Chapter - III

FINANCING OF WORKING CAPITAL AND THE RECOMMENDATION OF DIFFERENT COMMITTEES.
The most important and crucial aspect in the field of working capital management is the financing of working capital. After determining the optimal level of working capital requirements, the management has to take the decision regarding the sources to be used in financing the working capital. There is no doubt that the profitability of a firm mostly depends on the choice of sources for financing the working capital needs. There are different sources before a firm and it can use any of them or any combination of them for financing the working capital. But this is to be kept in mind that the costs of use of different sources are different and at the same time there are a number of sources for which the firm has to incur nothing as cost of use and which are termed as cost free sources. But in this case some degree of risk is involved.

Naturally, the main problem in this regard is the cost of financing. This is the important aspect relating to the financing of working capital which obviously affects the profitability of the firm to a large extent. But there is no restriction on the part of a firm regarding its choice of sources for financing. This mainly depends on the availability of the sources in favourable terms and conditions. But in order to maintain the liquidity position and to follow the industry norms, the management may impose some restrictions on the use of sources for financing the working capital.

3.1 Strategies of financing
There are different types of sources for financing the current assets of a firm—short-term, long-term, and spontaneous sources. The firm can exercise its option for using any source or sources mentioned above for financing its needs for working capital. But the use of any sources or any combination of the available sources depends upon the consideration of a number of factors like cost, risk preference, demand and supply position in the money market etc. In practice, a firm can adopt any of the following strategies in financing its current assets for smooth running of its day-to-day activities
a) **Matching approach**: According to this strategy of financing, the expected life of the assets should be matched with the expected life of the sources of fund to be used for financing the assets. It is most simply said that the short term assets or current assets should be financed by using the short term sources and the fixed assets or the asset having the fairly long life should be financed from the long term sources. As the purpose of financing is to invest in assets, so the liability arising from financing the asset should be liquidated at the end of life of the asset concerned. This is the main theme of this matching approach.

But if the long term sources are used for financing the short term assets, it should be costly for the firm because this fund remains idle for a long time after the expiry of the lives of the assets. Similarly, if the long term assets or fixed assets are financed by using short term sources, this should be hazardous to the firm because the liability has to be renewed again and again.

At last, it can be said that there is the limitation on the use of this approach for financing the assets of the firm, because it is difficult to know or to estimate the exact life span of the assets. As a result, it should be difficult for a firm to choose the proper source for financing the assets.

b) **Conservative approach**: In reality, it is very difficult to apply the principles of matching approach for financing the assets of the firm, although it has some advantages on the part of the firm. Therefore, the firm may show its conservativeness for financing both of its fixed and current assets. A firm is said to be conservative when it uses more long term sources than the short term sources for financing its assets. However, the use of more long term sources for financing the assets, the firm is said to be more conservative and vice versa. When a firm decides to apply this policy then all the fixed assets, all permanent current assets or hard core current assets should be financed from the long term sources. Naturally, the remaining part of the fluctuating or seasonal current assets should be financed from the short term sources. Moreover, in this case when the fund released from short term assets, this should immediately be invested in marketable securities temporarily. This ultimately helps to enhance the liquidity position of the firm. Therefore, to rely heavily on the long term sources, the less risky would be the firm’s decision regarding its liquidity.
c) **Aggressive approach:** It is just opposite to the conservative policy for financing the assets of the firm. A firm is said to be aggressive in financing its assets when it uses more and more short term sources. This means that the risk of use of short term sources is relatively higher than the long term sources. Under this approach, a part of the fixed assets is being financed from the short term sources. Naturally, dependence heavily on short term sources for financing both fixed and current assets, the more risky would be the firm’s decision and the firm has to face some unfavourable situation where it has to renew its liability on a continuous basis. This involves some extra costs which obviously impair the profitability of the firm. The adoption of this aggressive policy by a firm for financing its assets, the net working capital of the firm would be negative in most of the cases.

By evaluating the above three approaches for financing both fixed and current assets, it can easily be said that the firm can increase its return on capital employed by using the short term sources. In other words, the adoption of aggressive policy can give the highest return on capital employed, because the short term sources are less costly as compared to the long term sources. But in this case high degree of risk is involved. On the other hand, the return on capital would be lowest, if the firm adopts the conservative policy for financing its assets because the long term sources are relatively more costly as compared to the short term sources. But in that case, the risk pattern is minimum. Hence, if the firm adopts the aggressive policy or if its choice is confined to the use of more short term sources for financing its assets, the finance manager would not be required to give much more attention and time to bother about the profitability of the firm. So the adoption of a particular strategy for financing both fixed and current assets depends on the risk-return trade off.

### 3.2 Selection of the nature of financing

The first and foremost activity of the finance manager is to decide upon the nature of sources to be used in financing the working capital of the firm. By nature, there are two types of sources which can be taken into consideration: long term sources and short term sources. Each source has some special advantages of its own. A comparative study is to be taken before deciding the sources to be used to finance the working capital of the firm. The benefits derived from using the short term sources are —
a) Cost factor: The long term sources are more costly as compared to the short term sources. Moreover, the lenders remain always reluctant in investing their funds for a long period of time. They always try to avoid the risk involved in their investment. The longer the period of investment, the more would be degree of risk on the part of the lenders. Hence, the lenders of long term fund demand higher rate of return on their investment.

On the other hand, the lenders of short term fund can find an opportunity to invest their fund in the changing economic scenario in order to earn something more. Due to the inflation, the rate of interest is going to be increased with the passing of time. The lender in that case can avail of this benefit immediately after the expiry of the agreement. As in case of short term investment, the degree of risk as well as the length of time is minimum, so the lenders demand low returns on their investment.

b) Flexibility: The flexibility of the long term sources is relatively low as compared to the short term sources. The long term loan can not be repaid earlier i.e, before the expiry of the term, although the fund appears to be unnecessary to the firm before the expiry of the term. In that case the firm has to bear some amount of extra cost unnecessarily, although the funds remain idle. But in case of short term financing, the funds can be liquidated as and when it turns to be converted as surplus and there is no scope for its use. So the management prefers to use the short term sources for its higher flexibility.

From this discussion, it is concluded that the short term sources are less costly but more flexible in nature as compared to the long term sources. But the risk involved in using short term sources is relatively higher than the long term sources. This is also to be kept in mind that there is the inverse relationship between the use of short term sources and the liquidity position of the firm. With the induction of short term sources into the firm, the liquidity position of the firm decreases and vice versa.

Benefits of long term sources

i) Less risky: The risk involved in using long term sources is relatively low as compared to the use of short term sources. It does not affect the liquidity position of the firm. The firm can use it without any frequent disturbance for repayment and the
firm can also make necessary arrangement in advance to repay this liability either from its year to year profit or from any irregular sources.

**ii) Stability in use:** As the collected fund in this case is used in business for a long period of time, the firm can employ it to satisfy its long term or permanent requirements. It helps to provide stability in operation and the firm can use it with much more certainty, because the firm does not have to bother for its early liquidation i.e. before the expiry of the tenure of agreement.

**iii) Increase in liquidity:** As there is the certainty in using this source of fund for a long time, the firm can take the decision to invest it in long term profitable opportunities. As there is no question to repay it before the expiry of the tenure of agreement, it helps to increase the liquidity of the firm.

### 3.3 Sources of financing

A firm can exercise its option in using the different sources of fund for financing its working capital requirements. But the use of any source depends on its availability, costs, terms and conditions to obtain the funds etc. The following are the available sources of funds that a firm can use in order to fulfill its needs for working capital —

a) *Trade credit*

b) *Bank credit*

c) *Retained earnings*

d) *Long term sources, viz, equity capital, Debentures, Long term bank loan etc.*

**a) Trade credit:** Trade credit refers to the credit granted by the suppliers of goods/services in the normal course of the business. The customers do not have to pay their dues to the suppliers immediately on receipt of the delivery of goods. This type of deferral payment contributes the short term source of fund to the firm to satisfy its need for working capital. In India, it is an important short term source to finance the working capital needs and it constitutes about one third of the total short term financing. As to the small firm, it is very difficult to obtain bank loan or to use other sources of financing available in the capital market, hence, such a type of firm has to be dependent mostly on trade credit for financing its day-to-day operation.
There are some advantages that a firm can enjoy by using this source of financing, which are-

**Firstly**, it is very easy to obtain as compared to the other sources of financing. Except some special cases, it raises automatically during the normal course of business.

**Secondly**, it is very flexible in nature. A firm can repay it at any point of time when it finds surplus funds. Moreover, the need for additional funds for the purchase of goods/services due to the expansion of sales is automatically financed by trade credit.

**Finally**, it is a spontaneous and informal source of financing. It requires generally no prior agreement with the lenders. It takes place automatically through the normal business transactions. Besides this, the firm has not to incur any explicit cost for it.

b) **Bank credit**: Bank is an important and vital source of both short term and long term funds to meet the different types of need of the firm. It is also the main institutional source to finance the working capital needs in India. Normally, three-fourth of the working capital requirements of any industry is financed jointly through bank credit and trade credit. A firm can use this source by obtaining sanctioned credit by the bank in the following ways-

**Loan**: As per arrangement made, the entire amount of loan sanctioned by the bank is transferred to the borrower's account and the borrowers can draw the amount from their account as per their needs either in some instalments or at a time. But the borrower has to pay interest on the entire amount of loan sanctioned; not on the amount actually utilized. In other words, the firm is bound to pay interest on the total amount of loan sanctioned irrespective of the fact whether the firm can utilize the amount of loan to the fullest extent or not.

**Overdraft**: In this case, the borrower is allowed to withdraw amount in excess of the balance from current account up to a certain limit for a specified period of time. A firm can continue to enjoy this facility by
annual renewal of this limit. It is most flexible arrangement because this loan amount can be withdrawn or repaid at anytime when the firm desires within the stipulation. But the borrower can enjoy the facility by paying interest only on actual amount utilized, not on the total amount of loan sanctioned.

**Cash credit:** This is as like as overdraft arrangement. This facility is allowed to the firm against pledge or hypothecation of goods or current assets. The firm is allowed to draw the amount based on security margin. This is to be remembered that the firm is never allowed to draw the entire amount of loan sanctioned at a time, rather the firm can draw it periodically as per needs but the firm can repay or deposit the surplus amount at any time in cash credit account. This is also said to be a very flexible source of fund on the part of the borrowers.

**Purchase or discounting of bill:** This system is very recently developed in India. This facility is available to a firm as per new bill market scheme introduced by the Reserve Bank of India in 1970. But the amount provided under this scheme is within the overall maximum limit of overdraft or cash credit. Before discounting or purchase of the bill, the bank is required to be satisfied about the creditworthiness of the borrower or drawer and the genuineness of the bill. By discounting or purchasing the bill, the bank becomes the owner of the bill and it acts as security for the credit granted.

By introducing this system, the Reserve Bank of India takes an attempt to replace the cash credit system for financing working capital of a firm, because the cash credit system provided the double financing against the security of the same asset. This happens by purchasing goods on credit from the suppliers and obtaining cash credit by hypothecating the same goods to the bank.

**Letter of credit:** This is an indirect way of providing credit to the firm by banks. The suppliers living in foreign country try to be ensured in getting payment from the buyers bank, in case of his failure to make payment in
time. It is just like as guarantee on behalf of the buyers for making payment to the foreign suppliers. This is an arrangement which helps the buyers to purchase goods from abroad. If the buyer fails to make payment in due course, the bank takes the obligation to make payment under letter of credit arrangement. This facility is being provided by the bank only to the financially sound customers. But the question of this type of credit will arise only when the customers fail to honour its obligations by making payment to their foreign suppliers in time.

3.4 Types of security

At the time of providing credit to the customers, Bank requires adequate security against such credit. The bank decides the maximum amount to be granted as credit to the customers on the basis of the margin requirement of security. The margin is nothing but the percentage of the value of assets offered as security by the borrowers at the time of taking credit. The following are the types of security on the basis of which, bank provided credit to the borrowers-

a) **Hypothecation**: Under this system, the bank generally grants credit based on the security of movable property, mainly inventories. But in that case, the bank does not take the properties in its own possession. The borrower is, however, allowed to hold the hypothecated goods in his own possession. Hypothecation refers to the charge against the property for a debt for which neither ownership nor possession is passed to the lenders. The right of the lender depends on the terms and conditions of the contract between the parties. This type of credit is allowed to the customers with high level liquidity. This is not generally granted to the new customers.

b) **Pledge**: In this case also, the bank extends credit to its customers on the basis of security of movable property. But in that case the goods given as security are to be transferred in the physical ownership of the lenders. In other words, goods offered as security are to be kept under the custody of the lender. Therefore, keeping of goods under the custody of the lender is a type of bailment. Hence, the lender has to bear the responsibility regarding the goods offered as security. The lender has to take reasonable care of the goods pledged with him and the lender is fully responsible for any type of damage or loss of these goods, if it is
used for his own purpose. This is to be borne in mind that the lender has the right to sell the goods offered as security and to realize the loan amount together with interest due up to that date, if the borrower fails to repay it within the stipulated period.

c) **Lien**: Lien refers to the right to retain the goods by the lender which is belonging to the borrower until the debt due to him is fully realized. There are two types of lien: particular lien and general lien.

Particular lien means the right to retain the property until the claim relating to that property is fully realized. On the other hand, general lien is to be applied when all the dues are not paid. Bank normally enjoys the general lien.

d) **Mortgage**: Mortgage refers to the transfer of interest in specific immovable property which is offered as security against a loan. The person who transfers the interest is called mortgagor and the person in whose favour transfer is made, is called the mortgagee. In case of mortgage the possession of the property remains with the borrower but the full legal title is vested on the lender or mortgagee. In case of failure on the part of the borrower or mortgagor to repay the loan as per agreement, the lender cannot realize this claim by selling such mortgaged property without the court decree. The agreement between the mortgagor and mortgagee or the interest of the mortgagee in the property is terminated as soon as the loan is repaid by the borrower.

3.5 **Regulation of bank credit**: The Banks in India have been providing credit to the industry and trade based on the security provided by the borrowers. But at present the supply of bank credit is the subject matter of regulation and control. This is effective due to providing bank credit with planning priorities and to ensure the equitable distribution of bank credit to the various industries of the economy.

In view of this, the National Credit Council constituted a committee in 1968 under the chairmanship of V.T. Dehejia and subsequently a few number of committees have also been constituted on the same subject matter. The terms of references, their findings and recommendations are depicted below-
The committee was formed in October, 1968 to determine the extent to which credit needs of the industry and trade are likely to be inflated and how such trend could be checked. The major findings of this committee were-

a) The borrower always decides his amount of borrowings. The banker does not decide the amount to be lent. Naturally, the banker is not in a position to do credit planning.

b) The amount of credit extended to the borrower is based on the security provided by the borrower. The level of operation of the borrower is not taken into consideration.

c) There is the tendency on the part of the borrowers to obtain short term credit in excess of their actual needs for working capital and to use such excess amount for financing long term assets.

d) Only the security may not be the guarantee regarding the safety of bank credit. Efficient follow up of the industrial operation may assure the safety of bank funds.

Recommendations:

a) The committee was of the opinion that it is difficult to set the norms for lending credit to the industrial concerns. The banker should provide credit on the basis of the study of borrower’s total operation, not on the basis of security provided.

b) Another recommendation was that the total credit requirements of the firm are to be divided into hard core and short term components. The hard core part represents the minimum level of inventory required to support the given level of production as per industry norms and this should be financed by the formal term loan basis with a repayment schedule.

c) The committee recommended that a customer should confine his dealings to one bank only.
The Reserve Bank of India formed a committee in July 1974 under the leadership of Sri Prakash Tandon. The purpose to set up this committee was to frame guidelines for follow up of bank credit. The terms of references of the group were-

i) To suggest the guidelines for the commercial banks to follow up and supervise the credit from the view point of ensuring the end use of funds and keeping a watch on the safety of the advances.

ii) To make suggestion regarding the types of data and other information that are to be collected by the banks from the borrowers periodically and those are to be collected by the RBI from the lending banks.

iii) To make recommendation regarding the sources for financing the minimum working capital requirements.

iv) To make suggestions for prescribing inventory norms for different industries both in the private and public sectors and to indicate the broad criteria for deviating from these norms.

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

vi) To make recommendations as to whether the existing pattern of financing of working capital requirements by cash credit or overdrafts requires to be modified, if so, to suggest suitable modification.

vii) To make recommendation on any other related matters, as the committee may consider necessary to the subject of enquiry or any other allied matter which may be specified by the Reserve Bank of India.
Observations & recommendations:

The study group submitted its report to the Reserve Bank of India in August, 1975. The major recommendations of the committee were: –

a) The borrowers should prepare the operating plan for the ensuing year and submit it to the bank. On the basis of such plan, the borrower should indicate the likely demand for credit. In this way, it will be helpful for the lending bank to evaluate the borrower’s credit need in realistic manner and to follow up periodically during the ensuing year.

b) The banker should finance only the genuine production needs of the borrowers. The borrower should maintain the reasonable level of inventory and receivables which should be just enough to carry out its desired production. In this way, the efficient management would be able to eliminate the slow moving and obsolete inventories.

c) The committee recommended that the bank would finance a reasonable part of the working capital needs of the borrowers, not the entire part. The remaining part of the working capital needs should be financed by the borrowers from their own funds.

d) The bank should ensure the proper end-use of the bank credit. For this purpose, it should have to keep close contract with the borrower’s business.

e) For financing working capital needs, the borrower can obtain bank credit in different forms like cash credit, bills purchased and discounted; working capital term loan etc.

f) By keeping close contract on the operation of the borrower’s business, it would be possible for a bank by requiring them to submit data regarding their business and financial operations for both the past and future periods at regular intervals.

g) The committee had also recommended the lending norms under three alternatives-
a. Firstly, the borrowers will provide 25% of the working capital gap and the balance 75% can be financed from the bank borrowings which will give a minimum current ratio 1:1.

b. Secondly, the borrower should contribute 25% of the total current assets and the remaining working capital gap (i.e., the working capital gap-borrower’s contribution) can be collected from the bank borrowings. This alternative will provide the current ratio of 1.3:1.

c. Thirdly, the borrower will provide 100% of the core current assets and 25% of the balance current assets. The remaining working capital gap can be financed from bank borrowings. This method will also be helpful to strengthen the current ratio further.

h) The committee had also suggested the inventory and receivable norms. The term ‘NORM’ refers to the maximum level of holding inventories and receivables in each industry. In this context, the committee suggested the norms for inventories and receivables for 15 major industries. This covers about one-half of the industrial advances of the banks. The study group worked out the norms for Cotton & Synthetic Textiles, Man-made Fiber, Jute Textiles, Rubber products, Fertilizers, Pharmaceuticals, Dye and Dyestuffs, Basic Industrial Chemicals, Vegetables and Hydrogenated oils, Paper, Cement, Engineering manufacturers and other Capital equipment suppliers (other than Heavy engineering). The group had not suggested the norms for Heavy engineering and highly seasonal industries. In case of other industries, the group had suggested that those norms should be progressively extended to cover more and more industries including small scale industries.

The group suggested the norms relating to (i) raw materials including spares and other items used in the process of manufacture. (ii) Stock in process (iii) finished
goods (IV) receivables. The norms had been suggested on the basis of time element which are –

1. Raw materials as so many months’ consumption.

2. Stock in process as so many month’s cost of production.

3. Finished goods and receivables as so many months’ cost of sales and sales respectively.

The norms prescribed for the account receivable was related to the inland sales only on a short term basis. The receivables arising out of deferred payment of sales and export were excluded. The group did not suggest the norms for the stock of spares because this item forms a small part of the operational expenditure.

These norms indicated the maximum level of holding of inventory and receivables in each industry. The borrowers are not generally interested to hold more than that. But if the borrower can manage with the less amount; then they are allowed to do so.

The norms suggested by the study group for inventory and receivables were not rigidly to apply. Any deviation from the suggested norms may be permitted where it is found to be justified.

3.5.3 Chore committee

The Reserve Bank of India constituted another committee in April, 1979 under the leadership of Mr. K.B Chore. The main purpose of appointing such committee was to review the operation of cash credit system in regard to the gap between the sanctioned credit amount and the extent of their use. The committee submitted its report in August, 1979. The major recommendations of the committee were-

a) The borrowers should provide more funds for financing their working capital requirements. They must take steps to reduce their dependence on bank credit. In this context, the committee suggested to adopt the second method of financing as recommend by the Tandon Committee. If it is not possible for the firm to provide the sufficient funds as per its requirement immediately, the firm would be provided loan in the form of working capital term- loan and this should be
repaid in instalments within a period not exceeding five years. The rate of interest would be higher in that case than the usual rate under cash credit system.

b) The bank should fix up separate credit limit for the peak and non-peak level indicating the relevant period also for all the barrowers in excess of Rs.10 lacs. Adhoc or temporary credit limits should be generally discouraged by bank. If it is to be sanctioned under special circumstances, an additional interest of 1% p.a. should be charged on such sanctioned amount.

c) The existing three types of lending system viz. cash credit, loans and bills should be continuing. On the basis of the prevailing circumstances, the bank should take steps to replace the existing cash credit system by loans and bills.

d) The Committee also recommended for implementing the corrective measures to remove the obstacles in using the bill system of finance and also to remove the drawbacks observed in cash credit system.

e) Quarterly statement in the prescribed format should be obtained by the banks from all the barrowers having working capital credit limit of Rs.50 lacs and above

3.5.4 Marathe Committee

On account of following the recommendations of the Tandon committee and chore committee at the time of granting credit, the bank credit to the industries had been increasing under the direct control and supervision of the Reserve Bank of India. In 1982, it was felt to review the Credit Authorizations Scheme (CAS) which continued for several years and for this purpose, the RBI constituted a committee in November, 1982 to review the working of CAS. This committee was known as Marathe Committee. The Committee was given the wide term of references to examine the credit authorization scheme. The Marathe Committee submitted their report in July 1983. The important observations and recommendations of the Committee were-

1. Credit Authorization Scheme is not to be considered as a regulatory measure only confined to the large borrowers. The main purpose for the implementation of this scheme is to ensure the orderly credit management. This is also helpful to improve the
quality of credit by ensuring all types of credit whether large or small and which are in conformity with the policies and priorities as prescribed by the central banking authority.

2. The Committee recommended for evolving a system where there are incentives for the borrowers to comply all the requirements of the scheme. This incentive should also be extended to the bankers to bring improvement in quality of credit appraisal.

3. Another recommendation of the Committee was that the bank can exercise its discretion to disburse credit in CAS cases without obtaining prior authorization of RBI, if the borrower fulfils the following requirements-

   i) Reasonableness in estimates /projections in regard to sales, chargeable current assets, other current assets, current liabilities and net working capital.

   ii) Classification of current assets and current liabilities as per guidelines suggested by RBI.

   iii) Quick submission of quarterly operational statements for the last six months with an undertaking to do so in future.

   iv) Maintenance of minimum current ratio of 1.33:1

4. In case of deployment of credit by bank in its own discretion, a certificate duly signed by a senior executive is to be furnished along with the proposal complying all the requirements stated in (3) above.

5. The bank will be able to dispose off the credit proposal of an export oriented business having export not less than 75% of the turnover of the goods manufactured at the bank level without the prior approval of RBI, if the bank satisfies with reasonableness of the exporter’s credit needs.

6. Bank can allow adhoc limit for the period up to 3 months to the extent of 25% of the additional limit to the borrowers having working capital limit in excess of 5 crore. But in that case, bank should be satisfied about their needs.
7. A booklet on CAS is to be prepared by RBI and this should be available as priced publication. This should also be revised and updated periodically.

8. RBI should take steps to ensure prompt submission of data by banks in form No. A and B. This is to be considered as an effective instrument of monitoring their advance portfolios.

9. The present Credit Authorization Scheme may be redesignated as credit monitoring scheme, so as to reflect the important changes in broad approach.

3.5.5 Chakraborty committee

The Reserve Bank of India constituted a committee under the chairmanship of Sukhomoy Chakraborty to review the working of monetary system in India. The committee examined the matter in details and submitted its report in April, 1985 with wide ranging suggestions for its improvement. The committee made two major recommendations which were as under –

i) The observation of the committee was that the delay in making payment by public sector units, some big private sector units and Govt. departments continues unabated. The suggestion of committee in this regard was that the Govt. should take initiative to include a penal interest payment clause in purchase contracts with suppliers for delayed payments beyond a pre-specified period.

ii) The credit limits to be sanctioned to a borrower should be segregated under three different heads –

Cash credit-I - to cover the supplies to Govt.
Cash credit II - to cover special circumstances and contingencies
Normal working capital limit – to cover the balance of the credit facilities.
3.5.6 Kannan committee

In a meeting of the chief executives of selected public sector banks with the Deputy Governor of Reserve Bank of India on 31.8.96, IBA constituted a committee under the leadership of K. Kannan, Chairman & Managing Director of the Bank of Baroda. This committee is known as Kannan Committee. The purpose of the formation of this committee was to make free the banks from the rigidities of Tandon Committee’s recommendations in the area of working capital finance including the assessment of maximum permissible Bank finance (MPBF) and considering the ongoing liberalization in the financial sector.

The committee examined all the matters assigned to it and submitted its report to the IBA on 25th February 1997. The important recommendations of the committee were –

a) The banks should maintain regular connection with the borrowers in order to have clear cut information about business activities, the problems and constraints faced by the business and the future action plan to be undertaken.

b) The bank should obtain periodical affidavits from the borrowers declaring their assets, liabilities and operating performance.

c) The bank should exchange information periodically with the other financing banks and financial institutions in order to have the alarm signals at the earliest.

d) The step is to be taken to establish a credit information bureau to provide updated information about the existing or new borrowers before taking a credit decision.

e) Another recommendation of the committee was that the arithmetical rigidities in the form of maximum permissible bank finance computation, as suggested by Tandon Committee and which is reinforced by Chore committee should be waived. Each and every bank is to be given freedom to develop an own system of working capital finance for fastening delivery of credit in order to provide effective service to the borrowers in Indian economy.
On the basis of the recommendations of the Kannan Committee, the Reserve Bank of India issued a circular containing the following guidelines –

The assessment of working capital needs based on the concept of maximum permissible bank finance as suggested by Tandon Committee has been now withdrawn. Accordingly, the banks are given the freedom to evolve a system to assess the working capital needs of the borrowers within the prudential guidelines and exposure norms already prescribed.

For the small borrowers, the present turnover method may be continued to be used for the assessment of their credit needs for working capital. But for the large borrowers, the Bank may adopt the cash budget system for the assessment of their working capital needs. But the individual banks may also be allowed to continue the concept of maximum permissible bank finance with necessary modifications.

The Reserve Bank of India further instructed that the needs for working capital of the borrowers should subsequently be determined by the banks according to the prescription of the borrowers. Therefore, the banks should develop the transparent policy and guidelines for the disbursement of credit in respect of each broad category of economic activity.

3.6 Working capital leverage

Working capital leverage highlights the variation in the rate of return on investment due to the change in the level of current assets/working capital. This fact was first developed by Walker. According to him, “if the amount of working capital varies in relation to fixed capital, the amount of risk that a firm assumes is also varied and the opportunity for gain or loss increases”. This can also be termed as the impact of working capital management on the return of capital employed. Symbolically, it is written as –
Percentage change in return on investment (ROI)
Working capital leverage =  

Percentage change in current assets.

This formula can also be represented as under:

\[
W.C.L. = \frac{\text{Level of current assets / working capital}}{\text{Total assets or capital employed} \pm \text{Actual decrease in current assets / working capital}}
\]

OR

\[
W.C.L. = \frac{\text{Level of current assets / working capital}}{\text{Total assets or capital employed} \pm \text{actual increase in current assets / working capital}}
\]

The working capital leverage is always positive i.e., \(W.C.L. > 0\) and indicates the inverse relationship between the return on capital employed and the level of changes in working capital, provided that the total return remains constant irrespective of any change in the level of current assets / working capital. The working capital leverage may be greater than or less than or equal to one.

\(W.C.L. > 1\) indicates the increase in return on capital in a high percentage than the given percentage decline in current assets / working capital.

\(W.C.L. < 1\) implies the low proportional increase in returns on capital employed for a given percentage decline in current assets / working capital.

\(W.C.L. = 1\) states the equiproportional increase in return on capital employed for a given percentage decline in current assets / working capital.

Therefore, the decrease in current assets / working capital at any quantum without affecting the total profit of the firm indicates the efficiency of the management because it is beneficial to the firm to increase the return on investment to some extent. The working capital leverage enables the firm to get an idea about the same.