CHAPTER VII

FINANCING OF WORKING CAPITAL AND ITS CONTROL

The present chapter aims to examine how the working capital needs are financed. The relative role of long term and short term funds and relative proportion of different short term sources in the financing of working capital are also studied. Once we know the total working capital requirement of a concern and its composition, the next important job of the finance manager is to make arrangement for the required funds. Each source of finance is evaluated by the financial executive in terms of its merit and demerits to the concern and a final choice of the combination of sources is made.

The various sources of finance can be classified into two categories

(i) Long Term Sources of Finance

(ii) Short Term Sources of Finance

The funds which are available to the concern for a period of one year or less are termed as short term funds and the funds of more than a year duration are termed as long term funds. The various long term sources of finance are

(i) Share Capital.

(ii) Retained Earnings.

(iii) Debenture Capital.

(iv) Non-Current Provisions such as investment allowance, depreciation reserve etc.
(v) Long-term borrowings from banks and financial institutions.

The various short-term sources of finance are:

(i) Trade Credit

(ii) Bank Credit.

(iii) Non-bank Short term borrowings.

(iv) Commercial Paper.

(v) Factoring of receivables.

(vi) Current Provisions such as Provision for Taxation, Provision for Dividend etc.

SHORT TERM SOURCES OF FINANCE - A Brief Analysis

Since short term sources of finance are more commonly used in financing working capital needs, it is useful to know the nature of various short term sources of funds.

Trade Credit

Trade credit is the credit which a customer gets from the suppliers during the normal course of business. The buyer is not required to make the payment of the bill immediately at the time of delivery of goods. Rather the payment is to be made on some future date. Such postponement of payment is a short term financing in the form of trade credit. Trade credit is used invariably by all the concerns in India. It contributes about one-third of the
short term financing. The reason being that it is the informal mode of financing which does not require documentation, collateral security etc. The small concerns who are unable to procure short term bank loan because of their rigorous credit terms, rely on trade credit for the fulfillment of their short term requirement of funds. Trade credit is easily and spontaneously available and it expands with the expansion in sales. However, it is not to say that the trade credit is a cost-free source of finance. True, it does not have direct cost but it definitely costs to the user implicitly in the form of increased Purchase Price. So trade credit is to be used thoughtfully within the reasonable limits.

Bank Credit

Next to trade credit, bank credit is the important source of financing working capital requirements of the firms in India. Banks grant credit to the concerns on the basis of their present sales and future production plans after keeping a certain percentage of total current assets as security margin money.

Types of Bank Credit: The bank credit may be in the form of:

(a) Term Loans.

(b) Overdraft.

(c) Cash Credit and.

(d) Discounting of Bills.

Under the term loan, the bank gives loan of a specified amount to the borrower for a mutually agreed period at the prevailing rate of interest. This is

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normally a secured loan. Under the Overdraft facility, the bank permits the concern to overdraw from the current account maintained with the bank. The bank in turn charges bank interest on such overdrawn amount for the overdrawn period. No direct security is demanded by the bank at the time of granting overdraft. Under counting of Bills, the bank makes immediate payment of the bills receivables by the concern on some future date. For such service the banks, however, charge service charges & interest for the period involved for discounting the bills. Credit is the most popular mode of granting short term loans by the banks, whereby a separate bank account is opened in the name of the borrower with the amount of the loan. From this account the borrower withdraws as and when the need arises. The cash credit A/c is operated like a current account. The interest is levied by the banker on the actual amount of withdrawals for the period for which it remains withdrawn. Thus cash credit is the most flexible mode of credit from the viewpoint of the borrower.

Types of Security: Banks normally grant secured loans to the borrower in the following forms:

(a) Lien
(b) Pledge
(c) Hypothecation
(d) Mortgage

Under Lien the banker grants loan to the borrower with the right to retain any of the movable property belonging to him (i.e. the borrower) until he repays the loan amount. Under Pledge any specific movable property is transferred by the borrower to the banker as security. Thus, pledged property is not available for use with the borrower. Under Hypothecation, the loan is
granted by the banker on the security of any specific movable property belonging to the borrower without transferring its possession to the bank. Thus, hypothecated property is available with the borrower for use. Normally inventory is offered as hypothecation security. Under Mortgage, interest in any specific immovable property belonging to the borrower is transferred in favour of the banker as a security for the payment of debt.

**Commercial Papers & Factoring of Receivables**

Commercial Papers and factoring of receivables are new upcoming modes of financing short term capital needs in India. Commercial Papers are issued by financially strong companies as instruments to raise capital for short period. These papers are normally bought by the banks, insurance companies, unit trusts etc. The duration of these instruments is normally less than a year. In India, the issue of commercial papers takes place under the supervision of the Reserve Bank of India. The issuing company has to have net worth of Rs.10 crores and its securities should have been listed on the stock exchange. It is a competitive alternative mode to bank credit, which is gaining popularity in India. The commercial paper is a cheaper source of finance than the bank credit.

However, only financially strong and well-known companies are in a position to raise capital through issue of commercial papers. Further, these papers are normally of fixed duration. If the company is not in need of the funds, it cannot redeem the commercial paper before its maturity date. At the same time, these papers are to be redeemed on the maturity at any cost, even if the company does not have the requisite funds, otherwise it will bring discredit to the concern.
Factoring of receivables is another mode of raising short term capital. Under this arrangement the company sells its accounts receivables to another company. The buying company is called the factor and the practice of selling receivables is called the factoring. Once the receivables are bought by the factor, the factor becomes the owner of such receivables i.e in case of loss by non-payment, the factor has to bear such loss. It can not ask the selling company for any sort of protection. The factor may grant advances to the selling company against such receivables bought. Thus, the factor levies the service charges from the firm for credit evaluation of its customers, for bearing risk on account of losses by bad-debts, for granting advances against the receivables bought. This comes Out to be a costlier mode than other modes. But for small companies which are not well versed in evaluating credit worthiness of the customers and in the collection of book debts, factoring is a useful practice.

Other Modes of Short Term Finance

This residual category includes internal sources of raising short term funds such as provision for taxation, provision for dividend etc., non-bank short term borrowings and others. The contribution of this source is very meagre to the total working capital finance.

THE NATURE OF WORKING CAPITAL

It is necessary to understand the nature of working capital to decide the extent of long term financing and short term financing of the working capital. This aspect has been discussed in depth in chapter II of this study. Here it is worthwhile to mention that a part of working capital remains permanently with the concern for maintaining the present level of business activity. This is in the form of minimum inventory, minimum amount of cash for meeting day-
to-day transactions, inescapable amount of accounts receivables etc. Besides this, a business enterprise has to maintain working capital in excess of such permanent needs too for meeting contingencies. This portion of working capital is termed as temporary working capital. As a rule of thumb, it is advised that permanent portion of working capital should be financed out of long term sources of capital and temporary portion should be financed out of short term sources of capital. However, it is not so easy to calculate the permanent portion and the temporary portion of the working capital in exact terms. There are a number of personalised and temporary factors affecting the exact mix of working capital and thus the financing pattern of the working capital.

CONTROL OF WORKING CAPITAL FINANCING AND BANKING POLICY

Primary institutional sources of financing working capital is short term bank credit. In the present study all the companies uses a fair degree of bank credit during entire study period. Bank credit is playing a important role in financing of working capital requirement of the tyre companies.

However, bank credit has been subject to continuous regulations by Reserve Bank of India. Reserve Bank of India has appointed different study groups from time to time to regulate the availability of bank credit to industry so as to secure alignment of bank credit with planning priorities and ensure its equitable distribution to various sectors including weaker sectors of small industry, agricultural and new entrepreneurs of the economy. Hence, it is desirable to discuss different committees’ recommendations before answering above financing pattern of tyre companies. Following study groups’ reports are worth mentioning in this respect:
1. Dahejia Committee Report, 1969;
2. Tandon Committee Report, 1975;
3. Chore Committee Report, 1979;
4. Marathe Committee Report, 1983 and

**Dahejia Study Group**

The National Credit Council constituted in October 1968, a study group under the chairmanship of Shri V. T. Dahejia to examine “the extent to which credit needs of industry and trade are likely to be inflated and how such trends could be checked”. The term inflation, here, implied that borrowers had received credit in excess of their genuine requirements. The credit needs of industry or trade may be deemed to be inflated if (a) over a period of years, rise in short-term bank credit is found to be substantially higher than the growth in the value of industrial production and/or inventory; (b) short-term bank borrowings are diverted for the building up of fixed assets; (c) there is double or multiple financing; and (d) the period of credit is unduly lengthened.

The group submitted its report in September 1969.1

**Findings:** Major findings of the Dahejia Study Group were as follows:

In the absence of specific bank restraints, there was a tendency on the part of the industry generally to avail of short-term credit from banks in excess of the amount justified by the growth in production and/or inventories in value terms as shown by comparison of rise in the value

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of inventories, production and short-term bank credit. However, there was no evidence of excess bank credit to trade or commerce.

Diversion of finances from expansion in short-term bank liabilities including bank loans to gross fixed assets formation as shown by deterioration in current ratio of sample companies.

The then prevalent lending system, with cash credit as the major form of short-term bank credit and undue elongation of the period of trade credit had resulted in diversion of short-term liabilities for fixed assets financing.

Suggestions: The group made the following suggestions for a change in the lending system so as to check the inflation and diversion of bank credit.

(a) The appraisal of credit applications should be made with reference to the total financial situation, existing and projected, as shown by cash flow analysis and forecasts submitted by borrowers. This would help a diagnosis of the extent to which current liabilities had been put to non-current use and the manner in which liabilities and assets of the borrowers were likely to move over a period of time.

(b) The outstanding in the existing as well as future cash credit accounts should be segregated as between (i) ‘the hard core’, which would represent the minimum level of raw materials, stores and finished goods which the industry was required to hold for maintaining given level of production and (ii) the strictly short-term component which would be the fluctuating part of the account. The group suggested that, in the case of sound companies, the hard core element should be put on a formal term-loan basis, subject, to the repayment schedule. In the case of borrowers of not sound financial position or the size of hard
core was so large that repayment could not be expected within 7 to 10 years the borrowers should arrange long-term funds to replace bank borrowings. As the determination of the hard core element of the cash credit account might present some practical difficulties, the study group had opined that the Indian Banks Association and RBI should make a study of industry wise norms for minimum inventory levels.

(c) For handling the problem of double or multiple financing, the group suggested that a customer should generally be required to confine his dealings to one bank only. When the credit requirements of the borrower were very large and could not be met out of the resources of one bank only, the group recommended the adoption of a 'consortium arrangement'.

(d) To prevent undue elongation of the period of trade credit and the tying up of resources of banks for unproductive purposes, the group suggested that the period of trade credit should not normally exceed 60 days and in special circumstances 90 days. The undue delay in the settlement of bills by the government departments could be discouraged by stipulating that the departments should pay interest on bills if these had not been paid within 90 days of their receipts.

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Double or multiple financing may result where credit facilities are granted against receivables either by way of drawing against acceptance bills or drawing against book debts: the purchaser is in a position to obtain bank credit again by way of hypothecation/pledge of the stocks which have not been paid for. Suppose inventory of the value of Rs.1 lakh is carried to the extent of Rs.50,000 by creditors for purchases. Now assume bank provides cash credit say upto 75 percent on inventory: 25 percent being the margin representing the borrower’s contribution to carry the current assets. Borrower takes credit of Rs. 75,000 on inventory from bank. Had the customer drawn an amount of Rs. 50,000 from bank, this 25,000, he can divert to non-current uses without the banker’s knowledge.
(e) As a complementary measure to check the extension of extra bank credit, the group suggested that a levy of a commitment charge on unutilised limits, coupled with a minimum interest charge if necessary, could be considered. In the initial stages, from the point of view of administrative convenience, limits sanctioned up to Rs.10 lakhs might be exempted. The commitment levy might be progressively raised with the size of unutilised limits.

(f) The group had emphasised greater recourse to bill finance, such a practice would not only impose financial discipline on the purchaser but also help the supplier or producer to plan his financial commitments in a realistic manner. It would also help the development of a genuine bill market in India. To encourage the development of such bill market, a reduction in stamp duty on usance bills was recommended by the group to government.

Tandon Study Group

The RBI set up a study group to frame guidelines for follow up of bank credit in July, 1974 under the chairmanship of Shri Prakash Tandon. The terms of reference to the group\(^1\) were:

1. To suggest guidelines for commercial banks to follow up and supervise bank credit from the point of view of ensuring proper end use of funds and keeping a watch on the safety of the advances and to suggest the type of operational data and other information that might be obtained by banks periodically from such borrowers and by RBI from lending banks.

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\(^1\) Reserve Bank of India, Report of the Study Group to Frame Guidelines for Follow-Up of Bank Credit (Tandon Committee), Bombay. 1975.
2. To make recommendations for obtaining periodical forecasts from borrowers of (a) business/production plans and (b) credit needs.

3. To make suggestions for prescribing inventory norms for different industries both in the private and public sector and indicate the broad criteria for deviating from these norms.

4. To suggest criteria regarding satisfactory capital structure and sound financial basis in relation to borrowings.

5. To make recommendations regarding the sources for financing the minimum working capital requirements.

6. To make recommendations as to whether the existing pattern of financing working capital requirements by cash credit/overdraft system etc. required to be modified, if so, to suggest suitable modifications.

7. To make recommendations of any other related matter as the group might consider necessary to the subject of enquiry or any other allied matter which might be specially referred to it by RBI.

Observations and Recommendations: The study group submitted its report to the RBI in August 1975. The summary of the group’s main observations and recommendations is given below:

(a) Need for Change in Basis of Bank Lending System: The security-cum-guarantee system for credit, which prevailed, tended to favour large borrowers with strong financial resources, irrespective of their economic functioning leading to concentration of economic power. Nationalisation of 14 major commercial banks in July 1969, called for a new policy of banking system as credit agency due to increased demand for bank credit. It was realised to
provide credit on development and potential rather than on security only so as to assist weaker sectors of the economy particularly agriculture, small and new entrepreneurs. The public sector had also emerged as an important user of bank credit due to its turning increasingly to banks for its working capital finance instead of relying on government. Continuous growth in production resulting in higher levels of inventories with rising prices also increased demand for bank credit. While on the supply side, control on monetary expansion as part of anti-inflationary policy put added stain on the banking system. This called for a change in banking policy to grant credit.

(b) Cash Credit System and Financial Indiscipline: The problem of potential imbalance in demand for and supply of funds was accentuated by the manner in which banks extended credit under the then prevalent cash credit system of lending. Under that system, the level of advances in a bank was determined not by how much a banker could lend at a particular point of time but by a borrower's decision to borrow at that time. This made credit planning difficult in banks. The time was opportune to review the existing system and effect changes in such a way that under the new system the borrower would plan his credit needs and the banker would be able to plan., having known the borrower's credit requirements.

(c) Norms for Inventories and Receivables: The study group emphasised that the main function of a banker was only to supplement the borrower's resources to carry a reasonable level of current assets. Inventory and receivables comprised the bulk of the current assets. There was no uniformity

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1 Under that cash credit system, banker sanctioned a maximum limit within which the borrower could draw at his will. When the borrower's need for funds was low, the banker was faced with the problem of large unutilised funds, and when the borrower's need for funds was large the banker faced the problem of meeting the demand without notice. In fact, availability of funds with the bank and the customer needs did not always match.
in approach among banks in assessing working capital requirements, especially with regard to inventories.

The study group, therefore, stipulated norms for 15 major industries, representing the maximum levels for holding inventory and receivables in each of these industries. If, however, a borrower had managed with less in the past, he should continue to do so.

Norms, however, could not be absolute or rigid. Deviations from norms might be visualised under certain circumstances, e.g. bunched receipt of raw materials, power cuts, strikes, transport delays, disruptions in sales resulting in accumulation of finished goods etc.

For the industries for which no norms were stipulated, banks would be expected to keep in view the purpose and spirit behind the norms exercise and prevent excessive build up of inventories and receivables.

(d) Working Capital Gap and Bank Credit: The group identified working capital gap viz., the borrowers requirements of finance to carry current assets (based on norms) other than those financed out of his other current liabilities, could be bridged partly from his owned funds and long-term borrowings and partly by bank borrowings.

The group suggested that the maximum permissible level of bank borrowings could be worked out in three ways. First method, the borrower was to contribute a minimum of 25 percent of working capital gap from long-term funds, i.e., owned funds and term borrowings; resulting in minimum current ratio of 1:1. Second method, the borrower was to provide a minimum of 25 percent of total current assets from long-term funds; resulting in minimum current ratio of 1.3:1. Third method, the borrower was to provide
from long-term funds the entire core current assets plus a minimum of 25 percent of the balance current assets, further strengthening the current ratio.

The classification of current assets and current liabilities for computing the permissible level of bank finance should be made as per the usually accepted approach of bankers. A beginning might be made with the first method, covering all borrowers by this method within a period of about 1-year, and the ideal of third method should be reached in stages.

A request for additional credit on a regular basis from a borrower who already had an excess borrowing under any of the three methods might be considered only, if the borrower would bring in matching contribution required under the relative method of lending.

(e) Style of Lending: Once the quantum of bank funds to finance a reasonable level of current assets was agreed to, style of extending bank credit should also be changed. Instead of making available the entire credit limits as a cash credit for a year, it might be bifurcated into a loan and a demand cash credit, which would be renewed annually. The loan component would comprise the minimum level of borrowings, which the borrower would expect to use throughout the year, while the cash credit part could take care of his fluctuating requirements. As the loan would carry interest throughout the year, it would induce a discipline on the customers to plan his needs carefully to ensure that as little of it as possible would remain idle.

The demand cash credit should be charged a slightly higher rate of interest than the loan component. This approach would give the borrower an incentive for good planning. In order to ensure that customers would not use the new cash credit facility in an unplanned manner, the financing should be placed on a quarterly budgeting reporting system for operational purposes.
(f) Bill Finance: Apart from loan and cash credit, a part of the total credit requirement, within the overall eligibility, could also be provided by way of bill limits to finance a seller's receivables. It would be desirable that as far as possible receivables should be financed by way of bills rather than cash credit against book debts, though the latter could not be altogether eliminated. So far as the financing of purchases by cash credit or bills was concerned, each bank might take its own decision in consultation with the borrower, keeping in view the size of its operations, the individual transaction and the administrative set up in the bank.

(g) Coverage of Proposed System: The proposed system of lending and style of credit might be extended to all borrowers having credit limits in excess of Rs.10 lakhs from the banking system, while the information system might be introduced, to start with, in respect of borrowers with limits of Rs.1 crore and above from the entire banking system and then extending progressively to others.

(h) Information System: To ensure the end-use and safety of bank advance, the borrower was expected to subject himself to the budgeting and reporting system. The borrower would supply appropriate operational data and figures relating to financial position and flow of funds for future year, along with the application for advance or renewal for the purpose of fixation of overall credit limits. Borrowers with credit limits exceeding Rs. 1 crore should submit these reports quarterly for follow up.

(i) Follow-Up System: A bank would have to follow up and supervise the use of credit to verify, first, whether the assumptions of lending in regard to borrower's operations continued to hold good and second, whether the end use was according to the purpose for which the credit had been given.
From the quarterly forms, the banker would verify whether the operational results confirmed to earlier expectations and whether there was any divergence regarded as red signals; however variance upto 10 percent might be treated as normal.

In addition to the quarterly data, the large borrowers should submit a half-yearly performa balance sheet along with a profit and loss account within 2 months of the end of the half-year.

(j) Managerial Competence: Managerial competence is an important factor in the efficiency of operations, reflected in profitability, working capital and financial management. A banker should keep in mind that appraisal of management would be essential, particularly the new emphasis would be on viability and development rather than on security alone.

(k) Inter-firm Comparisons: To facilitate inter-firm and industry-wise comparisons for assessing efficiency, it would be of added advantage if companies in the same industry could be grouped under three or four categories, say according to size of sales and the group wise financial ratios, operating ratios and productivity ratios, would be compiled by RBI for furnishing to banks.

(l) Classification of Borrowers: For purposes of better control, there should be a system of borrower classification in each bank, within a credit rating scale. Such a system of classification according to credit risk would facilitate easy identification of the borrower whose affairs required to be watched with more than ordinary care. An incidental advantage of such classification would be the formulation of a rational base for purpose of fixing the rates of interest for the speculative borrowers.
(m) **Bank Credit for Trade**: While financing trade, banks should keep in view, inter alia the extent of owned funds of the borrower in relation to the credit limits granted, the annual turnover, possible diversion to other units or uses and amounts being ploughed back from profits into the business. They should avoid financing of goods, which had already been obtained on credit.

(n) **Norms for Capital Structure**: In discussing norms for capital structure, the group kept in mind both the relationships: long-term debts to equity and total outside liabilities to equity. Where a company’s long-term debt/net worth and outside liabilities/net worth ratios were worse than the medians, the banker should try to persuade the borrower to strengthen his equity base as early as possible. This would be a more practical approach for the banker than attempting to legislate absolute standards of these ratios for all industries or even industry by industry as these ratios are relative concepts depending on different factors like state of capital market, need to maintain current assets, marginal efficiency of capital or the opportunity cost.

(o) **Follow-Up Action**: Once danger signals were thrown up in the case of a borrower, speedy action would be called for on the part of the banker. The banker might intervene even in management, if that would be necessary in the interests of all concerned and the public.

**Chore Working Group**

RBI in March 1979, realising the slow progress achieved by banks in implementing the credit regulatory measures, and stressing the need for exercising continued restraint on expansion of credit, appointed a working group under the chairmanship of Shri K. B. Chore to review mainly the
system of cash credit and credit management policy for banks. The terms of reference\(^1\) were:

1. To review the operation of the cash credit system with reference to the gap between sanctioned credit limits and the extent of their utilisation;

2. In the light of the review, to suggest:
   
   (a) modifications in the system with a view to making the system more amenable to rational management of funds by commercial banks, and/or

   (b) alternative types of credit facilities, which would ensure greater credit discipline and also enable banks to relate credit limits to increase in output or other productive activities; and

3. To make recommendations on any other related matter as the group may germane to the subject.

The group submitted its report by the end of August 1979.

**Recommendations**

(a) Lending System: The group recommended that the existing system of three types of lending, viz., cash credit, loans and bills should be retained but whenever possible, the use of cash credit should be supplemented by loans and bills. It would also be necessary to introduce necessary corrective measures to remove the impediments in the use of bill system of finance.

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(b) Withdrawal of Bifurcation of Credit Limits: Bifurcation of cash credit limits as recommended by Tandon Committee; into a demand loan portion and a fluctuating cash credit component, and to maintain a differential interest rate between these 2 components, should be withdrawn. Such bifurcation might not serve the purpose of better credit planning by narrowing the gap between sanctioned limits and the extent of utilisation thereof. In cases where cash credit accounts had already been bifurcated steps should be taken to abolish the differential interest rates with immediate effect.

(c) Separate Limits for Peak Level and Normal Non Peak Level Periods: On the basis of the utilisation of credit limits by a borrower in the past, the bank should fix separate limits for normal ‘non peak level’, as also for ‘peak level’ credit requirements, indicating also the periods during which the separate limits would be utilised by the borrower. This procedure would be extended to all borrowers having working capital limits of Rs. 10 lakhs or above.

(d) Encouragement for Bill Finance: Advances against book debts should be converted into bills wherever possible and at least 50 percent of cash credit limit utilised for financing purchases of raw material inventory should also be converted into this bill system.

(e) Adhoc or Temporary Limits: Borrowers should be discouraged from frequently seeking adhoc or temporary limits in excess of sanctioned limits to meet unforeseen contingencies. Additional interest, in the form of stiff penalty, of at least 2 percent per annum should be charged for such limits except in case of RBI exemption of such penalty.

(f) Drawal of Funds to be Regulated Through Quarterly Statements: Before the commencement of each quarter, the borrower should be directed to
indicate in advance his quarterly requirements of funds within the sanctioned limits. Drawing less than or in excess of the operation limit so fixed, with a tolerance of 10 percent either way, should be deemed to be an irregularity and appropriate corrective action should be taken.

(g) Enhancement of Borrower's Contribution: In order to ensure that the borrower would enhance their contribution to working capital and to improve their current ratio, it would be necessary to bring them under the second method of lending recommended by the Tandon Committee which would give a minimum current ratio of 1.33:1. As many of the borrowers might not immediately be in a position to work under the second method of lending, the excess borrowing should be segregated and treated as a working capital term loan, which should be made repayable in installments. To induce the borrower to repay this loan, it should be charged a comparatively high rate of interest. This procedure should be made compulsory for all borrowers (except sick units) having aggregate working capital limits of Rs.10 lakhs or above.

Other recommendations made by the Chore Committee and approved by RBI

(a) Requests for relaxation of inventory norms and for adhoc increases in limits should be subjected to close scrutiny by banks and agreed to only in exceptional circumstances.

(b) The banks should devise their own checklists in the light of the instructions issued by the Reserve Bank for the scrutiny of data at the operational level.

(c) Delays on the part of the banks in sanctioning credit limits could be reduced in the cases where the borrower co-operate in giving the necessary information about their past performance and future projections well in time.
(d) As one of the reasons for the slow growth of the bill system had been the stamp duty on usance bills, with difficulty in obtaining the required denomination of stamps, the matter might have to be taken with state governments.

(e) Banks should insist on the public sector undertakings/large borrowers to maintain control accounts in their books to give precise data regarding their dues to the small units and furnish such data in their quarterly information system. This would enable the banks to take suitable measures for ensuring payment of the dues to small units within a definite period by stipulating, if necessary, that a portion of limits for bills acceptance (drawee bills) should be utilised only for drawee bills of small scale units.

(f) To encourage the bill system of financing and to facilitate call money operations, an autonomous financial institution on the lines of the Discount Houses in U. K. might be set up.

(g) A detailed study regarding the relationship between production and quantum of credit at the industry level should be made.

(h) To be effective, credit control measures would have to be immediately communicated to the operational level and followed up. There should be a ‘cell’ attached to the chairman’s office at the central office of each bank to attend to such matters.

(i) The bank should monitor the credit portfolio of the ‘key’ branches and utilisation of limits and inventory build-up of critical accounts.

(j) To reduce the delay in collection of bills and cheques, return of documents by the collecting branches etc., the group suggested to tone up the communication channels and systems and procedures within the banking system.
(k) Although banks usually objected to their borrowers’ dealings with other banks without their consent, some of the borrowers still maintained current accounts and arranged bill facilities with other banks, thus vitiating the credit discipline. The reserve bank should issue suitable instructions in this connection.

(l) To avoid delay in the submission of the returns simplified forms were proposed.

**Marathe Committee**

With the incorporation of the guidelines of the Tandon Committee and the Chord Committee, bank lending to the industry came increasingly under the direct supervision of the RBI. In Nov. 1982, it was felt that an independent review of the Credit Authorisation Scheme¹ (CAS) which had been in operation for several years would be useful and accordingly the RBI appointed a committee under the chairmanship of Shri S. S. Marathe to review the

¹ In Nov. 1965. RBI advised all scheduled commercial banks that in order that the growth of bank credit might be more closely aligned to the requirements of the Plans and as an additional measure of credit regulation they would be required to obtain the Reserve Bank's prior authorisation before sanctioning any fresh credit limit (including commercial bill discount) of Rs. 1 crore or above to any single party or any limit that would take the total limit enjoyed by such party from the entire banking system to Rs. 1 crore or more on secured or unsecured basis. This came to be known as CAS. (RBI Committee to Review the Working of the Credit Authorisation Scheme. Bombay, p. 6). Thus CAS of RBI regulates availability of bank credit for working capital finance. However, the objectives of CAS were enlarged and redefined to ensure greater degree of credit discipline on the part of banks and borrowers in May 1978 as under:

(a) to ensure that additional bank credit is in conformity with the approved purposes and priorities and that the bigger borrowers do not pre-empt scarce resources:

(b) to enforce financial discipline on large borrowers, where necessary, on uniform principles:

(c) where a borrower is financed by more than one bank, to ensure that the customer's proposal is assessed in the light of the information available with all the banks: and

(d) to bring about improvement in the technique of credit appraisal by banks and their system of follow-up.
working of CAS 'from the point of view of its operational aspects'. The terms of reference to the committee were:

1. To examine the objectives, scope and contents of the scheme and make suggestions with regard to making modifications therein, if any, having regard to the changing economic situation.

2. To examine the adequacy or otherwise of the credit appraisal machinery/procedures in commercial banks and suggest modifications.

3. To study the existing set-up for compliance with the requirements of the scheme within the commercial banks both at the Head and Regional office levels and suggest any modifications therein considered necessary to facilitate proper appraisal and expeditious disposal of applications and monitoring thereof.

4. To examine the existing data base for making recommendations by banks to RBI for authorising a given level of credit for a particular party and suggest modifications on that behalf.

5. To examine the existing formats for submitting applications by banks to RBI for seeking authorization and suggest necessary modifications therein.

To study the desirability of introducing time bound guidelines to be observed within commercial banks and RBI for speeding up the processing and disposal of applications.

To make any other recommendation which would be germane to the scheme.
The committee submitted its report in July 1983.¹

Recommendations: The important recommendations made by committee in respect to bank credit were as follows:

(i) CAS should not be looked upon as a mere regulatory measure which was confined to large borrowers only. The basic purpose of CAS was to ensure orderly credit management and improve quality of bank lending so that all borrowings, whether large or small, were in conformity with the policies and priorities laid down by Central Banking Authority. If the CAS scrutiny had to be limited to a certain segments of borrowers, it was only because of administrative limitations or convenience and it should not imply that there were to be different criteria for lending to the borrowers above the cut off point as compared to those who did not come within the purview of the scheme.

(ii) It would not be possible to avoid delays or improve quality of lending merely by concentrating on a single point. The borrowers would have to do their bit by providing all the necessary and relevant information in time. The long time taken in commercial banks in processing applications had to be reduced by suitable organisational changes. Similarly the time taken for scrutiny in the RBI also required attention partly because its being the last stage of the process. and because of earlier delays, it was found more irksome by the borrower. Improvement in the system as a whole should be a conscious and continuous process in order to achieve the desired result.
(c) Incentive should be given to the borrowers to comply with all the requirements of the scheme including the information system and the banks to improve the quality of credit appraisal. This could be best achieved by ensuring that all such cases would receive preferential treatment in the form of not requiring prior authorisation of RBI.

(d) The banks should be allowed discretion to deploy credit in CAS cases which satisfied the following requirements, without RBI's prior authorisation: (i) reasonableness of estimates/projections in regard to sales, chargeable current assets, other current assets, current liabilities (other than bank borrowings) and net working capital, in terms of past and future trends, (ii) classifications of current assets and current liabilities in conformity with the guidelines issued by the Reserve Bank, (iii) maintenance of minimum current ratio of 1.33:1 (except under exempted categories), (iv) prompt submission of quarterly operating statements by the borrower, for the past 6 months with an undertaking to do so in future also, and (v) an undertaking by the borrower to submit his annual accounts promptly and regular annual review being carried out by the bank even without enhancement in credit facility.

The Marathe committee envisaged that the need for a regulatory role for the RBI in respect of individual credit limits would diminish, if not disappear if the banks would not be able to evolve an operational culture which would be immune to unhealthy pressures and which would have an in-built discipline in conforming to the broader parameters of policy laid down by the Central Banking Authority.
Kannan Committee

Until Kannan Committee’s recommendations, bank credit to industry was highly regulated as suggested by Tandon Committee. Considering the ongoing deregulations and liberalisations in the financial sector including commercial banks, it was realised to free the banks from rigidities of the Tandon Committee recommendations (later on strengthened by Chore Committee) in the area of working capital finance. Accordingly, Indian Banks Association (IBA) constituted in Sep. 1996, a committee on ‘Working Capital Finance’ including assessment of Maximum Permissible Bank Finance (MPBF), under the chairmanship of Shri K. Kannan. Committee submitted its report to RBI in March 1997.

Recommendations

(a) Committee recommended for freedom to each bank in regard to evolving their own system of working capital finance for a faster credit delivery in order to serve more effectively various segments of borrowers in the Indian Economy. Micro-level credit administration should be handled by each bank individually with their own risk-perceptions, risk-analysis and risk-forecasting.

(b) Arithmetical rigidities imposed by Tandon Committee (and reinforced by Chore Committee) in the form of MPBF-computation, having so far in vogue, should be given a go-by. The proposed new system consists of the following:

In 1985, Chakravarty Committee formed “To Review the Working of the Monetary System,” also made recommendations in respect of bank credit. However, committee upheld the view that the normal working capital limits should be determined on the basis of Tandon/Chore Committee norms.
Working capital finance requirements should be determined on the basis of Desirable Bank Finance (DBF) Method. DBF method is based on 'Cash Deficit Lending' in place of 'Liquidity Level Lending' which is defacto security based lending-practised and stipulated so far by the banks. 'Cash Deficit Lending', which is in essence need based lending-indicating the financial support required by the borrower, has been aimed at to perceive the borrower's requirements, rather than to assess, after the deserving risk-analysis and risk-forecasting on case to case basis with perusal of the acceptability of the borrower's overall financial status, projected level of liquidity and activity, market reports, industry/activity profile and the economic strata which a particular borrower belongs to. Working capital finance requirements should be assessed by Turnover Method in case of borrowers up to Rs.2 crores and by Cash Budgeting System in case of large borrowers.

Existing system of assessment/fixation of sub-limits within total working capital credit requirements should be replaced by Line of Credit System (LCS) as prevalent in many advanced countries. LCS is not a credit facility, rather an outer limit of borrower's working capital requirements. funded and non-funded. Within this maximum limit, various types of funded and non-funded working capital facilities with appropriate limits shall be made available to the

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The criticism against the use of Tandon Committee norms has been that the approach rests on the use of balance sheet data. The norms being derived on the basis of funds flows statement. It is suggested that cash flow projections should be the proper basis of determining funds requirements.

Example of non-funded working capital finance is guarantee. Letter of Credit etc.

Different credit facilities are cash credit (Hypothecation of stock, book-debts, supply bills), inland bills purchased (clean/documentary), export credit, letter of credit for purchases other than capital goods guarantee.
borrower at the discretion of the sanctioning authority in lieu of borrower’s requirements for different facilities from time to time.

(iii) There shall be no commitment charge on unutilised portion of working capital finance. However, in a persistent default in availing at least 80 percent of the sanctioned limit, the borrower’s working capital credit requirements shall be reviewed by the competent authority for necessary revision in the sanctioned limit.

(iv) Any excess drawings over and above the confirmed LCS may be subjected to the additional rate of interest, say upto 2 percent, to take care of bank’s cost of managing the uncommitted funds/obligation.

However, MPBF system, introduced in 1975 as recommended by Tandon Committee, has been well established now. Despite its prescription being withdrawn by RBI, most of the banks are still continuing with this system. Cash budgeting system will require many changes in the accounting system of the borrowers and therefore the transition to the new system is going to be slow.

**PATTERN OF FINANCING WORKING CAPITAL IN THE SELECTED TYRE COMPANIES**

This part of chapter tries to analyse the financing pattern of the working capital of the sample companies over the study period.

**NATURE OF APPROACH USED IN WORKING CAPITAL FINANCING BY SELECTED TYRE COMPANIES**

First important issue is to find out whether the companies are following an aggressive, a moderate or a conservative approach in the
financing of working capital.\textsuperscript{1} The approach to be used depends, inter-alia, upon the philosophy of management. Different approaches result in different proportions of current and long-term liabilities used to finance current assets, resulting in different levels of risk in financing working capital assumed by the firm. This risk can be measured by

\[
R_F = \frac{CL}{CA}
\]

\(R_F\) - Risk in financing working capital

\(CL\) - Current liabilities

\(CA\) - Current assets

An enterprise is assumed to have followed the aggressive approach when current liabilities are used to finance not only entire current assets but also a portion of fixed assets. In other words, current liabilities are more than current assets. This approach as is indicated by name, results in the highest risk as even if all current assets are converted into cash,\textsuperscript{2} this will not be sufficient to pay-off all current liabilities. In terms of risk measure, this approach results in

\[R_F > 1 \text{ as } CL > CA\]

An enterprise is said to have followed a moderate approach, when both short-term and long-term sources are used to finance current assets. It means current liabilities are greater than zero but less than total current assets. In terms of risk measure, it results in

\textsuperscript{1} These approaches are explained in Chapter 2.

\textsuperscript{2} This generally does not happen in practice as current assets include inventory, prepaid expenses, debtors' etc. which can not be converted 100 percent into cash.
0 < R_F < 1 as 0 < CL < CA

Similarly, an enterprise is assumed to have followed a conservative approach when all current assets are financed by long-term sources. Current liabilities are nil as the enterprise does not want to assume risk. In terms of risk measure,

\[ R_F = 0 \text{ as } CL = 0 \]

Thus \( R_F \) measures risk assumed by the enterprise in financing working capital. As \( R_F \) increases, risk also increases. If it is greater than one, firm is highly risky as regards the financing of working capital.\(^1\)

Table 7.1 annexed to this chapter provides risk measure in financing working capital of different tyre companies. The most important result is that all the observations in table 7.1 fall between 0 and 1. It means all the firms followed moderate approach to finance working capital. The conservative approach is an extreme case and is generally not adopted in practice. So far as the aggressive approach is concerned, in the present study, no company followed aggressive approach. It is, perhaps, the result of continuous efforts of RBI in the form of credit rationing introduced by banks as a result of recommendation of different committees. This results in restriction on the supply of short term back credit to firms forcing them to resort to long term sources to finance current assets.

With moderate approach, risk can vary between 0 and 1. Table 7.1 shows that over the study period risk has increased on an average from .57 to .62 and .42 to .63 for Apollo and Ceat respectively. It shows that use of

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current liabilities for financing current assets has increased over the years for these two companies. As far as MRF is concerned risk has fallen in the same period from .45 to .35 showing less use of current sources for financing working capital.

Increase in risk over the study period was higher in Ceat Ltd. as compared to MRF. It is shown by higher co-efficient of variation in Ceat Ltd. It means Ceat has started using relatively more current liabilities to finance current assets.

To sum up, tyre companies followed moderate approach in the financing of working capital. Risk assumed in the financing of working capital has increased in Apollo Tyres and Ceat Ltd. and has fallen in MRF Ltd.

**RELATIVE ROLE OF LONG TERM AND SHORT TERM FUNDS IN THE FINANCING OF WORKING CAPITAL**

Working capital can be financed from long-term sources and/or short-term sources of funds. Long-term sources include internal sources like retained earnings and depreciation provision. External long-term sources include equity capital, debentures, long-term loans etc. Short-term sources consist of internal sources of dividend provision, tax provision and other short term provisions; and external sources of trade credit, bank credit, loans and advances from sources other than banks, outstanding expenses, short-term securities like commercial paper etc.

Net working capital measures the amount of long-term funds used in the financing of working capital. Net working capital divided by current assets and multiplied by 100 gives the percentage share of working capital financed by long-term sources. Current liabilities divided by current assets
multiplied by 100 measures percentage share of current assets financed by current liabilities. Percentage shares of long-term and short-term sources in financing of working capital are given in Table 7.2 attached with this chapter.

Robert H. Wessel and Earnest W. Walker\(^1\) emphasised that permanent working capital should be financed from long-term funds and temporary working capital should be financed by short-term funds. But, for an external analyst it is difficult to find out the amount of permanent working capital, as data on weekly and monthly basis are not available. However, with the growth in working capital, proportion of long-term funds used in financing of working capital remains stable or increase if the concept of financing of permanent working capital by long-term sources is to be satisfied. But this does not hold true for Apollo Tyres and Ceat Ltd. in the present study as the net working capital to current assets has declined from 43.14% to 37.06% in Apollo tyres and 58.24% to 37.29% for Ceat Ltd. over the study period. Only in MRF role of long term sources to finance working capital has increased from 55.47% in 1995-96 to 64.71% in 2004-05.

On an average the share of long term sources and short term sources is 41% and 59% respectively for Apollo Tyres 51% and 49% for Ceat Ltd. and 64% and 36% for MRF Ltd. It shows there is no uniform pattern of financing the working capital by all the companies.

**RELATIVE PROPORTION OF DIFFERENT SHORT-TERM FUNDS IN FINANCING OF WORKING CAPITAL**

The present section attempts at analysing the relative role of various short-term liabilities. Since use of long-term funds in financing the working

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capital is out of a common pool of long-term funds, it is not possible to isolate the relative contribution of different sources of long-term funds in financing the working capital. Hence, this exercises has not been attempted. In financing the working capital, the current liabilities or short-term sources of funds may be grouped into two categories: Internal and External.

**Internal Short-Term Sources of Funds**

Internal short-term sources include provision for taxes, provision for dividend and other short-term provisions like employees’ compensation fund. These are cost free and formalities free sources. Therefore, it should be used to the fullest possible extent. However, its availability to a large extent depends on profitability. Table 7.3 attached to this chapter shows the role played by internal short-term sources in the financing of working capital.

It shows that on an average over the study period of 10 years 6% of working capital is financed by current provisions in Apollo tyres 1.13% in Ceat Ltd. and 4.96% in MRF Ltd. The reason of very low financing by current provisions in Ceat Ltd. is because of its low profitability over the period. The role of current provision in financing the working capital of Apollo Tyres has been 3% to 5% in most of the years except in 2003-04, where it increased to 9.59%. But again it came down to 4.21% in the year 2004-05. Current provisions has not played a significant role in financing of working capital in Ceat Ltd. Over the 10 years period it has come down from 2.14% in 1995-96 to .05% in 2004-05. In MRF also, the share of current provision in financing working capital has declined from 4.81% in 1995-96 to 1.89% in 2004-05. It shows tyre companies are making relatively small provision for tax and dividend. A careful scrutiny of financial statements reveals that tax provision played more significant role than dividend.
provision. It is probably because of legal obligation of firms to pay income
tax in case of profit and hence make provision for tax.

**External Short Term Sources of Funds**

External short-term sources of funds include trade credit, short-term bank loans, other short-term liabilities like outstanding expenses, short-term loans from other than banks, short-term securities like commercial paper etc. It is the most important source of gross working capital. Following discussion analyses the relative contributions of important external sources like trade credit, short-term bank credit and commercial papers.

**Trade Credit**: Trade credit is one of the primary sources of funds to finance inventories. It is a spontaneous source as it is available in the natural course of business. It does not involve cost, if used wisely, like making payment on the last day of the credit period. But it is available only in the form of goods or services. Percentage share of trade credit in financing of working capital is presented in Table 7.4 attached to this chapter.

Table 7.4 shows that Apollo Tyre financed, on an average 41.67% of its working capital from this source over the study period, this is 35.21 percent for Ceat Ltd. and 28.14 percent in MRF Ltd. It shows MRF used relatively less trade credit as compared to Apollo & Ceat. The maximum use of trade credit for financing working capital has been done by Apollo tyres. The use of trade Credit for financing working capital has declined in MRF Ltd. from 35.46 percent in 1995-96 to 24.29 percent in 2004-05. Use of this source in MRF Ltd. was subject to fluctuation which is reflected in coefficient of variation. In Apollo tyres also there is a slight fall in use of trade credit i.e. from 44.59% to 40.61% over the study period. But, in case of Ceat Ltd. use of trade credit has increased from 34.21% to 44.23% in the same period.
Short Term Bank Credit: Commercial banks are primary institutional source of providing short-term credit to trade and industry. One of the major objective of commercial banks is to provide short terms credit to industry. Table 7.5 annexed to the chapter shows the extent to which short term bank credit has been used by selected tyre companies in financing its working capital needs. Throughout the study period bank credit has played significant role in financing working capital which is on an average 13.78%, 23.38% and 19.47% for Apollo, Ceat and MRF respectively. It indicates that among the three companies, Ceat has used bank Credit more extensively than MRF and Apollo. There is a decline in the use of bank credit in financing the working capital, it has come down from 19.02% to 15.81% in Apollo and 21.51% to 18.66% in Ceat over the study period. But the decline is more significant in case of MRF, it has fallen from 38.28% to 18.09%. This decline in the role of commercial bank credit in financing the working capital is because of stringent guidelines of R.B.I.

Commercial Paper: Following the Vaghul Committee's recommendations, RBI in March, 1989 announced its decision to introduce a scheme for the issuance of commercial paper by corporates albeit with stringent on the type of company that could issue commercial paper. As a result, in the recent past, commercial paper has been introduced as a source of short-term financing. Commercial paper consists of short-term unsecured promissory notes issued by corporate borrowers directly to investors in the money market. The commercial paper market has the advantage of giving highly rated corporate borrowers cheaper funds than they could obtain from the banks while still providing institutional investors with higher interest earnings than they could obtain from the banking system. "The issue of commercial paper

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1 RBI initially required the companies issuing commercial paper, should have tangible net worth of Rs.10 crores, that working capital limits of the company, be not less than Rs.25 crores, that the company must have a minimum credit rating of PI+.
impacts a degree of financial stability to the system as the issuing company has an incentive to remain financially strong. The possibility of raising short-term finance at relatively cheaper cost would provide an adequate incentive for the corporate clients to improve their financial position and in the process the financial health of the corporate sector should show visible improvement.1

There has been sizeable growth in the primary market for commercial paper. Therefore, we analyse the role played by commercial paper in providing short-term funds to finance working capital in tyre companies in India.

Table 7.6 attached to this chapter shows the use of commercial paper as a source of funds by tyre companies. Our data shows that this source is yet to gain popularity in the tyre companies. Analysis of the table shows that use of commercial paper on an average basis is only 6.21%, 0.41% and 4.03% in Apollo, Ceat and MRF respectively over the study period. Use of this source by Ceat is almost negligible. Apollo, in the year 2004-05 has issued commercial paper of Rs.150 crores.

CONCLUSIONS

The major conclusion that emerge from the above analysis are: First, the tyre companies have been using moderate approach towards financing of working capital, that is to say companies have been employing both long-term as well as short-term sources for financing of working capital. Secondly, it may be mentioned in this context that the share of long-term funds have been falling over the years in Apollo Tyres & Ceat Ltd. but increasing in MRF Ltd.

Thirdly, as far as short-term sources of funds are concerned, the industry in

1 Reserve Bank of India, Working Group on Money market (Chairman: N. Vaghul), 1987,
general has tended to rely more on external short-term sources than the internal sources. That is to say, conventional sources of bank credit and trade credit have been relied upon to a much greater extent than the other sources. The new and non-conventional sources of finance like commercial papers and factoring are yet to make mark in this regard.
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<th>YEAR</th>
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Note: For Current Assets and Current Liabilities (see Table 7.1).
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Table 7.3
RATIO OF SHORT TERM INTERNAL FUNDS TO CURRENT ASSETS IN THE SELECTED TYRE COMPANIES

(Rs. in Crore)
<table>
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### Table 7.5
RATIO OF SHORT TERM BANK CREDIT TO CURRENT ASSETS IN THE SELECTED TYRE COMPANIES

(Rs. in Crore)

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(Rs. in Crore)