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WORKING CAPITAL MANAGEMENT: CONCEPT, IMPORTANCE AND OBJECTS
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WORKING CAPITAL MANAGEMENT: CONCEPT, IMPORTANCE AND OBJECTS

1.1 INTRODUCTION

The present research seeks to study in depth the Working Capital Management of selected paper companies in India, with special emphasis on an examination of the management performance in regard to financial management. It hardly needs mentioning that inventory, accounts receivables and cash and its alert administration can go a long way in solving the problem of the efficient working capital management. In fact, the present research of working capital management needs special attention for the efficient working and the business. It has been often observed that the shortage of working capital leads to the failure of a business. The proper management of working capital may bring about the success of a business firm. The management of working capital includes the management of current assets and current liabilities. The present research undertakes to deal with the net concept of working capital: excess of current assets over current liabilities.

A number of companies for the past few years have been finding it difficult to solve the increasing problems of adopting seriously the management of working capital. Business concerns intent on developing their business have to use to the utmost, their available resources for the improvement and development of the business there by enabling them to increase their profits. Working Capital and change in working capital, especially in inventories, which is one of the components of working capital form a very important part of the total gross-capital formation in the paper companies. Efficient and the optimal utilization of fixed assets is very closely related to the proper management of working capital. The present research attempts to recognize initially the importance of working capital as a part of the total capital. It further goals to recognize the factors influencing the working capital, its volume, and in the process try to suggest remedial measures which might help in optimizing the use of working capital. It also considers as to how precisely “financing working capital” and further more what should be mix of different components of working capital.
Some important questions to which the research attempts to seek answer as follows:

1. Whether paper companies have planted their working capital requirement properly.
2. Have the paper companies utilized the investment in current assets?
3. Have the paper companies controlled and utilized cash resources effectively and profitably?
4. Whether paper companies resort to high build up of inventory.
5. How far have the paper companies been successful in collecting their cash resources efficiently and profitably?

Working Capital is the life blood of every business concern. Business firm cannot make progress without adequate working capital. Inadequate working capital means shortage of inputs, whereas excess of it leads to extra cost. So the quantum of working capital in every business firm should be neither more nor less than what is actually required. The management has to see that funds invested as working capital in their organization earn return at least as much as they would have earned return if it invested anywhere else. At the time of increasing capital costs and scare funds, the area of working capital management assumes added importance as it deeply influences a firm's liquidity and profitability. A notable feature of utilization of funds is that they are of recurring nature. Therefore, efficient working capital management requires a proper balance between generation and utilization of these funds without which either shortage of funds will cause obstruction in the smoother functioning of the organization or excess funds will prevent the firm from conducting its business efficiently. So the main objective of working capital management is to arrange the needed funds on the right time from the right source and for the right period, so that a tradeoff between liquidity and profitability may be achieved.

A firm may exist without making profits but cannot survive without liquidity. The function of working capital management organization is similar that of heart in a human body. Also it is an important function of financial management. The financial manager must determine the satisfactory level of working capital funds and also the optimum mix of current assets and current liabilities. He must ensure that the appropriate sources of funds are used to finance working capital and should also see that short term obligation of the business are met well in time.
1.2 DEFINITIONS OF WORKING CAPITAL

Definitions of Working Capital, as per various management experts are as under:

“Working Capital is the excess of C.A. over current liabilities.”
- H.G, Guthmann

“Working Capital is descriptive of that capital which is not fixed. But the more common use of the Working Capital is to consider it as the difference between the book value of the C.A. and current liabilities.”
- Hoglen. J. Bierman, and A. K. Mc Adams

“Working Capital represents the excess of C.A. over current liabilities”
- J.L. Brown and L.R. Housard

“Working Capital to a firm’s investment in short term assets cash short term securities, accounts, receivables and inventories.”
- Weston the Brigham

“Working Capital represents only the current capital assets.”
- Meal Baker Malott and Field.

“Working Capital means a sum of C.A”
- J.S. Mill.

“A Working Capital deficit exits if current liabilities exceed C.A.”
- Prof. C.W. Gerstoberg

“Working Capital equals the aggregate value of C.A. minus aggregate value of current liabilities”
- Lincoln.

“Gross Working Capital may be used to refer to total C.A. and net working capital refers to the surplus of C.A. over current liabilities”
- Prof. S.C. Kuchhal

1.3 CONCEPT OF WORKING CAPITAL MANAGEMENT

There are two concepts of working capital viz. quantitative and qualitative. Some people also define the two concepts as gross concept and net concept.
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According to quantitative concept, the amount of working capital refers to ‘total of current assets’. What we call current assets? Smith called, ‘circulating capital’. Current assets are considered to be gross working capital in this concept.

The qualitative concept gives an idea regarding source of financing capital. According to qualitative concept the amount of working capital refers to “excess of current assets over current liabilities.” L.J. Guthmann defined working capital as “the portion of a firm’s current assets which are financed from long–term funds.”

The excess of current assets over current liabilities is termed as ‘Net working capital’. In this concept “Net working capital” represents the amount of current assets which would remain if all current liabilities were paid. Both the concepts of working capital have their own points of importance. “If the objectives is to measure the size and extent to which current assets are being used, ‘Gross concept’ is useful; whereas in evaluating the liquidity position of an undertaking ‘Net concept’ becomes pertinent and preferable. It is necessary to understand the meaning of current assets and current liabilities for learning the meaning of working capital, which is explained below.

Current assets – It is rightly observed that “Current assets have a short life span. These type of assets are engaged in current operation of a business and normally used for short– term operations of the firm during an accounting period i.e. within twelve months. The two important characteristics of such assets are, (i) short life span, and (ii) swift transformation into other form of assets. Cash balance may be held idle for a week or two; account receivable may have a life span of 30 to 60 days, and inventories may be held for 30 to 100 days.” Fitzgerald defined current assets as, “cash and other assets which are expected to be converted in to cash in the ordinary course of business within one year or within such longer period as constitutes the normal operating cycle of a business.”

Current liabilities – The firm creates a Current Liability towards creditors (sellers) from whom it has purchased raw materials on credit. This liability is also known as accounts payable and shown in the balance sheet till the payment has been made to the creditors. The claims or obligations which are normally expected to mature for payment within an accounting cycle are known as current liabilities. These can be defined as “those liabilities where liquidation is reasonably expected to require
the use of existing resources properly classifiable as current assets, or the creation of other current assets, or the creation of other current liabilities.”

1.4 CIRCULATION SYSTEM OF WORKING CAPITAL

Working capital is also known as ‘circulating capital or current capital’ Kulkarni has remarked that, “The use of the term circulating capital instead of working capital indicates that its flow is circular in nature”.

![Figure – 1.1 Circulation System of Working Capital](image_url)

The funds in a business are obtained from the issue of share, the issue of debentures, and other long-term arrangement and from operations of business. A huge part of generated funds is used to acquire fixed assets, viz, plant and machinery, land building and some other fixed assets, while the remaining part of the generated funds is used for day to day operations of the business e.g. to pay wages and overheads expenses for the raw materials processed. This makes possible the stocking of
finished goods by whose sales either accounts receivables are created or cash is received. In this process profits are generated. A part of the profit is used to pay tax, interest and dividends, while the remaining part is ploughed back in the business. The circulation system of working capital may be depicted as shown in figure 1.1 as Above page page. The cycle goes constantly throughout the life of business.

1.5 TYPES OF WORKING CAPITAL

Following diagram clear the classification of working capital. According to the needs of business, the working capital may be classified into following two basis:

1) On the basis of periodicity
2) On the basis of concept

1.5.1 On the basis of periodicity:

The requirements of working capital are continuous. More working capital is required in a particular season or the peak period of business activity. On the basis of periodicity working capital can be divided under two categories as under:

Figure -1.2 Types of Working Capital

1) Permanent working capital
2) Variable working capital
3) Gross working capital
4) Net working capital
a) Permanent working capital

b) Variable working capital

(a) Permanent working capital:

This type of working capital is known as **Fixed Working Capital**. Permanent working capital means the part of working capital which is permanently locked up in the current assets to carry out the business smoothly. The minimum amount of current assets which is required to conduct the business smoothly during the year is called permanent working capital. For example, investments required to maintain the minimum stock of raw materials or to cash balance. The amount of permanent working capital depends upon the size and growth of company. Fixed working capital can further be divided into two categories as under:

(I) **Regular Working capital:**

Minimum amount of working capital required to keep the primary circulation. Some amount of cash is necessary for the payment of wages, salaries etc.

(II) **Reserve Margin Working capital:**

Additional working capital may also be required for contingencies that may arise any time. The reserve working capital is the excess of capital over the needs of the regular working capital is kept aside as reserve for contingencies, such as strike, business depression etc.

(b) Variable or Temporary Working Capital:

The term variable working capital refers that the level of working capital is temporary and fluctuating. Variable working capital may change from one assets to another and changes with the increase or decrease in the volume of business.

The variable working capital may also be subdivided into following two sub-groups.

1. **Seasonal Variable Working capital:**

Seasonal working capital is the additional amount which is required during the active business seasons of the year. Raw materials like raw-cotton or jute or sugarcane are purchased in particular season. The industry has to borrow funds for short period.
It is particularly suited to a business of a seasonal nature. In short, seasonal working capital is required to meet the seasonal liquidity of the business.

2. **Special variable working capital:**

Additional working capital may also be needed to provide additional current assets to meet the unexpected events or special operations such as extensive marketing campaigns or carrying of special job etc.

**Difference Between Permenent and Variable Working Capital:**

The distinction between permenent or fixed working capital and variable working capital or temporary working capital is of great importance in operating cycle and raising the funds. However, there is always a minimum level of current assets which is continuously required by the firm to carry on its business operations. This minimum level of current assets is referred to as permenent or fixed working capital and is permanent in the same way as the firm’s fixed asset.

![Figure 1.3 Permenent and Temporary Working Capital](image)

Figuer – 1.3 Permenent and Temporary Working Capital

Depending on the change in production and sales, the need of working capital, over and above the permanent working capital, will fluctuate.

For example, extra inventory of finished goods will have to be maintained to support the peak periods of sale and investment in receivables may also increase during the period. Both the kinds of working capital—permanent and temporary—are necessary to facilitate production and sale through the operating cycle, but temporary working capital is created by the firm to meet liquidity requirements that will last only
temporarily. In above figure shows the difference between permanent and temporary working capital.

It is shown in below figure that permanent working capital is stable over time, while temporary working capital is fluctuating—some times increasing and sometimes decreasing. However, the permanent working capital line need not be horizontal if the firm’s requirement for permanent capital is increasing or decreasing over period. For a growing firm, the difference between permanent and temporary working capital can be depicted the figure-1.4 as under.

![Figure 1.4 – Permanent and Temporary Working Capital Can be Depicted](image)

2) On the basis of concept:

on the basis of concept working capital is divided into two categories as under:

(A) Gross Working Capital:

Gross working capital refers to total investment in current assets. The current assets employed in business give the idea about the utilization of working capital and idea about the economic position of the company. Thus, gross working capital the amount of funds invested in different current assets. Gross working capital concepts is popular and acceptable concept in the field of finance.
(B) Net Working Capital:

Net working capital means current assets minus current liabilities. The difference between current assets and current liabilities is called the net working capital. If the net working capital is positive business is able to meet its current liabilities. Net working capital concept provides the measurement for determining the creditworthiness of company.

1.6 FACTORS DETERMINING OF WORKING CAPITAL

Papers, with their fixed investment, appear to have the lowest requirement for current assets. This does not mean that the problem of working capital may be minimized in this field of enterprise, since ready funds are still essential to cover disbursement for wages, interest on funds debt, purchase of materials and supplies, etc. indeed, under such conditions the working capital position may become even more strategic in character because of its relation to, and control of the large amount of fixed assets. Thus, one of the outstanding problems of paper management in recent years has been the maintenance of current position sufficiently strong to permit vigorous operations. Public utilities, like the paper, have a fixed investment which causes the current assets to constitute only a relatively small percentage of the total assets. There is a difference between operating and holding companies, but even then the funds required to cover current transactions are minor as compared with those necessary to finance the long term structure.

Industrial companies, generally, require a large amount of working capital although it various from business to business of lack of uniformity characterizing each field of enterprise. However, the underlying determinants of the amounts of fixed capital are required for operation; working assets may be expected to occupy a smaller niche in the assets structure. For similar reasons, a rapid turnover of capital will inevitably mean a large proportion of current assets. In the case of industries with fixed investment, one of the primary uses of working capital is its conversion into operating plant structure. In turn, it is expected that the income resized form operations will normally replace such defections. This means that the flow of a portion of working capital is circulating through fixed investment that its recovery is dependent upon the income realized. Where the current assets are relatively more
important, a rapid sales turnover is usually found. Often, as a case of retail concerns, the specific working assets constitute the object of sale and recovery is direct and immediate. In manufacturing enterprises, a large share of working capital management is more likely to become charged in form by conversion into finished products, but even here, the potentiality of recovery is not delayed as long as in the case of public utilities and paper companies. The need for working capital varies with changes in the volume of business. A considerable proportion of current assets is needed permanently as fixed assets. More than one production cycle may be in process at one and the same time, for business operations on a continuing basis. Materials are purchase and work is in progress. Finished inventory is sold. At the same time new receivables accumulate and old ones are converted into cash. Cash is utilized in the production process.

The following factor determine the amount of working capital

1. **Nature of Companies:**
   The composition of an asset is a function of the size of a business and the companies to which it belongs. Small companies have smaller proportions of cash, receivables and inventory than large corporation. This difference becomes more marked in large corporations. A public utility, for example, mostly employs fixed assets in its operations, while a merchandising department depends generally on inventory and receivable. Needs for working capital are thus determined by the nature of an enterprise.

2. **Demand of Creditors:**
   Creditors are interested in the security of loans. They want their obligations to be sufficiently covered. They want the amount of security in assets which are greater than the liability.

3. **Cash Requirements:**
   Cash is one of the current assets which are essential for the successful operations of the production cycle. Cash should not adequate and properly utilized. It would be wasteful to hold excessive cash. A minimum level of cash is always required to keep the operations going. Adequate cash is also required to maintain good credit relation. Richards Osbom has pointed out that cash has
a universal liquidity and acceptability. Unlike illiquid assets, its value is clear-cut and defines.

4. **Nature and Size of Business:**

The working capital requirements of a firm are basically influenced by the nature of its business. Trading and financial firms have a very less investment in fixed assets, but require a large sum of money to be invested in working capital. Retail stores, for example, must carry large stocks of a variety of goods to satisfy the varied and continues demand of their customers. Some manufacturing business, such as tobacco manufacturing and construction firms also have to invest substantially in working capital and a nominal amount in the fixed assets. In contrast, public utilities have a very limited need for working capital and have to invest abundantly in fixed assets. Their working capital requirements and nominal because they have cash sales only and supply services, not product. Thus, no funds will be tied up in debtors and inventories. The working capital needs of most of the manufacturing concerns fall between the two extreme requirements of trading firms and public utilities. Such concerns have to make adequate investment in current assets depending upon the total assets structure and other variables. The size of business also has an important impact on its working capital needs. Size may me measured in terms of the scale of operation. A firm with larger scale of operation will need more working capital than a small firm.

5. **Time:**

The level of working capital depends upon the time required to manufacturing goods. If the time is longer, the size of working capital is great. Moreover, the amount of working capital depends upon inventory turnover and the unit cost of the goods that are sold. The greater this cost, the bigger is the amount of working capital.

6. **Volume of Sales:**

This is the most important factor affecting the size and components of working capital. A firm maintains current assets because they are needed to support the operational activities which result in sales. They volume of sales and the size of the working capital are directly related to each other. As the volume of sales
increase in the investment of working capital-in the cost of operations, in inventories and receivables.

7. Terms of Purchases and Sales:

If the credit terms of purchases are more favorable and those of sales liberal, less cash will be invested in inventory. With more favorable credit terms, working capital requirements can be reduced. A firm gets more time for payment to creditors or suppliers. A firm which enjoys greater credit with banks needs less working capital.

8. Inventory Turnover:

If the inventory turnover is high, the working capital requirements will be low. With better inventory control, a firm is able to reduce its working capital requirements. While attempting this, it should determine the minimum level of stock which it will have to maintain throughout the period of its operations.

9. Receivable Turnover:

It is necessary to have an effective control of receivables. A prompt collection of receivables and good facilities for setting payable results into low working capital requirements.

10. Business Cycle:

Business expands during periods of prosperity and declines during the period of depression. Consequently, more working capital required during periods of prosperity and less during the periods of depression. During marked upswings of activity, there is usually a need for larger amounts of capital to cover the leg between collection and increased sales and to finance purchases of additional materials to support growing business activity. Moreover, during the recovery and prosperity phase of the business cycle, prices of raw materials and wages tend to rise and require additional funds to carry even the same physical volume of business. In the downswing of the cycle, there may be a brief period when collection difficulties and declining sales together cause embarrassment by the resulting failure to replenish cash. Later, as the depression runs its course, the concern may find that it has a larger amount of working capital on hand than current business volume may justify.

11. Value of Current Assets:
Decreases in the real value of current assets as compared to their book value reduced the size of the working capital. If the real value of current assets increases, there is an increase in working capital.

12. Variations in Sales:
A seasonal business requires the maximum amount of working capital for a relatively short period of time.

13. Production Cycle:
The time taken to convert raw materials into finished products is referred to as the production cycle or operating cycle. The longer the production cycle, the greater is the requirements of the working capital. An utmost care should be taken to shorten the period of the production cycle in order to minimize working capital requirements.

14. Credit Control:
Credit control includes such factors as the volume of credit sales, the terms of credit sales, the collection policy, etc. With a sound credit control policy, it is possible for a firm to improve in cash inflow.

15. Liquidity and Profitability:
If a firm desires to take a greater risk for bigger gains or losses, it reduces the size of its working capital in relation to its sales. If it is interested in improving its liquidity, it increase the level of its working capital. However, this policy is likely to result in a reduction of the sales volume, and therefore, of profitability. A firm, therefore, should choose between liquidity and profitability and decide about its working capital requirements accordingly.

16. Inflation:
As a result of inflation, size of the working capital is increased in order to make it easier for a firm to achieve a better cash inflow. To some extent, this factor may be compensated by the rise in selling price during inflation.

17. Seasonal Fluctuations:
Seasonal fluctuations in sales affect the level of variable working capital. Often, the demand for products may be of a seasonal nature. Yet inventories have got to be purchased during certain seasons only. The size of the working capital in one period may, therefore, be bigger than that in another.
18. Profit Planning and Control:

The level of working capital is decided by the management in accordance with its policy of profit planning and control. Adequate profit assists in the generation of cash. It makes it possible for the management to plough back a part of its earnings in the business and substantially build up internal financial resources. A firm has to plan for taxation payments, which are an important part of working capital management. Often the dividend policy of a corporation may depend upon the amount of cash available to it.

19. Repayment Ability:

A firm’s repayment ability determines level of its working capital. The usual practices of a firm are to prepare cash flow projections according to its plans of repayment and to fix working capital levels accordingly.

20. Cash Reserves:

It would be necessary for a firm to maintain some cash reserve to enable it to meet contingent disbursements. This would provide a buffer against abrupt shortages in cash flows.

21. Operational and Financial Efficiency:

Working capital turnover is improved with a better operational and financial efficiency of a firm. With a greater working capital turnover, it may be able to reduce its working capital requirements.

22. Change in Technology:

Technological developments related to the production process have a sharp impact on the need for working capital.

23. Firm's Policies:

These affect the level of permanent and variable working capital. Changing in credit policy, production policy, etc are bound to affect the size of working capital.

24. Activities of the Firms:

A firm’s stocking on heavy inventory or selling on easy credit terms calls for a higher level of working capital for it than for selling services or making Cash sales.

25. Attitude of Risk:
The greater the amount of working capital, the lower is the risk of liquidity.

`Whenever there is current strain, it has to be immediately diagnosed on the basis of the red signals which manifest themselves in the operations. The restrictions expressed as ratios of the elements of current assets and current liabilities are frequently referred to as current position constraints and include the current ratio, the acid test ratio, and the so-called “compensating balance” ratio. Contracts with fund suppliers frequently provide for current-position constraints.

If stock not moving fast, and if there is an excess inventory buildup corrective steps should be taken to sell the stock or bring down its level.

If the receivable have become sticky, effective recovery steps should be taken to reduce the debts and to increase the collections. If the strain is allowed to continue because of involvement in any other business or industry, the consequences may be disastrous. In such situation, the ability to meet current demands deteriorates; short term credits are not forthcoming; production is affected; sales decline; cash flow decline; income may disappear; and the whole enterprise may get into the red over a period of time. All the above points are the factors determining working capital management in all the companies. Some factors are controlled and some factor are not controlled by the management.

### 1.7 OPERATING CYCLE

The figure – 1.5 shows as under.

![Operating Cycle of Manufacturing Cycle](image)

**Figure- 1.5** Operating Cycle of Manufacturing Cycle:
The duration of time required to complete the sequence of events right from purchase of raw material / goods for cash to the realization of sales in cash is called the operating cycle, working capital cycle or cash cycle.

This cycle can be said to be at the heart of the need for working capital. In the words of O.M. Joy: “The operating cycle refers to the length of time necessary to complete the following cycle of events.”

The above operating cycle in figure relates to a manufacturing firm where cash is needed to purchase raw materials and convert raw materials into work-in-process is converted into finished goods. Finished goods will be sold for cash or credit and ultimately debtors will be realized.

Figuer 1.6 Operating Cycle of Non-Manufacturing Firm

The non-manufacturing firms, such as whole sellers and retailers, will not have the manufacturing phase; they will have rather direct conversion of cash into finished stock, into accounts receivables and then into cash. The operating cycle of a non manufacturing firm is shown as under.

The non-manufacturing firms, such as whole sellers and retailers, will not have the manufacturing phase; they will have rather direct conversion of cash into finished stock, into accounts receivables and then into cash. The operating cycle of a non manufacturing firm is shown as under.
In addition to this, some service and financial concerns may not have any inventory at all. Such firms have the shortest operating cycle as shown in figure-1.7 as next page.

![Operating Cycle of Service and Financial Firms](image)

**Figure-1.7 Operating Cycle of Service and Financial Firms**

### 1.8 WORKING CAPITAL TERM LOAN (WCTL):  

A working capital term loan (WCTL) should possess specific characteristics as laid down below:

- Working capital term loan is a shortage “long-term surplus” or net working capital (NWC) in a unit that a bank chooses to fund.
- It is a long-term need of the unit that is met by the bank though its short-term portfolio.
- Working capital term loan may be either clean or secured depending upon the margin stipulated or the amount of working capital term loan in relation to the chargeable current assets.
- It must be repaid in a prescribed maximum number of installments.
- It is not sanctioned as such but segregated out of existing outstanding, when outstanding exceed the unit’s eligibility.
- It is a sort of ‘once-in-a-life-time’ loan. It is a post-facto corrective measure, it should not be repeated normally.
It should be repayable from long-term sources. If the repayment is from short-term sources, the permissible bank finance will fall correspondingly and working capital term loan will rise there by neutralizing the process of repayment.

Moreover, both physical and financial follow up can be used to complement each other, if the concept of the ‘margin’ is refined and integrated into the maximum permissible bank finance (MPBF)

\[
\text{MPBF} = \text{NWC} + \text{OSCL} - \text{NCCA/CCA Margin}
\]

Where NWC is net working capital, OSCL means other current liabilities less creditors for purchases. NCCA are non-chargeable current assets on which no drawls are permitted. CCA means chargeable current assets on which margin are proposed to be stipulated. The application of margin would be coupled with the deduction of the value of creditors for purchases from the advance value to arrive at the drawing power. Once a margin is stipulated, it can be utilized as the operating thumb rule for monitoring the borrower’s stake in the stocks charged to the bank as well as a rough and ready method for keeping the drawings power within the MPBF limits.

1.9 ADEQUACY OF WORKING CAPITAL

N.K. Kulshrestha has observed that, “the need for maintaining an adequate working capital can hardly be questioned. Just a circulation of blood is very necessary in the human body to maintain life, smooth flow of funds is very necessary to maintain the heath of the firm”. Adequate working capital becomes necessary because of the following reasons:

- It protects a business from the adverse effects of shrinkage in the values of current assets.
- It is possible to pay all the current obligations promptly and to take advantages of cash discounts.
- It ensures to a greater extent the maintenance of a company’s credit standing and provides for such emergencies as strikes, floods, fibers, etc.
- It permits the carrying of inventories at a level that would enable a business to serve satisfactory the needs of its customers.
- It enables a company to extend favorable credit terms to customer.
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 It enable a company to operate its business more efficiently because there is no delay in obtaining materials, etc., because of credit difficulties.
 It enables a business to withstand periods of depression smoothly.
 There may be operating losses or decreased retained earnings.
 There may be excessive non-operating or extraordinary losses.
 The management may fail to obtain funds from other sources for the purposes of expansion.
 There may be an unwise divided policy.
 Current funds may be invested in non-current assets.
 The management may fail to accumulate funds necessary for meeting debentures on maturity.
 There may be increasing price necessitating bigger investments in inventories and fixed assets.

1.10 EXCESS OF INADEQUACY OF WORKING CAPITAL

The firm should maintain a sound working capital position. It should have adequate working capital to run its business operations. Both excessive as well as inadequate working capital positions are dangerous form the firm’s point of view. Excessive working capital means idle funds which earn no profit for the firm. Paucity of working capital not only impairs firm’s profitability but also results in production interruption and inefficiencies.

When the company is inadequate, a company faces the following problem:
 It is not possible for it to utilize production facilities fully for want of working capital.
 A company may not be able to take advantages of cash discount facilities.
 The credit-worthiness of the company is likely to be jeopardized because of lack of liquidity.
 A company may not be able to take advantages of profitability business opportunities.
 The modernization of equipment and even routine repairs and maintenance facilities may be difficult to administer.
A company will not be able to pay its dividends because of the non-availability of funds.

A company cannot afford to increase its cash sales and may have to restrict its activities to credit sales only.

A company may have to borrow funds at exorbitant rates of interest.

Its low liquidity may lead to low profitability in the same way as low profitability results in low liquidity.

Low liquidity would positively thirteen the solvency of the business. A company is considered illiquid when it is not able to pay its debts on maturity. It must be wound up under section 433 of the companies Act, 1956, upon its inability to pay its debts.

An enlightened management should therefore, maintain an adequate amount of working capital on a continuous basis. Sound financial and statistical techniques by judgments should be used to predict the quantum of working capital.

**Commercial Bank (Bank Credit):**

The major part of working capital is provided by commercial bank to their customer. Commercial banks play an important role in providing capital to its customers. Commercial banks are an important source of working capital in India. The rate of interest charge by the Reserve Bank of India, from time to time. Here it is to be noted that the terms of leading of the banks are very strict. Followings SIX CS are considered by the bank before sanctioning cedit.

1. Capital 2. Capacity
3. Character 4. Collateral
5. Condition 6. Coverage

Banks provided working capital in the form of cash credit, overdraft, discounting bills of exchanges etc. banks take into account the several factors of the borrowing concern before fixing credit limit. Bank credit to commercial sector was Rs. 21, 23,363 crores at the end of March 2007. There were 36,927 officers of nationalized banks at the end of March 2007.

**1.11 OPTIMUM LEVEL OF CURRENT ASSETS**
The financial manager should determine the optimum level of current assets so that the wealth of shareholders be maximized. In fact, optimum level for each type of current assets should be fixed. The question of optimum investment in each type of current assets is discussed. Here we simply discuss the basic concept involved in determining the level of current assets.

**Current Assets and Fixed Asset:**

A firm needs fixed and current assets to support a particular level of output. However, to support the same level of output, the firm can have difference levels of current asset. As the firm’s output and sales increase, the need for current assets increase in direct proportion to output; current assets increase at a decreasing rate with output. This relationship is based upon the notion that it takes a greater proportional investment in current assets when only a few units of output are produced than it does later on when the firm can used its current assets more efficiently.

![Alternative Current Assets Polices](figure.png)

**Figure – 1.8   Alternative Current Assets Polices**

The help of the above graph the most conservative policy is alternative A, where CA/FA ratio is greatest at every level of output. Alternative C is the most aggressive policy, as CA/FA ratio is lowest at all levels of output. Alternative B lies between the conservative and aggressive polices and is an average policy.

Other things assuming constant, a conservative policy implies greater liquidity and lower risk and poor liquidity. The current assets policy of the most firms may fall between these two extreme policies.
The level of current assets can be measured by relating current assets to fixed assets. Dividing current assets by fixed assets gives the CA/FA ratio. Assuming a constant level of fixed assets, a higher CA/FA ratio indicates a conservative current assets policy, and a lower CA/FA ratio means an aggressive current assets policy.

1.12 LIQUIDITY VERSUS PROFITABILITY: RISK-RETURN TANGLE

The firm would make just enough investment in current assets, if it were possible to estimate working capital needs exactly. Under perfect certainty, the current assets holdings would be at the minimum level. A ledger investment in current assets under certainty would mean a low rate or return investment for the firm, as excess investment in current assets will not earn enough return. A smaller investment in current assets, on the other hand, would mean interrupted production and sales, because of frequent stock-outs and inability to creditor in time to restrictive credit policy.

As it is not possible to estimate working needs accurately, the firm must decide about the levels of current assets to be carried. The current assets holdings of the firm will depend upon its working capital policy. It may follow a conservative or an aggressive policy. These polices have different risk-return implications. A conservative policy means lower return and risk, while an aggressive policy produces higher return and risk.

The two important aims of the working capital management are: profitability and solvency. Solvency, used in the technical sense, refers to the firm’s continuous ability to meet maturing obligations. Lenders and creditors expected prompt settlement of their claims as and when due. To ensure solvency, the firm maintains a relatively large investment in current assets holdings. If the firm maintains a relatively large investment in current assets, it will have no difficulty in paying the claims of the creditors when they become due and will be able to fill all sales orders and ensure smooth production. Thus, a liquid firm has less risk of insolvency; that is, it will hardly experiences a cash shortage or stock-outs. However, there is accost associated with maintaining a sound liquidity position. A considerable amount of the firm’s
funds will be tied up in current assets. And to the extent this investment is idle, the firm’s profitability will suffer.

<table>
<thead>
<tr>
<th>Details</th>
<th>Company A</th>
<th>Company B</th>
<th>Company C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales Units</td>
<td>200000</td>
<td>200000</td>
<td>200000</td>
</tr>
<tr>
<td>Rupees</td>
<td>3000000</td>
<td>3000000</td>
<td>3000000</td>
</tr>
<tr>
<td>Earnings before interest and taxes</td>
<td>300000</td>
<td>300000</td>
<td>300000</td>
</tr>
<tr>
<td>Current assets</td>
<td>1000000</td>
<td>800000</td>
<td>600000</td>
</tr>
<tr>
<td>Fixed assets</td>
<td>1000000</td>
<td>100000</td>
<td>1000000</td>
</tr>
<tr>
<td>Total assets</td>
<td>2000000</td>
<td>1800000</td>
<td>1600000</td>
</tr>
<tr>
<td>Return on total assets (EBIT/Total assets)</td>
<td>15%</td>
<td>16.67%</td>
<td>18.75%</td>
</tr>
<tr>
<td>Current assets/Fixed assets</td>
<td>1.00</td>
<td>0.80</td>
<td>0.60</td>
</tr>
</tbody>
</table>

To have high profitability, the firm may sacrifice solvency and maintain a relatively low level of current assets. When the firm does so, its profitability will improve as less funds are tied up in idle current assets, but its solvency would be threatened and would be exposed to greater risk of cash shortage and stock-outs. The profitability-solvency tangle of the working capital management may further be illustrated with the help of an example. Suppose, a firm has the following data for future year: Sales (200000 Units) - 3000000, Earnings before interest and taxes - 240000, Fixed assets - 1000000. The three possible current assets holdings of the firm are: Rs. 1000000, Rs. 800000, and Rs. 600000. It is assumed that fixed assets level is constant and profit do not vary with current assets levels. The effect of the three alternative current assets policies is shown as above page 28:

The calculation in table indicate that alternative A, the most conservative policy, provides greatest liquidity to the firm, but also the lowest return on total...
assets. On the other hand, alternative C, the most aggressive policy, yields highest
return but provides lowest liquidity and thus, is very risky to the firm. Alternative B
demonstrates a moderate policy and generates a return higher than alternative A but
lower than alternative C and is less risky than alternative C but more risky than
alternative A. this is a simple example of risk-return trade off. In practice, things are
more difficult. Risk and returns are affected differently by different assets and,
therefore, generalization is not easy to make. The problem of the level of each type of
current asset is discussed in subsequent chapters.

The Cost Trade-off:

A different way of looking into the risk-return trade of is in terms of the cost
of maintaining a particular level of current assets. There are two different kinds of
costs involved. First there is the cost of liquidity. If the firm carries too much
liquidity, the firm’s rate of return will be low. Funds tied up in idle cash and excess
inventory earn nothing, and receivables levels that are too large also reduce the firm’s
profitability. Thus, the cost of liquidity increases with the level of current assets.

There is the cost of liquidity, which is the cost of having too little invested in
current assets. If the firm carries too little cash, it may not be able to pay bills
promptly at they mature. This may force the firm to borrows at high rates of interest.
This will also adversely affect the credit-worthiness of the firm and it will face
difficulties in obtaining funds in future. This all may force the firm into insolvency.

If the firm’s inventory level too low, sales may be lost and customers may
shift to competitors. Also, low level of book debts may be due to tight credit policy,

which would impair sales further. Thus, the low level of current assets
involves cost which increases as this level falls.

If selecting an optimal level of current assets, the firm should balance the
profitability solvency tangle by minimizing the total cost of liquidity and cost of
illiquidity.

In the above all points are discussed by the researcher on the view point of
management of current assets in paper companies.
1.13 FIXED CAPITAL VERSUS WORKING CAPITAL

The maximization of the rate of return on capital employed is the ultimate goal of every company. The issue of fixed capital versus working capital could be examined appropriately only in the light of the role played by them in the attainment of this objective. In the maximization of the rate return, the fixed and working capital play functional, complementary and proportional and technical roles. As regards the functional role, it may be fairly well placed that fixed capital represents the products component of the business, it is utilized with or act upon the current or circulating capital to produce revenue or income for the enterprise; this it self is not expected to be held or produce revenue or income for enterprise. The expenditure of this class of capital is expected to be recovered only over a period of years through depreciation charge which are an element of cost. On the other hand, investment in working capital are relatively temporary in nature since the invested values are capable of being recovered within a short period of time depending upon the manufacturing as well as the collection cycles. In other words, it is the working capital, which after its transmutation into saleable product actually generated revenue for business.
Moreover, a low profit ratio could be geared to a high one by quickening the pace of working capital cycle, which, besides providing the will-springs for newer cycle, also increased the total realizable profit of a business organization. The complementary relationship between working capital and fixed capital is readily apparent. A fully equipped industrial company without a supply of material to process or without cash to pay for workmen’s wages and other current expenses or a store without merchandise to sell, is virtually useless. Consequently the working capital position of any company may readily become the controlling factor for determining the scope and character of its operation.

The proportional relationship between fixed and working capital is very important in the maximization of the rate of return. Inadequate working capital may mean that the fixed assets purchased form permanent capital cannot be utilized effectively. Shortage of materials or labour may mean that the machine can be used for only part of the available time.

On the other hand, if efficient use is not being made of current assets and working capital. Because working capital requirements are excessive there may be no resources left for the assets. If the low state of efficiency persists, the position may become aggravated still further. Assets wear out or become very costly to operate and profits are depleted, thereby making even the maintenance of adequate working capital quite a problem.

A business unit can maximize its rate of return on the capital employed provided it keeps pace with the scientific and technological developments taking place in the field to which it pertains. It is common to suggest that as soon as some technological and scientific development takes place, a business unit, in order to accelerate its profitability, should immediately introduce the same to its productive processes. In reality, however, the sufficiency of working capital determines the course of decision in this regard.

According to Professor N.K. Sharma- “Innovation is regarded by many economists and accountants as the mainspring of profit earnings; there is no doubt that this is true for many industries. If new ideas, products, methods and techniques are not germinated and brought into existence, a company will fail to keep its place in the competition. Innovation implies among other things, research sound organization
and the willingness to undertake risks. Without adequate cash there can be no progress. Research and development would be at a standstill and the essential innovation would fail to appear.”

A comparison between the fixed and working capital could be made on the basis of their investment relationship with each other.

It is found that in both the private and public sector Company’s working capital, as a proportion of working capital employed share almost equal honors with fixed capital. In the fifteen important industries of India the proportion of fixed working capital and variable working capital was the show on next page. In table form. It is evident from the table that with the exclusion of the industries had working capital is very high proportions in their capital employed.

<table>
<thead>
<tr>
<th>Sr. Number</th>
<th>Company name</th>
<th>Fixed capital (% to total capital employed)</th>
<th>Working capital (% to total capital employed)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Electricity Generation</td>
<td>75%</td>
<td>25%</td>
</tr>
<tr>
<td>2.</td>
<td>Shipping Company</td>
<td>70%</td>
<td>30%</td>
</tr>
<tr>
<td>3.</td>
<td>Aluminum Company</td>
<td>69%</td>
<td>31%</td>
</tr>
<tr>
<td>4.</td>
<td>Paper Company</td>
<td>60%</td>
<td>40%</td>
</tr>
<tr>
<td>5.</td>
<td>Iron and Steel Company</td>
<td>60%</td>
<td>40%</td>
</tr>
<tr>
<td>6.</td>
<td>Cement Company</td>
<td>55%</td>
<td>45%</td>
</tr>
<tr>
<td>7.</td>
<td>Chemicals Company</td>
<td>51%</td>
<td>49%</td>
</tr>
<tr>
<td>8.</td>
<td>Tea Company</td>
<td>50%</td>
<td>50%</td>
</tr>
<tr>
<td>9.</td>
<td>Mineral Oils Company</td>
<td>47%</td>
<td>53%</td>
</tr>
<tr>
<td>10.</td>
<td>Coal Company</td>
<td>45%</td>
<td>55%</td>
</tr>
<tr>
<td>11.</td>
<td>Cotton Textile Company</td>
<td>42%</td>
<td>58%</td>
</tr>
<tr>
<td>12.</td>
<td>Sugar Company</td>
<td>35%</td>
<td>65%</td>
</tr>
<tr>
<td>13.</td>
<td>Engineering Company</td>
<td>33%</td>
<td>67%</td>
</tr>
<tr>
<td>14.</td>
<td>Jute Company</td>
<td>32%</td>
<td>68%</td>
</tr>
<tr>
<td>15.</td>
<td>Trading Company</td>
<td>15%</td>
<td>85%</td>
</tr>
</tbody>
</table>

Proportion of fixed and working capital to the total capital employed in fifteen important companies in India as under. The electricity industry had fixed capital in
very high proportions because by its very nature this industry needs less of working capital and its business operate on what it has installed as permanent capital.

In time with the situation prevailing in the fifteen important Indian industries, the percentage of working capital to fixed capital in the total capital employed by the running companies of the Central Government is found both high and ascending during the years 2006 to 2010. The percentage of working capital to the capital employed for these companies was 36.3 in 2006. It rose to 42.2 percent in 2010. According to the Annual Survey of industries for the year 2010, the percentage of working capital to the capital employed in the case of all the registered factories on an average was 69. Thus, it is clear that the size of working capital in industrial companies tends to predominate the total capital employed by them. This sufficiently indicates that the prime object of making a profit in industrial companies must depend on the manner in which they administer their working capital.

1.14 FINANCING CURRENT ASSETS

The firm must find out sources of funds to finance its current assets. It can adopt difference financing policies. Three types of financing be distinguished: long term financing, short-term financing and spontaneous financing. The important sources of long term financing are shares, debenture, preference share, retained earnings and debt form financial institutions. Short-term financing refers to those sources of short term credit that the firm must arrange in advance. These sources included short-term bank loans, commercial papers and factoring receivable. The firm must find out the sources of funds to finance its current assets. In the words of O.M. Joy: “in comparing financing plans we should distinguish between three different kinds of financing: long-term financing, negotiated short-term financing and spontaneous short-term financing”. The major source of spontaneous short-term financing is trade credit and outstanding expenses. Therefore, a firm would like to finance its current assets with spontaneous source of the fullest extent. Every firm is expected to utilize spontaneous sources to the fullest extent. Thus, the real choice of financing current assets is between short-term and long term sources. The following three important approaches are applied in practice.

A. ) Matching Approach:
The firm can adopt a financial plan which involves the matching of the expected life of assets with the expected life of the source of funds raised to finance assets. Thus, a ten years loan may be raised to finance a plant with an expected life of ten years; stock to be sold thirty day may be financed with a thirty-day bank loan or so on. Thus, when the firm follows matching approach, long-term financing will be used to finance fixed assets and permanent current assets.

In Figure-1.10 shows the firm’s investment and financing patterns over time under a matching plan. As the firm’s fixed assets and permanent current asset levels increase, the long term-term financing level also increases. When temporary current assets level increase, short-term negotiated financing increase, and when the firm has no temporary current assets, it is also has no short-term negotiated financing.

B) Conservative Approach:

Conservative financing plans are those plans that use more long-term financing than is needed under a matching approach. The above figure-1.11 illustrates this approach. The firm is financing a portion of its temporary current assets requirements with long-term financing. Also, in periods when the firm has no temporary current assets, the firm has excess financing available that will be invested in marketable securities.
These plans are called conservative because they involve relatively heavy use of long-term financing.

**Figuer-1.11**

C) **Aggressive Approach:**

**Figuer- 1.12**

A firm may be aggressive in financing its assets. An aggressive policy is said to be followed by the firm when it uses more short-term financing than warranted by the matching plan. Under an aggressive policy, the firm finances a part of its permanent current assets with short-term financing.
Some extremely aggressive firms may even finance a part of their fixed assets with short-term financing. The relatively more use of short-term financing makes the firm more risky. The aggeressive financing policy is illustrated in above Figure- 1.12.

1.15 TONDON COMMITTEE RECOMMENDATIONS

The Reserve Bank of India set up in 1974 a study group to frame guide lines for follow up of bank credit under the chairmanship of P.L.Tandon. The study group reviewed the system of working capital financing and identified its major shortcoming as follows:

- The cash credit system of lending wherein the borrower can draw freely within limits sanctioned by the banker hinders sound credit planning on the part of the banker and induces financial indiscipline in the borrower.
- The security-oriented approach to lending favored borrowers with strong financial resources and also led to diversion of funds, borrowed against the security of current assets, for financing fixed assets.
- Relatively easy access to working capital finance led to large inventory levels with industry.
- Working capital finance provided by banks, theoretically supposed to be short term in nature, tended to be, in practice, a long-term source of finance. For the regulating bank credit, the study group made comprehensive recommendations which have been made by and large accepted by the Reserve Bank of India. These recommendations relate to:-

(A) Norms for inventories and receivables:

It is suggested for major industries. These norms have been based, inter alia, on company finance studies made by the Reserve Bank of India, process period in different industries, discussions with industry experts and feedback received on the interim report.

1. For raw materials (including stores and other materials used in process of manufacture):- maximum stock should not be more than by 2-3/4 times consumption of raw material in the industry in a month.

2. For stock in process (work-in-process):- should not be more than by half of the cost of production of a month.
3. For finished goods: it should not be more than by the two times of cost of goods sold off a month.

4. For receivable: it should not be more than by 1-1\(\frac{1}{4}\) times of a month sales.

The norms suggested may not be viewed as rigid or inflexible. Under certain circumstances like bunched receipt of raw materials, this may be permitted.

**(B) Quantum of permissible bank finance:**

Three methods have been suggested for determining the maximum permissible amount of bank finance:

1. 75 percent of excess of current assets over non-bank current liabilities.
2. 75 percent of current assets as reduced by non-bank current liabilities.
3. 75 percent of excess of current assets over core current assets as reduced by non-bank current liabilities.

In method 3 the core current assets means a part of current assets which should be permanent component of working capital.

The study group suggested that borrowings in excess of what is permissible under the first method should be converted into a working capital term loan repaid over a period of time. The borrowers should gradually move to the third method.

**(C) Style of lending:**

The study group suggested that overall credit limit may be bifurcated into a loan component, which would represent the minimum level of borrowing throughout the year and a demand cash credit, which would take care of the fluctuating requirements, both to be reviewed annually.

The demand cash credit should be charged a slightly higher interest rate than the loan component. This approach will give the borrower an incentive for good planning.

**(D) Information and reporting system:**

The study group suggested comprehensive information and reporting system which seeks to:

1. Induce the borrower to plan his credit need carefully and maintain a greater discipline in its use.
2. Promote free flow of information between the borrower and the banker so that latter can monitor the credit situation better.
3. Ensure that credit is used for intended purposes.

The study group suggested submitting quarterly information regarding profit or loss, current assets and current liabilities.

1.16. CHORE COMMITTEE

The Reserve Bank of India constituted in April, 1979 a six member working group under the chairmanship of K. B. Chore to review the system of cash credit and credit management policy by banks. The committee report as considered by the R.B.I. is as follows:-

1. The net surplus cash generation of established industrial unit should be utilized partly at least for reducing borrowing for working capital purpose. In assessing maximum permissible bank finance, bank should adopt the second method of lending, recommended by the Tandon study group, according to which the borrower’s contribution from owned funds and term finance to meet the working capital requirements should be equal to at least 25 percent of the total current assets. In cases where the borrowers may not be in a position to comply with this requirement immediately, the excess borrowing should be segregated and treated as working capital loan, repayable in half yearly installment (maximum five year) and rate of interest should not be less than the rate sanctioned for cash credit limit.

2. The existing system of lending (cash credit, loan and bill) should continue but wherever possible the use of cash credit should be supplemented by loans and bills. However, there should be scrutiny of the operation of the cash credit accounts at least once in a year.

3. Bifurcation of cash credit in demand loan for corporation and fluctuation cash credit component and to maintain a differential interest rate between these two components is withdrawn.

4. Banks should appraise and fix separate limits for the “normal nonpeak level” and for the “peak level” credit requirements for all borrowers in excess of Rs. Ten lakhs indicating the relevant periods.

5. Drawal of funds to be regulated through quarterly statements within the sanctioned limit, borrower should intimate his need of funds in advance.
6. Borrowers should be discouraged from frequent seeking adhoc or temporary limits in excess of sanctioned limits to meet unforeseen contingencies. Additional interest of one percent should normally be charged for such limits.

7. Advances against the book-debts should be converted to bills wherever possible and at least 50 percent of the cash credit limit utilized for financing purchase of raw material inventory should also be changed to this bill system.

According to the committee, the major plank of the cash credit system to be applied by the commercial banks is that commercial banks should assess the maximum permissible working capital limits to a borrower by adopting the seconf method of lending or Prakash Tondon Committee. Thus means that borrower’s contribution form his own funds and long-term resources for meeting working capital needs should be at least 25 percent of total current assets.

1.17 S.S. MARATHE COMMITTEE

The Reserve Bank of India appointed in November 1982 a committee under the chairmanship of Shri S.S. Marathe to review the working of the credit authorization scheme form the point of view of its operational aspects. The terms of reference of the committee were:

I. To examine the objective, scope and content of the scheme and make suggestion with regard to the changing economic situation;

II. To examine the adequacy or otherwise of the credit appraisal machinery/procedures in the commercial banks;

III. 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;

IV. To examine the existing data base for recommendations by banks to the RBI for authorizing a given level of credit for a particular period;

V. To examine the existing format for submitting applications for banks to the RBI in respect of seeking authorization and suggest modifications therein; and
VI. To study the desirability of introducing time-bound guidelines to be observed within the guidelines of the Reserve Bank for speeding up the processing and disposal of applications.

The committee submitted its report to the Reserve Bank in July, 1983. The recommendations of the committee were accepted with some modifications by the Reserve Bank. The banks have been advised to implement the following procedural changes in the administration of the credit Authorization scheme with effect from April 1, 1984 as indicated below:

1) Banks may release credit up to a maximum of 50% of the additional limits for which RBI authorization is sought wherever credit proposals satisfy certain stipulations;

2) As a measure of further incentive for predominantly export oriented units coming under the purview of CAS, RBI authorization is up to a maximum of 75% of the additional limits for which authorization is sought, subject to their satisfying the prescribed requirements;

3) All other credit proposals should be referred to the Reserve Bank of India for prior authorizations as at present;

4) In case the borrower is an urgent of funds, banks may grant facilities, as at present, on ad hoc basis over a period of three months to any of the CAS borrowers under exceptional circumstances not exceeding 25% of the existing working capital. This is subject to an overall ceiling of Rs.75 lakhs:

5) Banks need not refer to RBI for prior authorization for letters of credit facilities covering acquisition of capital as well as non capital goods, provided that the conditions prescribed are complied with before opening the letters of credit. The exemption of letters of credit facility form CAS is allowed on experimental basis:

6) The banks are advised that the discipline in use of bank credit employed in the credit authorization scheme has to be accepted as a permanent feature and that, for borrowers readily willing to between the submissions of a credit proposal and actual disposal recommendations of the Marathe Committee, substantial discretionary powers are vested in commercial banks to facilitate faster release of funds to parties covered by CAS without prior approval of
RBI provided that banks are satisfied with the proposal being fully in conformity with the norms laid down by the Reserve Bank.

**Recommendations:**

(1) Banks may release credit up to a maximum of 50% of the additional limits for which RBI authorization is sought wherever credit proposals satisfy certain stipulations. As a measure of further incentive to the predominantly export-oriented units, banks can deploy funds before receipt of RBI authorizations up to a maximum of 75% of the additional units for which the authorizations is sought;

(2) All other credit proposals would continue to be referred to RBI for prior authorizations;

(3) In case the borrow is an urgent need of funds, banks may grant facilities on an ad hoc basis for a period of 3 months to any of CAS borrowers under exceptional circumstance, not exceeding 25% of existing working capital limits. This is subject to an overall ceiling of Rs.75 lakhs as against Rs.50 lakhs earlier.

(4) Banks need not refer to RBI for prior authorization in proposal for letters of credit facilities covering acquisitions of capital as well as non-capital goods, provided the conditions prescribed are complied with before opening the letters of credit.

### 1.18 CONCLUSION

The relative liquidity of the firm’s assets structure is measured by the current assets to fixed assets ratio. The greater this ratio, the less risky as well as less profitable will be the firm and vice versa. Similarly, the relative liquidity of the firm’s financial structure can be measured by the short-term financing to total financing ratio. The lower this ratio, the less risky as well as less profitable will be the firm and vice versa. In shaping its working capital policy, the firm should keep in mind these two dimensions – relative asset liquidity and relative financing liquidity of the working capital management. A firm will be following a very conservative working policy if it combines a high level of current assets with a high level of long-term financing. Such a policy will not be risky at all and would be less profitable. An
aggressive firm, on the other hand, would combine low level of current assets with a
high level of long-term financing. This will have high profitability and high risk. In
fact, the firm may follow a conservative financing policy to counter its relatively
illiquid assets structure in practice. The conclusion of all this it that the considerations
of assets and financing mixes are crucial to the working capital management.
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