors' profit. In practice, some of the term lending institutions accept book value or the market value of the asset, whichever is lower. Book value, however, is often much lower than the market value as the value of the buildings especially in urban areas generally appreciates far in excess of their original cost. Since their value is not likely to come down, there may not be much risk in valuing them on the basis of market value.

Plant and Machinery :—The value of new plant and machinery during the first year of working is generally taken at invoice value plus freight, duties, insurance, transport and erection charges. Where the machinery has been in use for more than a year, it is usually taken at book value or cost less normal depreciation. Sometimes replacement cost less depreciation for the number of years the machinery has been worked is also taken. The basis adopted depends on the circumstances of each case. For example, where the machinery has been written down in the books to a nominal value, its book value would not be sufficiently representative of its present worth. It would be desirable in such cases to have the machinery valued by engineers or by specialists in the field. It is important to take into account the condition of the machinery, its maintenance and upkeep, its efficiency in working, the period of further useful service it can give, etc. All second-hand machinery should be valued separately as also electrical equipment, whether for power or light, together with the value of transformers, etc. The value of workshop machinery and repair machinery may also be included in the main valuation. In the process of valuation, it would be necessary also to ensure that overheads allowed, *viz.*, freight, duties, insurance, etc. are reasonable.

110. A proper valuation of security requires the assistance of technical and legal experts. Technical evaluation should, as far as possible, be entrusted to specialists in the particular field of industry. It will be useful if panels of

technical experts in different industries consulted by institutions like the Industrial Finance Corporation of India or the Industrial Credit and Investment Corporation of India are prepared and circulated periodically among the various term lending institutions. The examination of title deeds, documents, etc., should be done carefully and in the light of local laws, customs, etc. For example, advances against plant and machinery installed in rented premises have to be viewed against the background of the law prevalent at the locale of the property as the Rent Acts in some places do not permit of the transfer of tenancy rights. In the event of the borrower's failure to repay the loan, the lending institution might find itself in legal difficulties being unable to transfer the tenancy rights to the purchaser who would want to take over the unit as a running concern. Similarly, in the case of leased premises, the lending institution should ensure that the period of the unexpired lease is long enough, at least a few years longer than the period of the loan. As the title to the land would affect the title to the structure on the land, it should be ensured that the former title is clear and marketable. However, in deserving cases, where there is considerable delay in the verification of title to the immovable properties and such properties represent a small proportion of the total assets offered as security, the lending institution might consider accepting other assets against the loan though they may not provide full margin provided it is satisfied about the integrity and honesty of the borrower, his past performance and the future prospects of the project to be financed. The lending institution should closely examine the depreciation policy adopted by the concern and see how the book values of the assets have been arrived at. In estimating the value of machinery, it is usual to include such items as freight, duties, insurance, transport charges, etc., incidental to the commissioning of the plant, along with the invoice cost of the machinery. Similarly the capital value of assets may be taken to include installation charges, interest on borrowed funds during construction of factory and consultation and know-how fees. Valuation on the basis of the review of the assets by the experts (including consultants where necessary) should be adequate and realistic and be equitable to both the lending institution and the borrower.

Sharing of security or participation loans:

111. A concern which has already borrowed from a credit institution may sometimes find itself in need of further finance and may have to look to another institution for assistance as the total accommodation required by it may be too large for a single institution to provide. There may also be cases where credit institutions are restricted by statute from providing finance in excess of a prescribed limit. For example, the State Financial Corporations are not authorised to finance an individual industrial unit in excess of Rs. 10 lakhs except in the case of public limited companies and co-operative societies where the limit is Rs. 20 lakhs. In such cases, the difficulty in obtaining finance arises mainly because the entire security or part of it consists of fixed assets

which already stand charged against the original loan and which are either indivisible or otherwise incapable of being split up in such a way as to offer separate securities to more than one lender. Since a second charge is generally looked upon with disfavour, it would serve the interests of all concerned, if the original lender agrees to a *pari passu* charge being created on the assets already mortgaged to him in favour of the prospective lender. It will be worthwhile to indicate here some of the participation arrangements prevalent in other countries. One form is where two or more commercial banks make a joint loan against the same security and appoint one of them as the "lead" bank which is entrusted with the servicing of the loan on behalf of participating banks. A second form is where a joint loan is made against the same security by commercial banks and long-term lending institutions, the former financing the maturities falling due, say, within five years and the latter taking over subsequent maturities. Another variation of this arrangement is where the entire security is retained by the long-term lending institution which guarantees the loan made by commercial banks. While some of the banks in India have already adopted the first alternative, the other two have still to be developed here. It may be mentioned that the Industrial Finance Corporation of India and the Industrial Credit and Investment Corporation of India Ltd. are allowed to guarantee loans made by commercial banks and that with the recent amendment of the State Financial Corporations Act, these Corporations would also be authorised to give such guarantees. Participation loans can also be conveniently made by State Financial Corporations which, as stated earlier, are not authorised to make loans to a single unit in excess of a prescribed limit, as also by Industrial Finance Corporation of India and Industrial Credit and Investment Corporation of India Ltd.

112. In participation loans, where more than one institution provide finance, the co-operating institutions generally enter into a formal agreement containing clauses relating to the share of each participant, the distribution of income and expenses, the duration of the agreement, the mode of administration, etc. The method of administration differs according to the needs of each case. For example, the facilities to the borrower may be provided by one of the participating institutions which may act as agent for the rest and keep the security documents, disburse the loan, receive repayments and undertake all related work, or each participant may fulfil its obligations direct to the customer. After the participating institutions have developed close relations in joint financing they may even consider replacing the formal agreement by exchange of letters. The loan agreement with the borrower may usefully contain certain clauses which spell out the agent's functions vis-a-vis the other participating institutions. In the event of the borrower's failure to implement the terms of the contract it should not be difficult for the concerned institutions to agree to a conjoint action consistent with the interests of all the participants. Such participation arrangements can be worked out not only for loans but also for other purposes such as underwriting of shares, issuing guarantees, etc.

Special Provisions :

113. Despite the various safeguards taken by a financial institution, occasions may arise when it has to deal with defaults in repayment of loans. It is, therefore, desirable that some additional safeguards should be found to protect its interests if such an eventuality arises. In the ordinary course, the enforcement of security comprising immovable property involves a very elaborate procedure laid down in the Civil Procedure Code resulting in considerable delay and expense. However, in the case of the Industrial Finance Corporation of India and the State Financial Corporations, special provisions have been included in their respective statutes in order to make the enforcement of such security easier. These enable the attachment and sale of property in a more or less summary way by the judicial authority concerned when an application is made in this behalf by a duly authorised officer of the Corporation. These Corporations have also been specially empowered by law to take over the management of defaulting borrowing concerns, to transfer by way of lease or sale and to realise the property pledged, mortgaged, hypothecated or assigned to them.

114. With a view to protecting the interests of the lending institutions, a suggestion was made at the Hyderabad Seminar on the Financing of Small-Scale Industries in India that special provisions for the enforcement of security on the lines of those in the State Financial Corporations Act, etc. might be provided but the discussion on the subject was inconclusive. In fairness to the other institutions and in order to encourage term lending activity, it may be worthwhile to extend to them at least some of these facilities.

Meetings of Term Lending Institutions :

115. Security considerations, valuation of security, policies, methods of operation and procedures of different term lending institutions necessarily vary from one another to some extent. Absolute uniformity in policy and procedures is neither possible nor desirable. Each institution has to evolve its own policies and procedural details according to its needs and the expertise at its disposal. Most of the institutions are relatively new in the field of term lending and periodical exchange of views and experiences of institutions functioning in different regions is highly desirable. A forum for discussing matters of common interest to the financial institutions has been provided by the Reserve Bank of India at the annual Conferences of State Financial Corporations. These meetings are also attended by several other concerned interests and have proved useful; apart from this, newer Corporations could freely draw on the experience of the older ones. It is desirable to enlarge suitably the representation at the meetings so as to cover those commercial banks which are prominent in extending medium-term loans. Their participation in the meetings besides being useful to themselves will also help to solve certain problems in the matter of co-ordination of activities of the finance corporations and commercial banks.

CHAPTER V

TERM LOANS TO SMALL-SCALE INDUSTRIES

116. The somewhat comprehensive criteria which can be applied to the term loan applications from medium and large-scale industries cannot be used in respect of term loan proposals from small-scale industries for several reasons. Small-scale industries find it difficult to secure adequate finance from institutional sources even for their working capital requirements not to speak of longer term capital. This is the result of their own inherent limitations on the one hand and the generally high standards applied by the lending institutions to borrowers on the other. Organised credit institutions have generally been wary of lending to small-scale industries because in their eyes they generally constitute poor risk. By and large, small units have a low capital to turnover ratio, as a result of which the available block capital security is inadequate in relation to a given level of production; their markets are somewhat narrow, prospects for business frequently uncertain and hence their rate of mortality is rather high. Banks therefore encounter difficulties in assessing their creditworthiness. This structural weakness makes lending to small-scale industries a complicated matter. These industries, therefore, deserve special treatment especially because of their relatively high employment potential.

Definition of Small-Scale Industries :

117. For purposes of extending Governmental assistance and offering certain facilities, the currently accepted official definition covers those units with a capital investment not in excess of Rs. 5 lakhs. Here, capital refers to block assets comprising land, buildings and machinery. Where a concern is situated in rented or leased premises, the annual rent payable is capitalised at 8 per cent to arrive at the total value of block assets. The value of plant and machinery is taken at their original cost whether bought newly or secondhand or on hire-purchase basis. The ceiling of Rs. 5 lakhs has been partially relaxed in certain cases with a view to encouraging the development of small-scale industries as ancillary units of large-scale industries. Since these units would need costlier machines necessitating a capital investment beyond the ceiling of Rs. 5 lakhs, Government has decided to extend some of the facilities under the programme for development of small-scale industries also to units with investment upto Rs. 10 lakhs. Such facilities are, however, confined to technical assistance through the Small Industries Service Institute, supply of machines under the hire-purchase scheme and allotment of factories in the Industrial Estates. To begin with, this relaxation in capital ceiling is to apply to industrial units in manufacturing ancillaries and components for industrial and agricultural machinery, machine tools, electrical machinery and equipment, radios, electrical and mechanical instruments, transport industry, including automobiles, railway and shipping, bicycles, etc.

118. Under the impetus of the various promotional measures undertaken by the Central and State Governments, there has been a rapid growth in the size of the small-scale industrial sector which now covers a very large number of industries, such as, manufacture of biscuits, pens, pencils, oil engines, bolts and nuts, automobile spares, cycle parts, etc. The growth of the economy anticipated during the Third and the subsequent Plans will provide greater opportunities for further expansion in this field. In this context, the problem of providing adequate finance to this rapidly expanding sector naturally assumes great importance. For this purpose it would be useful to sub-divide the group further.

Structural Features :

119. Small-scale industries may be classified under three broad categories :

(1) Some industries are started on a small scale, but they are likely to develop into medium sized units within a short time. Like medium scale industries, these are capital-intensive, require relatively large investment in block assets and are generally in the corporate sector, organised as public or private limited companies or co-operative societies. In these concerns, borrowed capital bears a high proportion compared to owned capital. These concerns are in an advantageous position to offer adequate security by way of block assets or stocks and are also able to provide the necessary information for consideration of loan applications. The concerns in this group are comparatively well-managed and with a good sales turnover; they can be generally considered credit-worthy for institutional financing. At present, some of the industries falling in this group in India are the manufacture of biscuits, paints, pens, oil engines, grinding wheels, automobile spares, etc.

(2) Under the second category come units started on a small scale and which are likely to remain so for a long time, in view of the specialised nature of demand for their products. Though specialised types of machines are required by this sector, they do not require any large scale investment in block assets. These are organised generally as non-corporate concerns, principally partnerships, proprietary or joint family concerns. These concerns have little block assets to offer as security though they maintain sufficient stocks. They do not have godown facilities and transactions are mostly on a small scale. Nor do they have sufficient credit to raise finance on hypothecation from institutional agencies as pledge arrangement is inconvenient to them. The managerial ability of these concerns also varies considerably from unit to unit. Their own resources are blocked either in holding stocks or in giving short-term credits extending to 3-6 months to their customers. Their principal requirement, therefore, is working capital. With little scope for attracting outside capial, they usually borrow either from relatives or money lenders, finance secured from institutions being relatively insignificant. Units pro-

ducing agarbathies, bolts, nuts, oil-stoves, wire-nails, etc. come under this category.

(3) The last category covers concerns which starting as cottage industries have developed into small-scale industries or as feeder units to large-scale industries. This group, however, forms the smallest among the class of small-scale industries. These are mostly organised as proprietary or partnership concerns. Borrowed capital is relatively insignificant in their resources and the availability of institutional finance negligible. Being more labour intensive, the tangible assets of these units are limited; their management as well as maintenance of records are rather poor and assessment of the market prospects for their products, etc. is rather difficult. Under these circumstances, finance has to be provided primarily on the basis of judgement of the integrity and expertise of the management, and not unnaturally, institutional agents are reluctant to meet their financial requirements. Units producing toys, confectionery, coil springs, etc. come under this category.

Major Problems of the Small-Scale Industries:

120. Thus it will be seen that the needs as well as capacity to attract institutional finance vary considerably as between the different categories of small industries. There are, however, certain problems common to all of them which will have to be borne in mind in evolving measures to cater to their financial requirements. Not that these problems do not arise in the case of medium and large industries; but small industries have to be assisted somewhat differently bearing in mind the special features of the situation. In brief, the problems are as follows:

(1) *Inability to offer adequate security:*

Since most of the small-scale industries have limited financial resources they do not have their own buildings and are generally located in monthly rented premises. Thus they can only offer by way of security to the lending institutions their machinery and stocks.

(2) *Absence of specialisation:*

Due to non-availability of raw materials in adequate quantities some of the small units take up production of a variety of items. The result is absence of specialisation which makes it difficult for them to produce goods of standard quality or to sell them at competitive prices.

(3) *Import difficulties:*

Specialised types of machinery are required for the manufacture of certain products and many of them have to be imported from abroad. Sometimes,

small industrialists find it difficult to obtain specifications, quotations, etc. for the right type of machinery needed by them from manufacturers in foreign countries, and obtain import licences. For want of acceptable references and finance they are also unable to secure deferred payment facilities.

(4) *Lack of managerial and specialised skills:*

Unlike big units which are able to employ a number of technical hands small industries cannot afford to engage persons with adequate technical ability. Besides, most of the small units depend for their success on single individuals and their removal by death or otherwise might result in the collapse of even comparatively well run businesses.

(5) *Lack of adequate transport facilities:*

To ensure smooth and efficient production, adequate transport facilities between the factory site and supply centres of raw material, coal, etc. on the one hand, and the market centres on the other, are essential. Due to the cost involved, small industries cannot afford to have their own transport and have to depend on the existing facilities which are sometimes inadequate.

(6) *Power shortage:*

Due to demands overtaking the available supply of power the small industries usually suffer from shortage of power.

(7) *Absence of proper audited accounts:*

As the bulk of small industries is in the non-corporate sector and as there is no statutory obligation on them to maintain proper accounts and to have them audited, they neglect this most essential aspect of a well run business establishment. There is also a tendency among them to view audit by an outside party with suspicion.

The adoption of an active policy by the Central and State Governments to assist the development of small-scale industrial sector has led to a series of measures designed to provide them with technical advice and information, credit and other facilities. In the field of credit, for example, a substantial provision has been made for loans under the State Aid to Industries Act to meet the long and medium-term requirements of the small industrial sector. However, the provision which can be made for such direct assistance by the State in the Plan being necessarily limited in relation to the requirements of the small-scale sector, it requires to be supplemented in a significant measure by loans from the financial institutions such as State Financial Corporations, commercial banks, etc.

Difficulties in Procuring Institutional Finance:

121. As stated earlier, small-scale industries are generally not regarded as sufficiently creditworthy since they are not able to fulfil the criteria laid down by the lenders. The grant of medium and long-term loans involves not only the assessment by the lenders of creditworthiness of the borrowers and the security offered by them but also the observance of rules and regulations governing such advances by the borrowers. The financial position of a borrowing concern should be fairly sound and should show profitable working or should have the prospect of improving its earning capacity if the financial assistance is granted; the equipment and technical processes employed in the production of goods and services should be efficient; the unit concerned should belong to an industry which has an assured market or should produce items in the shape of spare parts which are absorbed by a large industry and the borrowing concern should be owned by men of integrity and business standing. Assessment of the risk factor in advancing to small industries naturally poses a problem to the lender.

122. On their part, small industries are confronted with:

(1) some rigidity of approach on the part of lending institutions in dealing with the borrowers and the absence of close association with them; (2) the complicated nature of information required from the borrowers; (3) strict requirements of security, rigid prescription of acceptable collateral; and (4) delay involved in the sanction of loans.

123. The institutions which normally respond to a certain extent to the needs of the small-scale industries are the smaller banks, whose field of activity is restricted to a small area. These banks are often managed by local men who, unlike branch agents of large banks, are able to develop informal relationship with the small industrialist. In view of their personal contacts with customers, local banks are better able to adopt a flexible attitude and dispose of the applications expeditiously. However, the resources of these banks are generally small and unless the bigger banks with large resources and branch organisation take a promotional view in the initial stages and extend the much needed assistance to the small industries, they would be forced to borrow from non-institutional lenders, the disadvantages of which need no elaboration here. As a consequence, they would fail to raise their standard of operation which alone can help them to develop and become creditworthy. On their part, the small industrialists should appreciate that banks have to operate on business principles and as such cannot lower their lending standards to any appreciable extent in order to meet the financial needs of small-scale sector. The industrialists should therefore make earnest efforts to meet the requirements of lending institutions.

Application Forms:

124. It is usual for some of the credit institutions to require an applicant for finance to fill in a very elaborate questionnaire. It is suggested that in the first instance only such information as would enable the lending institution to judge whether the unit is creditworthy and whether the project for which the finance is required is *prima facie* feasible, may be obtained. In other words, the information should be comprehensive enough, without being too detailed, to assist the lending institutions to judge whether the proposal should be accepted for further detailed examination. The form in Appendix IIIA would seem suitable for the purpose. In the preparation of the form the fact that most of the small industrialists do not have audited or published accounts has been taken into account, and this would explain why Section B of the form dealing with the financial position of the borrower is somewhat more detailed. If on an examination of this application it is found that there is a *prima facie* case for acceptance of the proposal, additional information in greater detail may be obtained either by a supplemental questionnaire or by interview method. Appendix IIIB sets down more or less exhaustively the items of supplementary information. It can be adapted suitably by the investigator having regard to the circumstances of individual cases. The intention is that an experienced official should gather the supplemental information or help the applicant in filling up the form.

Audited Accounts:

125. As many of the small industrial units are either proprietary or partnership concerns, difficulty is usually experienced in obtaining financial statements in an acceptable form. While the aim should be to obtain audited accounts, some latitude may be shown in deserving cases. For example, where a concern is unable to furnish audited accounts for the last few years, at least the latest accounts should be audited and presented to the lending institution.

Personal inspection:

126. Before a loan appraisal is complete it is desirable that an experienced officer of the financing institution inspects the concern so that a proper evaluation could be made of the proposal in the beginning. The small industrialists do not often know how to present their case to the satisfaction of the lending institution. It will, therefore, be useful if the latter, having regard to the circumstances of each case, provides the requisite guidance to the unit. Sometimes, slight modifications in the project, if agreed to by the unit, may make it acceptable.

Suggestions for improving the facilities for Institutional Finance:

127. If institutional credit is to play a more vital role in catering to the requirements of these industries, measures to overcome the difficulties pointed

out above will have to be taken. This calls for responsive co-operation between both the lenders and the borrowers; the nature of adjustment in attitudes and other matters necessary on the part of lending institutions on the one hand and borrowing units on the other is indicated below.

(*A*) *Lending Institutions:*

128. Some suggestions which may be useful to lending institutions catering to the needs of small-scale industries are given below:

(1) Lenders should take into account not only the value of security offered but also the character and technical ability of the borrower, the prospects of the industry, the nature and quality of goods produced, etc.

(2) Acceptance of only a few commodities as security and that too on a pledge basis makes it difficult for the industries to become eligible for advances from the institutions. Wherever possible, factory type advances may be given.

(3) The small and medium sized banks which cannot afford to maintain technical staff (engineers, business technicians, etc.) individually could join together and set up a common advisory board for the purpose. One solution would be to utilise the services of the State Departments of Industries and the Small Industries Service Institutes which, under instructions from Government of India, offer their assistance to credit institutions in the matter of technical appraisal of projects.

(4) Lending institutions may maintain personal contacts with borrowing units through periodical visits, etc.

(5) One way of meeting the problem of paucity of technical data required for appraisal of creditworthiness would be to make use of the available official data on small-scale industries. Some of the sources that may be tapped are:

(*a*) Data released by the Development Commissioner and the Ministry of Commerce and Industry.

(*b*) Reports on Studies made by Small Industries Service Institutes.

(*c*) The Industry Reports prepared by the Economic Investigation Division of the Central Small Industries Organisation. The Division also gives investment guidance to parties and advice on the propects of the various industries. The Division has also taken up the preparation of Industry Prospect sheets on a large number of industries. These sheets are more or less miniature analysis of planning reports, containing information on the appropriateness of the industry (i.e. technical feasibility, competitiveness and size of investment for an economic unit, supply-demand position, etc.). As these sheets generally become out of date with lapse of time, they have to be used with due caution.

The information available from these sources could be supplemented by the data furnished by the borrowers, when they are inadequate.

(6) The interest charged should be reasonable and the period of repayment should be determined with reference to the earning capacity of the unit. The first instalment may be allowed to be paid after a year or two to enable the borrower to stabilise his position and strengthen his repaying capacity. The margin of security should be liberal varying between 25 and 50 per cent consistently with safety of the loan.

(7) To enable financial institutions to liberalise their lending criteria, Government of India has introduced the Credit Guarantee Scheme which is operated by the Reserve Bank of India and the institutions can avail themselves of the guarantee facilities in order to cover a part of their risk. The maximum amount of *loss* recoverable under the scheme is Rs. 1 lakh which is substantial in relation to the size of a small unit. Such guaranteed loans if given on a term basis are also eligible for refinancing facilities offered by the Refinance Corporation for Industry Ltd.

(8) The different agencies could supplement each other's resources and thereby share the risks by participating in the loans of other agencies. Thus participation between commercial banks and State Financial Corporations or between bigger and smaller banks would be helpful. Such participation loans can also be covered under the Credit Guarantee Scheme referred to above, provided one of the participant institutions is an eligible institution and undertakes to assume risk of loss in the loans to the extent of at least 25 per cent.

(9) Lending institutions should be practical and flexible in their attitude rather than strictly legal. This would give an opportunity to the concerns to overcome any temporary difficulties. While resort to legal action or recourse to security should not be delayed once it becomes clear that the loan cannot otherwise be recovered, such a drastic step should not be taken immediately a default in payment of interest or instalment occurs. Not infrequently, defaults occur due to circumstances beyond the borrower's control and timely advice and guidance, allowing some time to overcome the temporary difficulty or providing additional financial assistance where so warranted, would enable him to avert a crisis. Only when other avenues have been explored without result, or the borrower is considered to be recalcitrant or dishonest, should the lending institution force a closure.

(*B*) *Small-scale industries:*

129. There are certain directions in which small-scale industries, on their part, could improve their methods of operations, etc. and make their proposals acceptable to the lending institutions. These are indicated below:

(1) It may not be usually possible for small industries to furnish financial and other data in a thorough and detailed manner. In such cases, as much information as is available on the following aspects of the concern may be made available to the lending institutions, *viz.*, available details on the nature of the industry and its products, data regarding past performance, estimated cost of production and selling price, estimates regarding market prospects, capital invested, proportion of borrowed capital, etc., purpose of the loan, results expected from the investment, etc.

(2) Concerns should, in their own interest as also to facilitate assessment of loan proposals by lending institutions, try to maintain audited accounts.

(3) The units must be able to produce acceptable evidence for verification of value of assets offered as security.

(4) Loans sanctioned should not be used for purposes other than those for which they are taken.

(5) In cases where the prospects of an industrial concern depend on a single individual or individuals, and where the loan is given on personal security or guarantee, the lender's interests could be safeguarded by insuring the life of such individual or individuals or guarantors during the loan period. Special type of policies may be devised for the purpose with special rates somewhat on the lines of fire insurance. The premiums may be borne by the lending institutions or partly by them and partly the borrowers.

130. To sum up, while on the one hand, it is essential that financial institutions should safeguard their interests with adequate security, on the other hand, small industrial concerns should, as far as possible, not be denied the assistance they deserve or need. Lack of finance is often not the cause but the result of difficulties in other spheres as outlined earlier. In such cases what is needed is remedial measures for setting right those factors which would render financial assistance fruitful. It is common knowledge that the small-scale sector needs non-financial assistance in the form of marketing, technical guidance and training in management, etc. In order to assist the small industries, the Government has already established special institutions like Small Industries Service Institutes, National Small Industries Corporation, provided Industrial Estates with necessary facilities and arranged training programmes; but the scope of operations of these need to be expanded still further. Above all, there is a need for greater co-ordination at all levels between the financial institutions and non-financial institutions and agencies engaged in promotion of small industries with a view to solving the financial problems.

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The members of the Working Group particularly wish to express their deep appreciation of the most able manner in which the Chairman, Shri K. N. R. Ramanujam, planned and conducted the work of the Group.

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Member

Y. V. Sivaramakrishnayya
Member-Secretary.

BOMBAY, *April 15, 1962.*

APPENDIX I

Check-List

General.

1. Name of applicant.

2. Address of applicant.

3. Amount and type of financial assistance sought from the lending institution.

4. Constitution of applicant.

   (Sole Proprietorship/Partnership/Joint Hindu Family/Private or Public Co./Co-operative society, etc.—If applicant is a member of a group of associate companies brief description of the group and applicant's relation to it should be given).

5. Names and addresses of bankers.

6. Whether the applicant's bankers have been authorised to furnish such information regarding financial background and credit-worthiness as the lending institution may require.

7. Bankers' references on applicant.

8. Commercial references, if any.

9. Nature of present and/or proposed business.

10. Purpose of the financial assistance sought.
    (full details of proposed utilisation of loan proceeds to be given)

Details of present business activities.

11. Brief history of the existing business.

12. Final accounts for the last 5 years and Directors' reports together with *pro-forma* Balance Sheet and if possible Profit and Loss Account if the last audited Balance Sheet is more than six months old.

13. Explanations for any abnormal items in the above accounts.

14. Details of present valuation of (1) land and buildings (2) machinery and equipment. Are the above mortgaged/under legal charge? If so, details thereof.

15. Reasons for revaluation of assets, if any.

16. A copy of the report on which the above revaluation is based.

17. Present borrowings :

    (Showing amount, period, source, security furnished, and its value and rate of interest).

Outstanding debentures.

Outstanding mortgages and other long-term debt.

Outstanding bank borrowings and maximum limit.

18. Whether copies of documents in support of the above have been produced.

19. Depreciation policy.

20. Present position regarding income-tax assessments.

21. Details of pending litigation either by or against the company.

22. Details of contingent liabilities, if any.

23. Names of major shareholders and their respective holdings of ordinary and preference shares.

24. Copy of Memorandum and Articles of Association/Partnership deed, etc.

MANAGEMENT

25. Name/s of proprietor/partners/Karta/directors/promoters, their financial standing, business connections and technical competence.

26. Names of officers holding important posts, their qualifications and experience.

27. Names of Managing Agents, Secretaries and Treasurers.

28. Names and brief particulars of the companies in which the persons mentioned in 25 above are acting in similar capacities or otherwise (with details).

29. Interest of Managing Agents/Secretaries and Treasurers in the company particularly as regards shares held.

30. Terms and conditions of their appointments (copy of Managing Agency or Secretaries and Treasurers Agreement).

31. Name of person who will direct construction.

32. Name of manager.

33. Brief account of his experience.

34. Extent of foreign technical/managerial assistance needed on a temporary/permanent basis.

35. Means of obtaining the above.

36. Names of purchasing and sole selling agents.

37. Copies of purchasing and sole selling agency agreements.

Project Report

38. Full technical report on the project.

39. Report on completion of preliminaries :

whether the concern has obtained :

1. Licence under the Industries (Development & Regulation) Act, 1951.
2. Capital issues consent.
3. Reserve Bank consent in respect of issue of shares, etc. to non-residents and other foreign exchange requirements of the project.
4. Import Licence.

40. Organisation of the Company :
whether the project will be executed by the same organisation/company or whether it is proposed to have a new organisation or company (with full details of name, address, financial standing and business connections of principal promoters or participants).

41. List of products manufactured/to be manufactured.

42. Method of production and process, etc. (full details) of each product line.

43. Specifications (quality, size, etc.) of each product.

44. Cost of production—estimates.
(tentative estimates to be given).

45. Existing and proposed rated capacity for each product.

46. Normal expected production of each product, indicating the basis of estimates such as number of normal working days in a year, number of shifts to be worked, etc.

47. Year by year percentage of production capacity until normal production is reached.

48. Percentage of normal productive capacity of existing lines of production.

49. Schedule of construction of the major items of work such as the development of site, construction of buildings, finalisation of orders, commencement of production, etc.

50. Actual location of plant (full address).

51. Location of plant vis-a-vis
(*i*) geological & topographical conditions
(*ii*) suitability of process
(*iii*) availability of raw materials—
domestic and imported :
(*a*) estimated price and sources of supply.
(*b*) the quantity and value of each item to be imported.
(*c*) import licensing position—whether import licence has been or is being obtained.

(*d*) whether any contracts have been entered into for their purchase —terms of the contracts.

(*iv*) fuel—source, availability and rate.

(*v*) water, in terms of litres per day and its rate per 1000 litres—source, availability and provision for water treatment.

(*vi*) power consumption/requirements in terms of kwts. per day. Rate and source of supply.

(*vii*) skilled and other labour—(i) reference to labour housing colonies, community centre and amenities available or expected to be provided by the factory ; (ii) number of managerial, technical, skilled and unskilled labour ; (iii) facilities for training local staff ; (iv) availability of trained technical labour ; and (v) allocation of labour into various operations.

(*viii*) transport and communication facilities, their nature *i.e.*, whether suitable for bringing in raw materials and heavy machinery and moving out finished goods, if bulky or heavy.
Distance from nearest railway station (name) and port (name). Whether railway siding or jetty is existing or contemplated.

(*ix*) markets and sales outlet.

(*x*) local regulations concerning pollution by smoke, dust, effluent discharge, etc. Arrangements for their proper disposal.

52. Whether competitive quotations were obtained prior to selection of suppliers for plant and machinery.

53. Comparative statement showing the various quotations and reasons for final selection.

54. Report on major machinery supplier/s and/or foreign collaborator/s and their experience in the line.

55. Lists showing individual items of plant and machinery (with corresponding cost) to be imported and purchased locally.

56. Full details of contracts for technical/financial collaboration. What arrangements have been made for training of Indian personnel ?

57. Lay-out of the plant and flow sheet of the process.

58. Extent to which construction and erection work will be performed by applicant departmentally or through contractors by inviting tenders.

59. Extent of future expansion proposed.

60. Details of the phasing of proposed expansion (with dates and capacity levels).

Cost of the Project

61. Detailed break-up of the capital cost of the project on the following lines, indicating expenditure :

(*i*) already incurred.
(*a*) in rupees.
(*b*) in rupee equivalent of foreign exchange.

and

(*ii*) to be incurred.
  (*a*) in rupees.
  (*b*) in rupee equivalent of foreign exchange.

Land including :

(*i*) cost of land.....acres at Rs.....per acre.
(*ii*) legal expenses.
(*iii*) taxes and expenses for basic improvements.
(*iv*) development expenses.

Buildings

(*i*) factory and administrative buildings, godowns, silos and other civil works.
(*ii*) housing colony.
(*iii*) site facilities e.g., wells, reservoirs, water mains, sewers, fencing, roads and outdoor lighting.

Plant & Machinery:

(*i*) Imported F.O.B. costs of the main plant and auxiliaries including power plants, transformers, etc., if any.
(provision for escalation of price to be shown separately).
(*ii*) Insurance and freight.
(*iii*) Import duty.
(*iv*) Indigenous equipment.
(Provision for escalation of price should be shown separately).
(*v*) Transportation charges to site on both imported and indigenous equipment.
(*vi*) Provision for distribution of power, cabling and lighting.
(*vii*) Spare parts for imported and indigenous equipment.
(*viii*) Erection charges including expenses and fees of foreign technicians.

Miscellaneous fixed assets :

(*i*) Vehicles, furniture, fixtures, etc.
(*ii*) Workshop and laboratory equipment.
(*iii*) Fire fighting equipment.
(*iv*) Effluent treatment and disposal plant.
(*v*) Water supplies, storage and treatment systems.
(*vi*) Railway siding.

Technical know-how/Consulting/Engineering fees :
for construction of project or royalty for technical collaboration.

Intangible expenses :

(*i*) Patents.
(*ii*) Licences.
(*iii*) Payments for goodwill.
(*iv*) Trade marks.
(*v*) Trade names.
(*vi*) Copyrights.
(*vii*) Any other similar items.

Preliminary expenses :

(*i*) Legal expenses.
(*ii*) Brokerage.
(*iii*) Commission.

Pre-operative expenses upto the start of commercial production :

(*i*) Promotion expenses.
(*ii*) Working expenses.
(*iii*) Expenses for training personnel.
(*iv*) Interest on borrowings, guarantee charges, etc.
(*v*) Interest on deferred payments.

Interest during construction :

(to be capitalised and regarded as a capital cost of project).

Allowances for unforseen costs :

(indicating basis of estimate).

Initial requirements of working capital :

(showing details of total requirements and arrangements made therefor).

MEANS OF FINANCING

62. Sources of funds for the project requiring financial assistance should be shown giving terms of issue and of redemption under the following heads :

(*i*) by issue of equity share capital.
(*ii*) by issue of preference share capital (different types).
(*iii*) by issue of secured debentures (different types).
(*iv*) by mortgage loans.
(*v*) by unsecured loans and deposits.
(*vi*) by deferred payments to machinery suppliers.
(*vii*) from internal resources.
(*viii*) from banks (maximum limit allowed).
(*ix*) from Government subsidies and grants.
(*x*) from other sources.
(Source of funds for expenditure in Rupees and in foreign exchange should be shown separately.)

63. Financial contribution by promoters.

64. Financial contribution by foreign collaborators.

65. Assistance sought from lending institution.

66. Indicate how foreign exchange component is expected to be financed.

67. Security offered in respect of borrowings (details such as the basis of valuation of security to be given).

68. Present and proposed capital structure.

69. Extent to which any capital contribution will be made in any form other than cash.

70. Details of other applications for financial assistance made in India or abroad.

Cost of production and profitability

71. Detailed statement of cost of production and profitability for each product line, setting out distinctly production from existing lines and from expansion separately for each year during :

(*a*) construction (in the case of going-concerns), and
(*b*) operation

on the following :

(*i*) *Raw materials :*
(Separately for each item of raw material indicating also the quantity required per unit of finished product and the price at which it will be obtained).
(*ii*) *Consumable stores :*
Chemicals, dyes, etc.
(*iii*) *Power :*
(*a*) Cost of power bought out.
(*b*) Cost of power generated internally.
(*iv*) *Steam*
(*v*) *Fuel*
(*vi*) *Water*
(*vii*) *Labour* (direct).
(*viii*) *Repairs and maintenance of plant*
(*ix*) *Factory supervision and overheads*
(*x*) *Administrative overheads:*
(office salaries, insurance, rent, travelling and other expenses).
(*xi*) *Selling & advertising expenses :*
(*a*) commission.
(*b*) outward freight.
(*c*) packing.
(*d*) advertising and publicity.
(*xii*) *Interest* (rate to be indicated).
(*a*) on bank borrowings for working capital.
(*b*) on medium and long-term borrowings.
(*xiii*) *Depreciation* (rate to be given for all items).
(*xiv*) *Managing Agents'/Managing Directors'/Secretaries & Treasurers' Remuneration*
(indicate also rate).
(*xv*) *Sales* (indicate quantities and prices for each product line).
(*xvi*) *Operating profits*
(*xvii*) *Taxation*
(*xviii*) *Net Profits.*

72. Whether details and/or supporting documents have been supplied wherever possible and particularly regarding :

(*a*) Source and rate of raw materials, power, steam, fuel, water, etc.
(*b*) Number of labourers and other personnel employed and the basis of the estimated cost of labour.
(*c*) Basis for selling prices assumed.

73. Sales and Profitability ratios:
   (*i*) Ratio of sales to total capital employed.
   (*ii*) Ratio of sales to receivables.
   (*iii*) Ratio of operating profit to sales.
   (*iv*) Ratio of profit (before taxes with interest on long-term debt added back) to total capitalisation.
   (*v*) Ratio of net profit to equity.

74. At what percentage utilisation of capacity will it 'break even' financially, after plant is completed ? *i.e.*, will the total gross income be just sufficient to cover all essential expenses, interest and payments towards amortisation of debt ?

   Note: Where additions to existing enterprise are involved, the question has to be answered with reference to the total project including the new project.

75. Facilities for costing and internal check.

SOURCES AND APPLICATION OF FUNDS

76. Statement of income and cash-flow by regular periods before and after attainment of normal production, on the following lines :

Sources and application of funds as follows :

(*a*) Sources of funds :
   Net profit (before taxes with interest added back but after depreciation and development rebate reserve).
   Share capital increase.
   Increase in long-term borrowings.
   Increase in short-term borrowings.
   Depreciation provisions.
   Development Rebate Reserve.
   Others (to be specified).

(*b*) Application of funds :
   Fixed assets and capital expenditure.
   Current assets (such as book debts, closing stock, bills receivable etc.)
   Repayment of long-term borrowings (including deferred payments).
   Repayment of short-term borrowings.
   Interest.
   Other assets.
   Taxation.
   Other expenses.
   Debt service coverage ratio.

Pro-forma Balance Sheets

77. *Pro-forma* balance sheets of company during the currency of the loan on the following lines, indicating for each year during (a) construction and (b) operation, the estimated capital and liabilities, and assets of the concern :

(*i*) *Capital & liabilities :*
   Share capital
   Reserves and surplus
   Long-term debt
   Current liabilities

   Total ..

(ii) *Assets :*
Gross fixed assets
Less Depreciation
Current Assets
Investments
Intangible assets
Others

Total ..

78. Current ratios as per the above balance sheets.

79. Debt-equity ratios as per the above balance sheets.

MARKETABILITY

80. Company's sales of each product line for the past 5 years :

Quantity } at home
Value }

Quantity } exports
Value }

Total

81. Consumption of the commodity in India in the last 5 years :
Amount provided from domestic production

Amount provided from imports

Total

82. Present demand for the commodity (on the basis of figures).

83. Future demand for the commodity (the basis on which this is estimated should be stated).

84. Prevailing domestic prices (ex-factory) of comparable commodity.

85. Prevailing import prices (CIF) of comparable commodity.

86. Government controls over prices.

87. Other Government measures affecting sales.

88. Degree of protection afforded by :

(i) import duties.
(ii) import quotas.

89. Percentage of prospective sales intended for :

(*i*) home market.
(*ii*) export.

90. Advantages, if any, available from Government for exports.

91. Regional scope of markets :
(*i*) home.
(*ii*) foreign.

92. Expansions or new projects contemplated in the industry, apart from the present project.

93. Company's output as percentage of :

(*i*) present domestic production.
(*ii*) prospective domestic production.

94. Names of principal competitors—Indian and foreign :

(*i*) *Home market :*

(*a*) nature of competition in price.
(*b*) nature of competition in quality.

(*ii*) *Outside markets :*

(*a*) nature of competition in price.
(*b*) nature of competition in quality.

95. Main classes of buyers.

96. Average profit margins in the industry.

97. Methods of distribution :

(*i*) Existing { at home. / abroad.
(*ii*) Proposed { at home. / abroad.

98. Details of sales organisation.

(Full details to be given).

99. Prospective place of the industry in Indian economy.

PRE-SANCTION INSPECTION

100. (*i*) Verification of correctness of *all* information furnished by borrower.
(*ii*) Supplementing the above information with further details where necessary.
(*iii*) Physical verification of assets and security offered.
(*iv*) Valuation of security and assets.

(*v*) Verification of details of depreciation policy.
(*vi*) Investigation of details of borrowings, liabilities—existing and contingent—and claims admitted as well as in dispute.
(*vii*) Quality of management.
(*viii*) Worth of guarantors.

RECOMMENDATIONS AND TERMS & CONDITIONS :

101. Recommendations.

102. Reasons for the recommendations.

103. The purpose and broad outline of the agreements.

104. The general and exact uses to which the funds are to be loaned.

105. Total amount of borrowings that may be outstanding under the agreement.

106. Interest—rate, and time of interest payments.

107. Due dates of instalments of repayments of principal amount of the loan.

108. Schedule of disbursement of the loan.

109. Audited statements and interim statements to be submitted periodically.

110. Special conditions to be attached to the agreement :

(*i*) material change of ownership/management.
(*ii*) maintenance of adequate insurance.
(*iii*) condition to make loan rank superior to other loans.
(*iv*) payment of all taxes when due.
(*v*) negative pledge clause.
(*vi*) maintenance of minimum working capital.
(*vii*) maintenance of current ratio.
(*viii*) maintenance of net worth.
(*ix*) limitation of total debt by restriction in :
  Amount.
  Ratio to working capital.
  Ratio to net worth.
  Debt-equity ratio.
(*x*) other term borrowings.
(*xi*) other current borrowings.
(*xii*) limitation on dividends.
(*xiii*) limitation on retirement of capital.
(*xiv*) limitation of capital expenditure.
(*xv*) limitation of investments in or advances to subsidiaries.
(*xvi*) limitation of loans to stock holders.
(*xvii*) limitation of guarantees of obligations.
(*xviii*) limitation of subsidiary borrowings.
(*xix*) restriction on sale of subsidiaries.
(*xx*) restriction on sale of assets.
(*xxi*) restriction on pledge of assets.
(*xxii*) restriction on merger or amalgamation.

(*xxiii*) restriction on distribution of selling commission/Managing Agency commission.

(*xxiv*) right to appoint a nominee on the board of directors of the concern.

111. Default clauses :

(*i*) Period of grace.
(*ii*) Failure to repay instalments of principal on due dates.
(*iii*) Failure to pay interest.
(*iv*) Failure to perform covenant.
(*v*) Failure to meet other obligations.

112. Provisions for waiver of conditions.

FOLLOW-UP

113. Periodical (quarterly or half-yearly) reports on the following lines :

(1) *Construction :*
- (*i*) Progress made in the acquisition and development of land, construction of buildings and site facilities.
- (*ii*) Finalisation of orders for plant and machinery, their delivery according to schedule and the progress made in their installation.
- (*iii*) Availability of foreign technical know-how and engineering services.
- (*iv*) Progress of plans regarding training of labour and supervisory cadre overseas and in India.
- (*v*) Statement of expenditure already incurred and yet to be incurred indicating the availability and source of funds.
- (*vi*) Deviations or changes in the financial plans requiring revision of the financial estimates—reasons for the changes.

A final report on the project at the end of the construction as *completed* may be called for indicating the cost, sources of funds and the major changes from the original plans.

(2) *Production and Sales :*
- (*i*) Production (State nature of product)
  - (*a*) quantity.
  - (*b*) cost.
- (*ii*) Sales (State nature of product).
  - (*a*) quantity.
  - (*b*) value.
- (*iii*) Cost of products sold.
- (*iv*) Reasons for deviations from the earlier estimates of production costs and profitability.

(3) Position regarding employment of labour and technical personnel and whether wages and salaries have been paid on the due dates.
(4) Particulars of additions, if any, to financial resources of the concern.
(5) Changes, if any, in the value of security and in the financial position or means of guarantors.
(6) *Pro-forma* balance sheet and profit and loss account for the period ended—(quarterly/half-yearly as may be desired).
(7) Other particulars and explanations having a bearing on the progress of the concern not covered under any of the above heads.
(8) Details of insurance cover held against the assets charged as security.

	Type of risk covered	Amount Rs.	Date of expiry of the Policy
(*a*) Buildings			
(*b*) Plant and Machinery			
(*c*) Others (Specify)			

(9) Position regarding income-tax—whether necessary provisions have been made up-to-date and outstanding liability, if any.

(10) Position regarding rent, rates, taxes—whether they have been paid on the due dates.

POST-SANCTION INSPECTION

114. (1) That the loan has been used for the purpose for which it was intended ;
(2) that the terms and conditions of the loan, particularly the restrictive covenants, are being duly implemented ;
(3) the progress made in construction and operations ;
(4) the reasons for changes in plans or estimates ;
(5) value of security ;
(6) verification of inventory ;
(7) financial position of the concern with particular reference to the following :—
  (*a*) reasons for changes in capital, if any ;
  (*b*) the reason/purpose behind increase or decrease in reserves ;
  (*c*) whether adequate reserves for taxation, bad debts, etc. have been created ;
  (*d*) whether any fresh charge on assets already mortgaged has been created ;
  (*e*) increase or decrease in borrowings and the rates of interest thereon;
  (*f*) any abnormal increase in liabilities ;
  (*g*) nature and size of contingent liabilities ;
  (*h*) schedule of capital assets and the valuation thereof ;
  (*i*) nature of investments of the concern and their effect on its liquid position ;
  (*j*) extent of interlocking of funds.
(8) reasons for defaults, if any, or delayed repayment of the instalments of the loan ;
(9) production and sales record ;
(10) availability of raw materials, power, etc. ;
(11) position regarding insurance ; and
(12) any factors impeding or threatening the progress of the concern according to plan.

APPENDIX II

Illustrative Example of Appraisal of Loan Application of Messrs. X. Y. Wires Ltd.

(The financial data and other particulars given here are hypothetical and are intended to be illustrative of appraisal of a loan application with particular reference to its financial aspects. No specific reference to any existing concern is meant).

(1) *Name and other particulars of the company :*

(*i*)	Name	X. Y. Wires Ltd.
(*ii*)	Constitution	Public Limited Company.
(*iii*)	Location of Registered and Head Offices	No. 1, Steel Wires Building, Calcutta.
(*iv*)	Location of factory	Near Howrah.
(*v*)	Date of establishment ..	3rd November 1961.
(*vi*)	Type of industry	Iron and Steel Fabrication.
(*vii*)	Nature of products	Manufacture of high tensile steel wires used in umbrella ribs, bicycle spokes, electrodes, etc.
(*viii*)	Amount of loan	Already sanctioned—Nil. Now applied for—Rs. 30 lakhs.
(*ix*)	Period of the loan	7 years (to be cleared in 1969-70).
(*x*)	Purpose of the loan	To finance a part of the cost of the first phase of the project.

(2) *Brief history and management :*

The idea of manufacturing high tensile steel wires was mooted by two of the promoters intimately connected with the Engineering Corporation Ltd. They pursued the idea with T. C. Co. Inc., U.S.A., reputed engineering consultants and manufacturers in the field, who agreed to collaborate in the project. The company was established on 3rd November 1961 on that basis.

The company is managed by a Board of Directors consisting of the following :

(1) Shri A, Calcutta (Chairman).
(2) Shri B, Kanpur.
(3) Shri C, Calcutta.
(4) Shri D, Calcutta.
(5) Shri E, New Delhi.
(6) Shri F, Madras.
(7) Shri M. D., Calcutta.

Sarvashri B and C are well known industrialists. Sarvashri A and D bring to this concern the benefit of their experience, connections and managerial skill gathered from the Engineering Corporation Ltd., which is one of the largest rib manufacturing concerns in Asia. The other two directors, *viz.*, Sarvashri E and F are ex-

perienced businessmen having interests in the engineering field. On the whole the directorate is of high standing. The Managing Director Shri M. D. is an engineer with 20 years' experience, who had training recently in the U.S.A. in the manufacture of steel wires and allied products. Thus, the management of the concern appears to be sound and efficient.

(3) *Project :*

The project is for the manufacture of high tensile steel wires with an initial capacity of 7,500 tons. The capacity is expected to be doubled after two years of operation. The concern has been licensed under the Industries (Development & Regulation) Act, 1951. Necessary consent from the Controller of Capital Issues has been obtained. Government has approved the collaboration agreement. Import licence for the import of plant and machinery has also been obtained by the concern.

(i) *Location :* The factory will be located on a twenty-acre plot of land near Howrah, a few kilometres from the railway station. The plot is adequate for the factory both for its immediate and future requirements. The plot has the advantages of availability of water, power, easy access to skilled and unskilled labour, and transport and communication facilities. It has also the advantage of proximity to the market.

(ii) *Schedule of construction :* The development of the site and the construction of factory buildings are expected to be completed by the middle of 1962. The building will be constructed in two stages so as to house initially the machinery for the 7,500 ton plant and the rest of the machinery required for (increasing the capacity to 15,000 tons) the second phase will be housed in an extension. Erection of machinery for the first phase is expected to be carried out by June 1962, and trial runs may be completed by the end of 1962-63. Commercial production is expected to commence from 1st April 1963. The second phase of expansion is likely to be completed by March 1965.

(iii) *Plant and machinery :* The company has entered into an arrangement for technical collaboration with T. C. Co. Inc., who have two factories in the United States manufacturing special steel wires. The latter company also designs and fabricates furnaces required for the heat treatment of the wire products. This company will provide all the technical know-how to the applicant company and arrange for the services of two U.S. technicians to supervise the installation of the plant and machinery and also the initial operations and train the Indian personnel for a period of 2½ years. For these services, the collaborators will be entitled to a royalty of one per cent on sales.

The project has been screened by eminent local engineering consultants and their report on the technical feasibility of the project had been submitted to Government by whom it was accepted.

The design and specifications have been completed by the collaborators for all equipment including electric furnaces and wire drawing machines. A part of the equipment will be imported and the rest fabricated locally ; four furnaces will be imported from T. C. Company Inc. and nine more built in India under their supervision, for the first phase. Six wire drawing machines have been ordered from the U.S.A. Further, forty drawing machines are being made by local machine manufacturers Messrs. M. M. of India Ltd., as per the design of the U.S. machines.

(iv) *Raw materials :* Wire rods required for manufacturing electrodes and other mild steel wires are indigenously available and the Iron and Steel Controller has already sanctioned the required quota to the company. Wire rods for high carbon wires have to be imported at present, though there are prospects of these being produced domestically in the near future.

(v) *Essential services :* The concern will require power to the extent of 1500 K.W. and satisfactory arrangements for the supply of power have been made for the initial phase. No difficulty is envisaged for getting additional power for further expansion. Water will be required in small quantities only and this is easily available.

(vi) *Labour :* It has been estimated that about 250 employees including some 200 workers would be necessary. The skilled workers will be trained by the foreign experts. As there is a concentration of engineering and metal industries around this area, no difficulty is likely to arise in the availability of skilled labour.

(4) *Cost of the project :*

A detailed break-up of the estimated capital cost of the project is as under :

(In lakhs of Rupees)

	First Phase 7500 tons	Second Phase 15000 tons	Total
(1) Land and development expenses	9·90	..	9·90
(2) Buildings	12·98	10·35	23·33
(3) Plant and machinery—Imported (Rupee equivalent of U.S. $)	12·76	10·73	23·49
Indigenous	23·44	15·45	38·89
(4) Insurance, freight, duty and transportation to site ..	2·90	2·25	5·15
(5) Erection charges & engineering fees	2·46	1·42	3·88
(6) Miscellaneous assets	4·80	1·65	6·45
(7) Pre-operative and Preliminary expenses	8·16	0·75	8·91
(8) Contingency margin on rupee expenditure	2·10	3·15	5·25
	79·50	45·75	125·25
(9) Working capital	25·50	22·50	48·00
Total	105·00	68·25	173·25

Factory land and building : Negotiations for the purchase of 20 acres of land at Howrah have been completed. The estimate for site development includes provision for drainage facilities and land filling. The expenditure on factory building is based on the layout plan prepared by the collaborators and estimates given by the architects. A large part of the work has already been entrusted to Messrs. B. C., Building Contractors, after inviting competitive tenders.

Estimated expenditure : The estimates of expenditure on plant and machinery for the first phase are reasonable and purchase orders have already been finalised. Estimates for the second phase have been based on the prices fixed for the first phase and are tentative.

Contingency margin : Adequate allowance has been made for contingencies in the above estimates.

Working capital : The estimate for working capital is about three months' cost of production which is considered adequate.

(5) *Means of financing :* The project is proposed to be financed as under :

(In lakhs of Rupees)

	First Phase	Second Phase	Total
(1) Share capital	45·00	20·00	65·00
(2) Deferred payments	13·50	9·75	23·25
(3) Bank borrowings (short term)	16·50	7·00	23·50
(4) Term loan required	30·00	15·00	45·00
(5) Internal Finance (Cash accruals for 1963-64 and 1964-65)*	—	16·50	16·50
	105·00	68·25	173·25

Share capital : The share capital of Rs. 45·00 lakhs in equity shares required for the first phase will be raised as under :

¼ of the issue to be allotted to the Chairman.

¼ of the issue to be allotted to other Directors.

½ of the issue (balance) to be offered to the public for subscription.

Messrs. U. R. have agreed to underwrite the issue. In view of the excellent prospects of the industry and the standing of the Directors, the entire issue of ½ of the share capital offered to the public is expected to be subscribed fully. The further capital to be issued during the second phase is also expected to be allotted in the same proportion.

(In lakhs of Rupees)

* Cash accruals (vide Annexures A and B)

	(1) 1963-64	(2) 1964-65
Net Profit after taxes	3·95	12·12
Add Depreciation	9·39	8·07
Total cash generated ..	13·34	20·19
Less anticipated long term commitments	6·00	7·50
	7·34	12·69

Total cash accruals for 1963-64 and 1964-65 .. = 7·34 + 12·69 (1) + (2) .. .. = 20·03

Thus the estimate of Rs. 16·50 lakhs is fairly conservative.

Foreign exchange and deferred payments : The project, it is understood, was recommended by the Government of India who have allowed the entire foreign exchange requirements of the company. For the present, however, the company has received an import licence covering its requirements for the first phase only and expects to obtain the licence for the second phase at the appropriate time. The company has made arrangements with the machinery suppliers for deferred payment in respect of machinery worth Rs. 13·50 lakhs and Rs. 9·75 lakhs required respectively in the first and second phases of expansion. The terms of agreement with them, however, stipulate that the relative amounts have to be repaid in not more than three instalments in each case with interest at 6 per cent per annum. The deferred payments have been guaranteed by the D.P.G. Bank Ltd. against the personal security of the Directors.

Bank borrowings : Arrangements have been made with the D.P.G Bank Ltd. for a cash credit limit of Rs. 16·50 lakhs against hypothecation of stocks, subject to the maintenance of a margin of 30%. The concern expects to receive financial facilities for Rs. 23·50 lakhs from the bank during the second phase. It may be noted that the balance of the working capital requirements will be met from the company's own resources.

Present loan : The term loan sought presently for Rs. 30 lakhs is for the financing of a part of the first phase. (The company expects a further loan of Rs. 15 lakhs for the second phase.)

Debt-Equity Ratio : This may be placed at 49 : 51 on 31st March 1963, i.e., date of completion of the first phase. The ratio is expected to improve thereafter.

(6) *Financial statements :*

The following statements are appended hereto :

(*i*)	Cost of Production and Profitability	(Annexure A)
(*ii*)	Cash-Flow	(Annexure B)
(*iii*)	*Pro-forma* balance sheets of the company	(Annexure C)

The Cost of Production and Profitability Statement (Annexure A) indicates the profitability of the project. The availability of profit is assured because of the considerable margin between the fixed price of raw materials and that of finished products as fixed by the Iron and Steel Controller. Selling prices have been conservatively assumed at or below the price fixed by the Iron and Steel Controller. As both the purchase price of raw materials and selling price of finished goods are controlled, the profitability would depend upon operating efficiency and the selection of the most profitable product-mix. The profitability statement has been conservatively worked out. It indicates that adequate returns can be expected after completion of the first phase. The percentage of operating profit to sales will average about 9 per cent and the percentage of net profit to total capitalisation will average about 14 per cent (please see the ratios at the bottom of Annexure A).

The Cash-Flow Statement (Annexure B) has been prepared for the first 6 years on the assumption that the first phase will be completed on 31st March 1963 and the second phase by 31st March 1965. The *pro-forma* balance sheets prepared on the basis of the above may be seen at Annexure C. The gap in the resources

required for acquisition of fixed assets both in the first and the second phases would be adequately met by the proposed loan and by increases in borrowings from the company's bankers, who have agreed to provide the necessary short-term accommodation. The estimates of retained earnings are reasonable. Thus, the means of financing the entire project mentioned under item (5) above seem realistic. It will be seen from the cash-flow statement that the company will be in a position to declare a maiden dividend in 1965-66. It would also be able to meet its deferred payment liabilities on due dates. The second phase of the company's project is expected to be completed only by March 1965, up to which time the company will not only be incurring heavy capital expenditure but is also committed to a reduction of its deferred payment liability during the first phase of production. Hence, taking into account the yearly cash accruals from profit, depreciation reserves etc. on the one hand, and the interest payment, deferred payment liability, etc. on the other, the amortisation of the loan can commence only from 1st April 1965 onwards. The annual instalments of Rs. 6 lakhs each from 1st April 1965 would be well within the means of the company which at the same time will leave a sufficient cushion and not impose an undue financial burden on the company. Not more than 5 yearly instalments have been recommended in this case, as a larger number of instalments of smaller amounts are unnecessary and will result in waste of resources. If both phases are completed, as scheduled, the repayment of the present loan (Rs. 30 lakhs) as well as a fresh borrowing from us (Rs. 15 lakhs) can be made, as shown in the Cash-Flow Statement.

Debt service coverage : In compiling the cash flow estimates and fixing the repayment schedule, care has been taken to see that the interest on term borrowings and amortisation of this loan will be covered about twice by cash accruals comprising net profit (after taxes) with interest on long-term debt and depreciation added back, during the five years ending 31st March 1968. Thus a reasonable margin by way of cushion is available.

Break-even point : It will be noted from Annexure A that while the costs of raw materials, electric power and water more or less vary directly with the output, the cost of labour, maintenance of plant and administrative expenses are less elastic. Depreciation is calculated on the reducing balance system and the Managing Director's remuneration will be at 5 per cent on profits subject to a maximum of Rs. 80,000. Taking a conservative view, it is expected that the plant will break even at 50 per cent of its capacity in 1964-65.*

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* The expenses may be estimated as under when the plant works at 50% capacity in 1964-65 (vide Annexure A) :

(Rupees in lakhs)

Raw material	31·42	50% of 1964-65
Power	2·79	50% of 1964-65
Water	0·45	50% of 1964-65
Labour	2·89	55% of 1965-66
Maintenance	2·07	60% of 1964-65
Administrative overheads	1·22	60% of 1964-65
Interest	4·60	100% of 1964-65
Depreciation	8·07	100% of 1964-65
Managing Director's remuneration	0·35	50% of 1964-65
Royalty	0·54	50% of 1964-65
	54·40	which is roughly equal to 50% of sales during the year.

(7) *Marketability :*

The products to be manufactured by the company are at present not being manufactured in India to any appreciable extent, and even the small quantities manufactured are not of good standard. The country's requirements are, therefore, met by imports. The company will, thus, be in a favourable position from the point of view of marketing and a large part of its output will be used by the other companies with which the promoters are connected.

The company has carried out an extensive market survey in respect of the items proposed to be manufactured. It may be observed that the company intends to meet only a portion of the demand which exists for the products. It will also be observed that the company will be in an advantageous position being the pioneer in the field, having already progressed to a considerable extent in the process of establishing itself.

Selling arrangements : The products being controlled items, distribution will be made by the Iron and Steel Controller. There is, therefore, no need to have special selling agencies. In the event of decontrol, the company does not expect any difficulty in setting up a suitable sales organisation.

(8) *Security for the loan :*

The company offers first mortgage of all its existing and future movable and immovable properties and a floating charge on the other assets subject to hypothecation arrangements to secure bank borrowings for working capital. A margin of more than 50 per cent will be available on the fixed assets alone.

We have received a satisfactory report from the company's bankers. They have been authorised by the company to furnish such information on its creditworthiness and financial position from time to time, as may be required.

(9) *Recommendation :*

Steel wires are a vital raw material on which the hardware, bicycle, steel ropes and electrical industries, etc. depend. They are at present mainly imported. The company is a pioneer in this field and will save valuable foreign exchange to the country when its plant goes into production.

A loan of Rs. 30 lakhs may be sanctioned on the undernoted terms and conditions—

(*i*) Interest—6½ per cent per annum.

(*ii*) Repayment—In five equal annual instalments of Rs. 6 lakhs each commencing in 1965-66.

(*iii*) *Other terms and conditions :* As per approved documents with such adaptations as may be deemed necessary in consultation with Legal Adviser (and, where necessary, Solicitors) and the borrowing company, and in particular the following :

(*i*) the company should make satisfactory arrangements to raise the share capital of Rs. 45 lakhs required for the first phase and the additional Rs. 20 lakhs for the second phase ;

(*ii*) it should not undertake any expansion or new project without prior approval ; and

(*iii*) the right to appoint a Director on the Board of Directors of the company will be retained.

ANNEXURE A

(In lakhs of rupees)

Cost of Production and Profitability

	After completion of				
	First Phase — 7500 tons		Second Phase — 15000 tons		
	1963-64	1964-65	1965-66	1966-67	1967-68
(1) Raw material	62·24	62·85	122·01	122·01	122·01
(2) Electric power	5·58	5·58	11·16	11·16	11·16
(3) Water	0·90	0·90	1·80	1·80	1·80
(4) Labour (including maintenance staff for factory)	5·25	5·25	8·73	8·73	8·73
(5) Maintenance of plant	3·45	3·45	5·73	5·73	5·73
(6) Administrative overheads	2·03	2·03	2·62	2·62	2·62
(7) Interest :					
(*a*) on long-term debt	2·33	3·07	3·82	3·46	2·28
(*b*) on bank borrowings	1·06	1·53	1·53	0·88	0·55
(8) Depreciation	9·39	8·07	13·19	11·35	9·78
(9) Managing Director's Remuneration	0·20	0·70	0·80	0·80	0·80
(10) Royalty*	0·97	1·08	1·90	1·90	1·90
(11) Cost of Production	93·40	94·51	173·29	170·44	167·36
(12) Sales	97·35	108·00	190·20	190·20	190·20
(13) Operating Profit (12)—(11)	3·95	13·49	16·91	19·76	22·84
(14) Development Rebate as per Act@	3·95	4·45	6·00	..	..
(15) Exemption from tax up to 6% of capital employed†	..	6·30	10·39	10·39	10·39
(16) Net assessable income (13)—[(14)+(15)]	..	2·74	0·52	9·37	12·45
(17) Taxation [at 50% of (16)]	..	1·37	0·26	4·68	6·22
(18) Net Profit (before Development Rebate) (13)—(17)	3·95	12·12	16·65	15·08	16·62
Ratio of sales to total capital employed	0·9:1	0·7:1	1·2:1	1·3:1	1·4:1
Percentage of operating profit to sales	4%	12%	9%	10%	12%
Percentage of net profit (before interest) to total capitalisation	7%	12%	15%	18%	20%
Percentage of net profit to equity	8%	15%	18%	15%	15%

* 1% of sales, vide para (3) (*iii*) of the appraisal.

@ 20% of cost of plant and machinery including insurance, freight, etc., and erection charges and engineering fees for the first and second phases (vide section 33(1) (*ii*) of the Income-tax Act, 1961).

First phase—20% of Rs. 42 lakhs (vide items (3) to (5) under para (4)—Cost of the project)

=Rs. 8·40 lakhs.

As the profit during 1963-64 is expected to be only Rs. 3·95 lakhs and in terms of Section 33(2) (*i*) of the Income-tax Act, the sum to be allowed by way of development rebate shall be only such amount as is sufficient to reduce the profit (total income) to nil, the balance of Rs. 4·45 lakhs has been carried forward to next year in terms of Section 33(2) (*ii*) *ibid.*

Second phase—20% of Rs. 30 lakhs (vide items (3) to (5) under para (4)—Cost of the project)

=Rs. 6·00 lakhs

Full provision has been made in 1965-66.

† 6% of capital employed i.e., the cost of the project and working capital (vide Sections 84 and 101 of the Income-tax Act 1961 read along with the relevant rules).

At the end of first phase — 6% of Rs. 105·00 lakhs
=Rs. 6·30 lakhs

At the end of second phase— 6% of Rs. 173·25 lakhs
=Rs. 10·39 lakhs

ANNEXURE B

Cash-Flow Statement

(In lakhs of rupees)

	Pre-operation	After completion of First Phase		After completion of Second Phase		
	April 1962-Mar. 1963	April 1963-Mar. 1964	April 1964-Mar. 1965	April 1965-Mar. 1966	April 1966-Mar. 1967	April 1967-Mar. 1968
A. *Sources of funds*						
1) Net Profit (before taxes with interest added back but after depreciation and development rebate reserve)	..	4·37	14·75	17·76	24·10	25·67
2) Share capital	45·00	..	20·00	..	..	..
3) Long-term borrowings	30·00	..	15·00	..	..	..
4) Deferred payments	13·50	..	9·75	..	..	..
5) Bank borrowings	16·50	..	7·00	..	..	..
6) Depreciation provision for the year	..	9·39	8·07	13·19	11·35	9·78
7) Development rebate reserve*	..	2·97	3·34	4·50	..	..
	105·00	16·73	77·91	35·45	35·45	35·45
B. *Application of funds*						
1) Fixed assets and capital expenditure	79·50	..	45·75			
2) Increase in current assets	25·50	..	22·50			
3) Repayment of long-term borrowings :						
(*a*) first loan	..	..	..	6·00	6·00	6·00
(*b*) second loan	..	..	..	3·00	3·00	3·00
4) Repayment of deferred payments	..	6·00	7·50	4·25	3·00	2·50
5) Repayment of bank borrowings	..	..	..	..	10·00	5·00
6) Interest :						
(*a*) on long-term debt	..	2·33	3·07	3·82	3·46	2·28
(*b*) on bank borrowings	..	1·06	1·53	1·53	0·88	0·55
7) Taxation	..	..	1·37	0·26	4·68	6·22
8) Dividend	..	..	..	3·25 (5% Gross)	6·50 (10% Gross)	9·75 (15% Gross)
	105·00	9·39	81·72	22·11	37·52	35·30

[*continued on p. 86*]

ANNEXURE B (*Contd.*)

Cash-Flow Statement

(In lakhs of rupees)

	Pre-operation April 1962-Mar. 1963	After completion of First Phase April 1963-Mar. 1964	First Phase April 1964-Mar. 1965	Second Phase April 1965-Mar. 1966	Second Phase April 1966-Mar. 1967	Second Phase April 1967-Mar. 1968
a) Opening balance of cash	..	..	7·34	3·53	16·87	14·80
b) Surplus/deficit between sources and application of funds	..	+7·34	—3·81	+13·34	—2·07	+0·15
c) Closing balance of cash	..	7·34	3·53	16·87	14·80	14·95
Debt service coverage ratio†	..	2	2	2	2	2

* 75% of Development Rebate given against item (14) in Annexure 'A', in terms of Sections 33 and 34 of the Income-tax Act, 1961.

† This ratio is obtained as follows :

$$\frac{\text{Cash accruals—Net profit (after taxes) + Interest on long-term debt + Depreciation}}{\text{Instalments of repayment of long-term debt and deferred payments + Interest thereon}}$$

Working for the year 1963-64 :

Cash accruals:

Net profit after taxes	=	Rs. 3·95 lakhs—Item (18) of Annexure A.
Interest on long-term debt	=	Rs. 2·33 lakhs—Item (7) (*a*) of Annexure A.
Depreciation	=	Rs. 9·39 lakhs—Item (8) of Annexure A.
		Rs. 15·67 lakhs, say, Rs. 16·00 lakhs
Instalment of deferred payment	=	Rs. 6·00 lakhs—Item B. (4) above.
Interest on long-term debt	=	Rs. 2·33 lakhs—Item B. (6) (*a*) above.
		Rs. 8·33 lakhs, say, Rs. 8·00 lakhs

Debt service coverage ratio $= \frac{16}{8} = 2$

ANNEXURE C

(In lakhs of rupees)

Pro-forma Balance Sheet as at

	After completion of					
	First phase			Second phase		
	31st March 1963	31st March 1964	31st March 1965	31st March 1966	31st March 1967	31st March 1968
Capital and Liabilities						
(1) Share Capital	45·00	45·00	65·00	65·00	65·00	65·00
(2) Reserves and Surplus* ..	—	3·95	16·07	29·47	38·05	44·92
(3) Long-term loan	30·00	30·00	45·00	36·00	27·00	18·00
(4) Bank loans	16·50	16·50	23·50	23·50	13·50	8·50
(5) Deferred Payments ..	13·50	7·50	9·75	5·50	2·50	—
Total ..	105·00	102·95	159·32	159·47	146·05	136·42
Assets						
(6) Gross Fixed Assets ..	79·50	79·50	125·25	125·25	125·25	125·25
Less : Depreciation ..	—	9·39	17·46	30·65	42·00	51·78
	79·50	70·11	107·79	94·60	83·25	73·47
(7) Current Assets	25·50	25·50	48·00	48·00	48·00	48·00
(8) Cash	—	7·34	3·53	16·87	14·80	14·95
	105·00	102·95	159·32	159·47	146·05	136·42
Debt-Equity Ratio .. .. [(3)+(5):(1)+(2)]	49:51	43:57	40:60	31:69	22:78	14:86
Current Ratio .. .. [(7)+ (8): (4)]	1·5:1	2:1	2·2:1	2·8:1	4·7:1	7·4:1

*Computed by adding to the Reserves and Surplus of the previous year the Development Rebate Reserve provided during the current year and the surplus of net profit after taxes and after providing for development rebate and dividends.

APPENDIX III-A

SMALL—SCALE INDUSTRIES

LOAN APPLICATION FORM

Application for loan of Rs.....

A. GENERAL INFORMATION

1. Borrower:
   (*a*) Name ——————————

   (*b*) Constitution ——————————
   (whether sole proprietorship, partnership, joint Hindu family, co-operative society or public or private limited company)
   Please enclose, where applicable, a copy of the Partnership Deed/ Registered Bye-laws/Memorandum and Articles of Association duly certified as up-to-date.

2. (*a*) Name(s) of—————————————————
   (Proprietor/Partners/Karta/Directors)
   (*b*) Particulars regarding Managing Agents, if any (Period, terms of appointment, etc.)

3. Address:

   (*a*) Head or Registered Office
   (*b*) Factory

4. History:

   (*a*) Date when the factory was started
   (*b*) Nature of industry and articles produced
   (*c*) Capital investment and its source

      (*i*) Owned (capital and reserves)
      (*ii*) Borrowed

5. Is the factory working to full capacity?

   If not, to what extent?

6. What kind of power is used (electricity, oil, etc.)

7. (*a*) No. of shifts worked
   (*b*) Staff employed per shift

      (*i*) Skilled
      (*ii*) Unskilled

8. (*a*) Enumerate the main raw materials used
   (*b*) Sources of their supply
   (*c*) Are they available throughout the year or seasonally ?
   (*d*) Give value of raw materials required for a month.

9. (*a*) Annual production (quantity/numbers and market value)
   (*b*) Annual Sales

10. Marketing

   (*a*) Are Government orders executed?
   (*b*) What is the extent of the market (within the State or outside also)?

3. FINANCIAL POSITION

(*Note:* Balance Sheets and Profit and Loss Accounts for the last 3 years to be furnished, if available. *Pro-forma* Balance Sheet and Profit and Loss Account as on a recent date should also be attached.)

1. Fixed Capital:

   (*a*) Land and Buildings:

      (*i*) Present valuation of
         (A) Land
         (B) Buildings

         Depreciation provided
      (*ii*) Are these mortgaged?
         If so, to whom and for what amount?

   (*b*) Machinery and Equipment:

      (*i*) Details of machinery
      (*ii*) Present valuation
         Depreciation provided
      (*iii*) Is there any charge on them?
         If so, to whom and for what amount?

2. (*a*) Working Capital:

      (*i*) Stocks and Stores
      (*ii*) Book debts and advances due

   (*b*) Details of stock position at present:

      (*i*) Raw materials
      (*ii*) Finished products
      (*iii*) Semi-finished products

3. Borrowings:

   (*a*) Amount
   (*b*) Period
   (*c*) Source
   (*d*) Security furnished and its value
   (*e*) Rate of interest.

4. Other Liabilities:

   (*a*) Contingent (including guarantees given)
   (*b*) Tax
   (*c*) For expenses and goods purchased.

5. **Profit or loss in the last 3 years**

C. PURPOSE OF THE LOAN

1. Use of the proceeds of the Loan.	*Amount*
(*a*) For purchase of land	Rs.
(*b*) For construction of factory building	Rs.
(*c*) For purchase of machinery	Rs.
(*d*) For repayment of debts	Rs.
(*e*) For replenishment of resources, recently utilised for the acquisition of fixed assets within the last 3 years	Rs.
(*f*) For working capital	Rs.
Total loan required	Rs.

2. Period for which loan is required and how repayments are proposed.

3. Security proposed to be offered :

(*a*) Market value of	
(*i*) raw materials	Rs.
(*ii*) finished products	Rs.
(*b*) Value of existing fixed assets :	
(*i*) Land	Rs.
(*ii*) Buildings	Rs.
(*iii*) Plant and Machinery	Rs.
(*c*) Value of additional fixed assets :	
(*i*) Total value of assets to be acquired shown in items No. 1(a), (b) & (c) above	Rs.
(*ii*) Value of additional assets consisting of residential property, etc., offered as mortgage	Rs.
(*d*) Value of other security, if any	Rs.
Total :	Rs.

4. Name and address of guarantor(s) proposed, if any.

5. General Remarks :

I/We hereby certify that the particulars given above are, to the best of my/our knowledge and belief, true and correct and no material fact has been concealed or withheld.

I/We shall be pleased to give you such further information as you may require, from time to time.

Place :

Date : **Signature of applicant.**

APPENDIX III-B

SMALL-SCALE INDUSTRIES

SUPPLEMENTARY INFORMATION

(to be obtained at the investigation stage of a loan application)

(*Note:*—The points on which additional information is to be obtained are set out somewhat in detail ; however, the actual points on which investigation should be made by the lending institution or its representative in a given case would depend upon the circumstances, etc.)

A. GENERAL INFORMATION

1. Whether the concern has any branches, if so, their location

2. Other trade names and/or names of associate concerns with their addresses

3. (*a*) In the case of sole proprietorship, the age, father's full name, address and technical qualifications, if any, of the proprietor

   (*b*) In the case of partnership,

   (*i*) Full name and address of each partner, age, special qualifications, if any, share in the partnership and mode of remuneration, if any
   (*ii*) Particulars regarding minor(s), if any, admitted to the benefit of partnership
   (*iii*) Whether the partnership is registered under the Indian Partnership Act, 1932 or any State Act. If so, a copy of the Registrar's certificate in this behalf may be obtained

   (*c*) In the case of joint Hindu family concern,

   (*i*) The age, father's full name and address of Karta
   (*ii*) Full name, age and address of each member of the joint Hindu family and his relationship with Karta

   (*d*) In the case of co-operative society,

   (*i*) Whether limited or unlimited
   (*ii*) A copy of certificate of registration may be obtained
   (*iii*) Full names, designations and addresses of Directors/Members of Managing Committee

(*iv*) Full name, qualifications and remuneration payable to Secretary/Manager

(*e*) In the case of public or private limited company,

(*i*) Whether limited by guarantee or by shares

(*ii*) Obtain authenticated copies of Certificate of Incorporation and in the case of public limited companies, of Certificate to commence business and Prospectus or Statement in lieu of Prospectus

(*iii*) Age and address of each Director, office held by him, number of years for which he has been associated with the company and details of directorship held by him in other companies

(*iv*) (*a*) Office allowance, commission on net profits or sales and any other remuneration paid to the Managing Agents

(*b*) Compensation, if any, payable to Managing Agents on termination of their office as Managing Agents

(*c*) Names and Addresses of Directors/Partners of Managing Agents

(*d*) Obtain certified up-to-date copies of

1. Managing Agency Agreement and other Agreements, if any

   [If there are any clauses in the Agreements which are likely to affect adversely the interests of the Mortgagee, the Managing Agents will have to agree to delete, renounce or suspend them during the currency of the loan.]

2. Memorandum and Articles of Association/Partnership Deed of Managing Agents

3. Balance Sheets of Managing Agents

(*v*) Names of associate or subsidiary concerns, if any, the interest of the company in, and the control exercised over these concerns

(*vi*) Name, designation, duties and remuneration payable to Chief Executive Officer(s) of the concern

4. Who were the previous owners, promoters and/or Managing Agents of the concern ?

5. When was it acquired by the applicant, from whom, and under what circumstances ?

6. What was the basis of valuation of the acquired properties ? Obtain copy of valuation report, if any.

7. (*a*) Name and address of bankers.
(*b*) Whether necessary instructions have been issued to the bankers to give full information on request to the lending institutions. If so, a copy of the letter may be obtained.

B. FINANCIAL POSITION

1. (*a*) Purpose of earlier borrowings
(*b*) Date(s) availed of
(*c*) Amount
(*d*) Instalments of principal in arrears, if any
(*e*) Instalments of interest in arrears, if any
(*f*) If from banks

(*i*) nature of accounts, whether overdraft, cash credit, etc.
(*ii*) limit sanctioned
(*iii*) margin stipulated

2. (*a*) Whether other source(s) were approached for raising necessary funds or fresh capital for financing the scheme. If so, with what result ?
(*b*) Are any application(s) pending with other financing agencies ? If so, what is the latest position ?

3. If the value of the assets has been written up under any scheme in any year, full particulars to be obtained.

4. Particulars of any pending litigation either by, or against, the concern, the sole proprietor or any member of the joint Hindu family, or all, or any, of the partners of the firm, as the case may be

5. Particulars of any contingent liability, guarantees or endorsements, affecting the concern, its sole proprietor, the members of the joint Hindu family owning it or the partners composing the applicant firm, as the case may be or given on behalf of Directors or Managing Agents

6. (*a*) No. of shares of each class held by

   (*i*) each Director
   (*ii*) Managing Agent

   (*b*) Calls in arrears

   (*i*) From Directors
   (*ii*) From Managing Agents
   (*iii*) From Others

7. Details of debentures issued, if any

   (*a*) Amount
   (*b*) Rate of interest
   (*c*) Date or dates of repayment
   (*d*) Name of the trustees or debenture-holders
   (*e*) Security charged and value thereof
   (*f*) Are the debentures Registered or Bearer ?

8. (*a*) Details of investments in shares or debentures
   (*b*) Loans or advances to subsidiaries
   (*c*) Loans or advances to others

9. Position regarding Income-tax

   (*a*) Upto which year has the concern been assessed ? Give the assessment figures
   (*b*) What is the total outstanding liability in respect of the years for which assessment has been made ?
   (*c*) Provision, if any, against outstanding income-tax liability
   (*d*) What is the approximate liability for income-tax for the years for which assessment has not so far been made ?
   (*e*) Does Section 104 of the Income-tax Act, 1961 apply to the Company ?
   (*f*) Refund, if any, due from Government
   (*g*) Any proceedings have been instituted against the concern for any income escaping assessment under Section 147 of the Income-Tax Act, 1961

10. Accounting Arrangements

(*a*) Language and script in which the accounts are maintained
(*b*) Do the accounts maintained reflect the manufacturing cost of different articles and the profits thereon ?

11. Insurance

(*a*) Have the assets of the concern been adequately insured ?
(*b*) Whether the concern carries any insurance for riot and civil commotion ?

12. Working Funds

What arrangements have been made, or are proposed to be made with bankers or otherwise for obtaining working funds against raw materials, stock-in process and finished goods ?

3. PURPOSE AND PARTICULARS OF THE LOAN

1. What is the present capacity of the factory and what will it be when the scheme is completed ? Annual production of articles manufactured for the past three years

(*a*) the capacity of each of the existing plants and the plants proposed to be added, separately ;
(*b*) the existing capacity of the factory for each of the products at present manufactured and the future capacity for each of the products manufactured or proposed to be manufactured
(*c*) Labour employed

	Existing	*Proposed*
Skilled ..		
Unskilled ..		
Office ..		

2. How far has the concern succeeded in producing articles of quality in the past and what reputation do its products enjoy in the market ?

3. What is the estimated demand for the type of products manufactured or proposed to be manufactured ?

4. Why has it become necessary to expand the plant or order new machinery or to try allied or subsidiary lines ?

5. Particulars regarding total cost of the scheme together with detailed break-up of the cost.

6. What investigations have been carried out as to the prospects if a new line is to be tried ?

   (Obtain copies of the opinions of competent authorities consulted, if any)

7. (*a*) What technical personnel will be required and what arrangements have been made to secure them ?
   (*b*) Names and qualifications of existing technical personnel

8. What arrangements have been made for research ?

9. What arrangements have been made for fuel and power ?

10. What arrangements have been made for land ? Is the land lease-hold, free-hold or acquired under the Land Acquisition Act ? (Obtain a copy of the lease-hold deed or the title deed, as the case may be)

11. (*a*) What arrangements have been made for obtaining the necessary plant and machinery and other equipment ? Give particulars of the plant and machinery and equipment to be imported, the name of the country of origin and approximate time in which delivery may be expected (copies of correspondence with the exporters)
    (*b*) Whether approval of the Government of India has been obtained for the release of foreign exchange.

12. What are the prospects of getting a steady supply of raw materials and/or components required ?

    (*a*) Variations in prices for the last three years
    (*b*) Whether transport is available without difficulty

13. (*a*) Present cost of each unit of production *i.e.* each unit may be taken at 1 kgm, 1 gross or 100 pieces as may be applicable
(*b*) Estimated cost of each unit of production as in (a) after expansion
(*c*) Present selling price of each unit of production as in (a)
(*d*) Present margin of profit or loss

14. (*a*) In what markets (local/abroad) does the concern sell its products and at what price and what portion of the yearly production ?
(*b*) Details regarding arrangements for marketing products :

(*i*) If any selling agents are employed, their names and the commission paid on sales
(*ii*) Names of the principal customers

(*c*) Proportion of sales on credit to total sales
(*d*) Details of sales for the last two years in each market separately. (Approximate figures will suffice)

15. Which are the other important factories within the area of operation producing the same type of goods ?

16. What is the estimated demand for the type of products manufactured or proposed to be manufactured ?

17. How far is the demand met from indigenous products and to what extent from imports ?

18. Foreign competitors, if any

19. Are there any special advantages which the concern enjoys in the matter of raw materials, labour, technical knowledge, etc. ?

20. Are there any special handicaps, or disadvantages, from which the concern suffers, or which it would have to encounter ?

21. Do the rates quoted compare favourably with those of other companies, both foreign and Indian ?

22. (*a*) Has the concern been registered under the Industries (Development & Regulation) Act, 1951 ?
(Obtain a copy of the certificate issued)

(*b*) Has the concern obtained necessary licence from the Central Government for the establishment and expansion of the industrial undertaking now envisaged under the Industries (Development & Regulation) Act, 1951 ?
(Obtain a copy of the licence)

23. Details of existing and proposed assets offered as security :

(*a*) Existing land :

(*i*) Location
(*ii*) Area
(*iii*) Whether freehold or leasehold
(*iv*) Purchase price of land, if owned
(*v*) Rent in case of leased land
(*vi*) Terms of lease (period and due date)
(*vii*) Ground rent payable per year

(*b*) Proposed land :

(*i*) Location
(*ii*) Area
(*iii*) Whether proposed to be purchased
(*iv*) Purchase price of land if proposed to be purchased and owned
(*v*) Terms of lease, if proposed to be leased (period of lease)
(*vi*) Ground rent payable per year

(*c*) Existing buildings :

(*i*) Location
(*ii*) Whether owned or leased
(*iii*) Purchase price of building, if owned
(*iv*) Rent in case of leased premises
(*v*) Terms of lease (period and due date)
(*vi*) Particulars of workshop, godowns, administrative offices and other buildings such as

(1) Type of structure (whether pucca or temporary)

(2) Dimensions

(3) Area

(4) Actual cost

(5) Date of erection

(*d*) Proposed buildings :

(*i*) Location
(*ii*) Whether proposed to be purchased or constructed
(*iii*) Purchase value or estimated cost
(*iv*) If proposed to be leased, rent and period of lease proposed
(*v*) Particulars of the structures

(1) Type of structure (whether pucca or temporary)

(2) Dimensions

(3) Area

(4) Estimated cost

(*e*) Existing machinery :

(*i*) Name of machine
(*ii*) Number
(*iii*) Specifications
(*iv*) Production capacity per hour
(*v*) Estimated cost—Rs.....
(*vi*) Date of acquisition
(*vii*) Source of supply (state if purchased second hand)

(*f*) Proposed machinery :

(*i*) Name of machinery and country of origin
(*ii*) Number
(*iii*) Specifications
(*iv*) Production capacity per hour
(*v*) Estimated age of machinery
(*vi*) Cost

24. Occupation and estimated means of proposed guarantor(s)

25. Probable earning capacity after completion of project in respect of *each* product:

(*a*) Present annual production in terms of weight or other measure
(*b*) Value
(*c*) Estimated increase after expansion
(*d*) Value after expansion
(*e*) Present cost of each unit of production (*i.e.*, 1 kilogram or 1 gross or 100 pieces)
(*f*) Estimated cost of each unit after expansion
(*g*) Present selling price of each unit
(*h*) Present margin of profit

26. Estimate of probable profits in a normal year of working after completion of project

(*a*) Gross sales
(*b*) Cost of sales :

(*i*) Raw materials
(*ii*) Wages
(*iii*) Depreciation
(*iv*) Miscellaneous expenses

(*c*) Administration and selling expenses
(*d*) Interest
(*e*) Net profit

27. Capacity to repay the loan after providing for taxation, etc.

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