4.1 The Preliminary Remarks

Working capital management is important from the perspective of sources and uses of the funds. The working capital is described as a spontaneous source and use of funds as it arises from trading activities based on a significant number of business transactions. In many companies, the amount of funds committed to the current assets can and often exceeds that of the fixed assets. Decisions relating to the working capital and short-term financing are referred to as working capital management. These involve managing the relationship between a firm’s short-term assets and its short-term liabilities. The goal of working capital management is to ensure that the firm is able to continue its operations and that it has sufficient cash flow to satisfy both maturing short-term debt and upcoming operational expenses. A business can fail because of lack of cash than for want of profit. If the business is operating profitably, then it should generate cash surpluses. If it does not generate cash surpluses, then the business will eventually run out of cash and close down.  

Kargar and Blumenthal (1994) in their study showed that businesses can go bankrupt even when they are making profits owing to working capital mismanagement.

The investment in raw material, stock-in-progress, finished goods, and receivables (the principle constituents of current assets) often varies a great deal during the course of the year. Hence, the financial manager generally spends a good chunk of his time in finding money to finance current assets.

33 Working Capital Management: A Study of Maharashtra’s bulk drugs listed companies by Rakesh Yadav, Ms. Vani Kamath, and Dr. Pradeep Manjrekar, Chemical Business, July 2009, pg.27.


After estimating working capital requirement, the things become quite clear about the arrangement of funds in current assets. Financing of current assets is the responsibility of fiancé manager who may require to spending a good amount of time for raising finance.\(^\text{36}\)

There are two components of working capital - temporary and permanent and the firm may adopt various approaches - hedging approach, aggressive approach, aggressive approach, or conservative approach to finance the current assets. There are various sources of financing the current assets. They could be long term and short term. The long term sources may include ordinary share capital, preference share capital, debentures, and term loans. While short term sources can be bank finance, public deposits, and commercial papers. Financing can be through spontaneous finance as well.

Spontaneous or self-adjusting finance emerges during the normal course of business and as a result, is readily accessible to the firm. These include outstanding expenses or accruals, deferred income, provisions and trade credit. As long as a business remains a going concern, this financing is available more or less in proportion to the level of operation, according to the trade conditions and practice of that industry.

**The various sources of short term working capital are as follows:**

**4.1.1 Trade Credit:**

It refers to the credit extended by the supplier of goods and services to the firm during normal course of business. It holds very important position in short term financing due to the competition for all manufacturers or traders.

In order to get this finance, the buyer needs to have acceptable and dependable creditworthiness and reputation in market. Trade credit, generally, extended in the form of open account or bills of exchange. Open account is the form of trade credit, where supplier sends goods to the buyer for the payment to be received in future as per terms of the sales invoice. It represents 25-50% of the total short term sources of financing working capital requirements. Getting trade credit may be easy to the well established, but for a new or the firm with financial problems will generally face problem in getting trade credit. Generally, the suppliers look for earning record, liquidity position, and payment record.

Trade credits are an easily available source of finance for financially sound companies. It is quite flexible. The credit may increase with the growth of the firm’s credit. It is an informal, spontaneous source of finance. It, normally, does not require any negotiations and/or formal agreement. However, it is not cost free source of finance though it does not involve explicit interest charges. The cost of credit may be charged from the buyer by increasing the price of the goods supplied to him. The user of trade credit needs to be making use of it intelligently else it will be incorrect financing decisions. If possible the buyer may pay cash immediately and avail cash discount. The buyer incurs an opportunity cost when he does don’t avail cash discount. It is advisable to the firm that it should compare the opportunity cost of trade credit with the cost of other sources of credit while making its financing decisions. In 1996, a survey of trade credit policies in Europe, Svensson (1997)\textsuperscript{37} found that 75% of Belgian firms offered a discount for prompt payment (within 10 days), and the average discount offered was 3%.

It has been observed that meeting the financial needs, sometimes a firm stretches its accounts payables. Instead of generating additional short term finances, it can prove to be a very costly source. The firm will not only sacrifice cash discount or pay any penalty but its creditworthiness also will be adversely affected. It may be a hindrance to obtain finance from other sources.

Following is the formula to calculate the implicit rate of interest.

\[
\text{\% Discount} \times \frac{360}{100 - \text{\% Discount} - \text{Credit period} - \text{Discount period}}
\]

According to Hofmann and Kotzab (2010), suppliers may be forced to delay raw material ordering, squeeze work-in-process inventories, or skimp on service levels or quality processes, when they are strapped for cash and lack of adequate access to the affordable capital. This triggers downstream delays and quality issues for the buyer, including manufacturing breakdowns, or late orders for the key accounts. In addition, suppliers are eventually forced to include the cost of extended payment in terms of the cost of goods sold. Over the long-term, cost shifting to the suppliers will result in an overall higher cost of goods sold versus competitors who have established more collaborative practices in their supply chain.

4.1.2 Accruals:
These expenses represent an accountability that a firm has to pay for the services which it has already availed. It is a spontaneous and interest-free source of financing. Generally, salary, wages, interest, and taxes are major elements of accruals. Accrued wages and salaries, normally, are paid at some fixed intervals like one month or week. The longer the payment interval, the greater the amount of funds provided by the employees. After considering legal and practical aspects a firm can enjoy this benefit. Tax will be paid on earned profit. These are paid quarterly during the year in which it is earned. This is a deferred payment of the firm. Therefore, it is a source of finance. Likewise, interest is paid periodically during a year while the firm is continuously using the borrowed funds. However, these expenses are not postponable for long and the firm does not have much control over their frequency and magnitude. Hence, it is a limited or restricted source of short term finance.

4.1.3 Deferred Income:
It is the funds received by the firm for goods and services, which, it has agreed to supply in the future. These funds are useful to increase the firm’s liquidity in the form of cash; therefore, they constitute an important source of finance. An advance payments made by the customers are the main items of deferred income. These payments are not showed as revenue till the supply of goods or services, but showed in the balance sheet as income received in advance. In competitive market, getting advance form the customer is possible for capital goods or special products for special order and product which are in great demand.

4.1.4 Commercial Papers (CP)
It represents a short term unsecured promissory note issued by the firms that have a fairly high credit rating. It was first introduced in USA and is an important money market instrument. In India, Reserve Bank of India introduced CP on the recommendations of the Vaghoraking Group on money market. CP is a source of short term finance to only
large firms with sound financial position. The maturity period of CP ranges from 15 to 365 days (but in India it ranges between 91 to 180 days). It is sold at discount and redeemed at its face value. There is no secondary developed market for CP. RBI has laid down few conditions to determine the eligibility of the company that can issue the CP. The tangible net worth of the issuing company, as per the latest audited balance sheet should be Rs. 4 crores. The company should have been sanctioned fund base limit for bank finance and/or all the India financial institutions. Company can issue CPs amounting to 75% of the permitted bank (working capital limit) credit. It should have minimum rating of P2 from CRISIL, A-2 from ICRA, etc. The minimum size of each CP is Rs. 5 crores and the size of single issue should not be less than Rs.1 crore. This is useful during the period of tight bank credit. It is a cheaper source of short term finance when compared to the bank credit. However, it is available for the large and financially sound companies. It cannot be redeemed before the maturity date.

4.1.5 Public Deposits:
Public deposits or term deposits are in the nature of unsecured deposits, have been solicited by the firms from general public, primarily, for the purpose of financing their working capital requirements. Fixed deposits accepted by companies are governed by the Companies Amendment Rules 1978. According to it, a firm cannot issue public deposits for more than 25 per cent of its share capital and free reserves. Its duration can be 6 months to 3 years. Maximum period of 5 years is allowed for non-banking financial corporation.

Inter-Corporate Deposits (ICDs): A deposit made by one firm with another firm is known as inter corporate deposits. Usually, it is made for a period up to six months. Such deposits can be call deposit which is payable on one day notice, where generally 12% interest is paid per annum. It can be in a form of three months or six months deposits as well. Three months deposits are very popular among companies for investing
the surplus funds, where they may get interest up to 14% per annum. On the other hand, six months deposits are given to category ‘A’ borrowers normally at 16% rate of interest per annum. There are no legal regulations for ICDs hence transactions can be made very conveniently and secrecy can be maintained. Such deposits are given based on the borrowers’ financial sound position, but in practice lender lends money based on personal contacts.

4.1.6 Bank Finance:
The banks provide different types of finances that are suitable for specific needs of a firm. Such finance can be fund based or none-fund based. Mainly they are:

A] Overdraft: Under this facility, the borrower is allowed to withdraw funds in excess of the balance in the firm’s current account up to a certain limit during a specified period. It offers flexibility to the borrower to withdraw and repay the cash whenever he/she wants within the given stipulation. Interest is charged on daily overdrawn balances, along with certain minimum bank charges.

B] Cash Credit: It is the most popular source of working capital finance in India. It is similar to overdraft but the bank permits a borrower to withdraw money up to a sanctioned credit limit against tangible security or guarantees. Instead of withdrawing the total sanctioned credit at a time, the borrower can withdraw the required amount and repay the surplus cash in the borrower’s cash credit account. Interest is paid on the actual used amount and there is no commitment charge.

C] Bill Discounting: It is also known as bill purchasing. Bills receivables arise out of the credit sales transactions, the seller draws a bill and the buyer accepts it. This bill can be documentary of clean bill. If the credit worthiness of the seller is satisfactory, the bank purchases or discounts it and provides the funds. The discounted amount is always less than the bill amount. If the discounted bill is dishonoured by the buyer, the seller or
drawer is liable to pay the bill amount and other expenses incurred to the bank. If the bill is purchased then the bank takes the risk of non-payment.

**D] Working Capital Loan:** A borrower may require ad hoc or temporary funds in excess of the sanctioned credit limit to meet unforeseen contingencies. Banks provide such funds through a demand loan account or a separate non-operable cash credit account. The borrower is required to pay a higher rate of interest above the normal rate of interest on such additional credit.

Banks generally do not provide working capital finance without adequate security. The bank either goes for hypothecation, pledge, mortgage or lien of the assets.

**Regulation of Bank Finance:** Banks have been following certain norms in granting working capital finance to companies. These norms generally are influenced by the recommendations of various committees appointed by the Reserve Bank of India from time to time. The norms of working capital finance followed by the bank since mid-70’s were mainly based on the recommendations of the Tandon Committee. The Chore Committee made further recommendation to strengthen the procedure and norms for working capital finance by banks. In deregulated economic environment in India, recently, the banks have considerably relaxed their criteria of lending. Now, each bank can determine its own criteria for the working capital finance. Still in order to gain an insight into various aspects of working capital finance, the major recommendations of some of the important committees set up by RBI are given below.

➢ **The Dahejia Committee:** The Dehejia Committee constituted by the National Credit Council in 1968 observed that short term finance provided by the banks for the sale of stocks in the form of credit against the collateral of book debts, in most
cases, results in extending the period of bank credit, as no discipline is imposed on the purchaser to pay the dues within a stipulated period. The Committee, therefore, suggested that the practice of culminating credit sales by issue of usance bills is to be promoted to impose financial discipline on the purchaser and also to help the suppliers or the producers to plan their financial commitment in a realistic manner. With a view to encouraging development of bill market, the Committee recommended that the Central Government may consider reduction in the stamp duty on usance bills. The Dehejia Committee, in particular, pointed out three aspects of it:

1. There has been a general increase in the borrowing from the banks both in relation to production and inventory. Even financing by other sources, such as trade credit, has shown a marked increase.
2. The period of credit was unduly lengthened and the quantum of bank credit tended to be stabilized at higher levels.
3. In some cases, the misuse in acquiring long term assets even spilled over into financing fixed capital assets.

➤ The Tandon Committee

The study group to frame guidelines for the follow-up of bank credit programmes was constituted by the Reserve Bank of India in July 1974 under the chairmanship of Shri P. L. Tandon. The study group submitted its report in August 1975, which is popularly referred to as the Tandon Committee Report. The Tandon Committee had identified the problems associated with cash credit system and recommended for the bifurcation of the credit limit into a loan component and a fluctuating cash credit component. The information system recommended by the Committee is intended to ensure proper end-use of the credit besides the introduction of financial discipline on the part of borrowing companies. The recommendation of the committee referred its approach to lending like:
i. The bank should act as a supplemental source for financing the current assets.

ii. The bank should finance a part of the working capital gap and the balance should be financed through long-term sources comprising equity and equity borrowings. Three alternative methods were suggested for calculating the maximum permissible bank borrowing.

a. Method I: In this method, the bank will finance at the most 75 per cent of the working capital gap. This method will ensure a minimum current ratio of 1:1.

b. Method II: In the second method, the borrower will finance 25 per cent of total current assets through long term sources and the remaining of the working capital gap can be financed through bank borrowings, i.e. maximum permissible bank finance = (0.75*Current assets) - Current liabilities. This method will ensure a current ratio of 1.33:1.

c. Method III: In the third method, the borrower will contribute 100 per cent of core assets and 25 per cent of the remaining current assets. The remaining working capital gap can be financed through bank borrowings. Maximum permissible bank finance = 0.75(Current assets - Core current assets) - Current liabilities.

➢ The Chore Committee

Various committees constituted by the Reserve Bank of India including the Tandon Committee had pointed out the drawbacks of the cash credit system. Though the Tandon Committee had recommended for the bifurcation of the credit limit into a demand loan and a fluctuating cash credit component, the progress achieved in this respect had been very slow. Consequently, a small working group was set up by the Reserve Bank of India under the chairmanship of Shri K. B. Chore in April 1979. The working group analyzed the existing data in respect of cash credit/overdraft by the banking sector practices followed by the other countries and submitted its report on 31st August 1979.
The recommendations of Chore Committee were accepted by the Reserve Bank of India and implemented by the commercial banks.

- **The Marathe Committee**

To accomplish the objective of regulating the growth of bank credit to be more closely associated to the requirements, the Reserve Bank of India advised all commercial banks to obtain its prior authorization before sanctioning credit limit to any single party which resulted in a limit of Rs. 1 crore or above from the entire banking sector. This was felt imperative as the economy was passing through a period of considerable stress during 1965 and the stipulation of the Reserve Bank of India provided an additional measure of credit regulation for ensuring greater alignment of bank credit to the requirement of the plan. This regulation of RBI is the genesis for what has come to be known more popularly as the credit authorization of scheme (CAS).

Since 1965 many environmental changes took place. These include the nationalization of banks in 1969; the fixing up of percentages of bank credit to priority sector borrowers such as small-scale industries, agriculture, etc.

- **The Kanan Committee**

This committee headed by Bank of Baroda Chairman, Mr. K. Kannan was formed on the suggestion of the Reserve Bank of India in January 1997 to examine the validity of the MPBF concept and to suggest suitable replacement. The report submitted in March 1997 put forth the following recommendations.

1. The report suggested doing away with the prescribed uniform formula for MPBF with the bank having sole discretion to determine the borrowing limits of the corporate.

2. In a significant move, the committee has said that developing the modalities of working capital assessment of borrowers will be lift the banks, which may devise
a flexible system. Corporate borrowers may be allowed to issue short term working capital debentures of 12-18 months’ maturity and the banks may subscribe to such debentures as working capital assistance.

3. Alternatively, the borrowers with working capital requirements of over Rs. 20 crores may be granted working capital facility in full by way of a demand loan. The borrowers with requirements of over Rs. 10 crores up to Rs. 20 crores may have a loan component of 75 per cent.

4. Interest rate incentives will be provided to the borrowers availing full working capital finance by way of loan component. Also, margin and holding level of stocks, book-debts, etc. as security for working capital facility, may entirely be left to the discretion of the financing bank. The borrowers have to obtain prior approval for the investment of funds outside the business, like inter corporate deposits, investment in associate concerns or in other investments.

5. The committee recognizes that the exiting norms as prescribed by the Tandon-Chore Committee in 1974 do not serve the need of the productive sectors of the economy. It recommended that need-based working capital finance should be made available without sticking to an age-old rule, which may have largely outlived its utility.

➢ The Nayak Committee
A committee headed by Mr. P.R. Nayak, the ex-Deputy Governor of RBI was set up in December 1991 to look into the adequacy of the institutional credit to SSI sector, to do modifications to the financing norms to SSI as per Tandon-Chore Committee norms and revisions, if any for the rehabilitation of sick units. Among them the relevant portions for the computation of working capital requirement of SSI should be worked out and the limit should be to the extent of 20 per cent of the projected turnover. This recommendation was accepted and the process of assessment of the working capital requirement was made very simple and easy. However, the onus lies with the bank; the
bank to check up the genuineness of the project turnover with the performance of already existing entrepreneurs in the same industry. If the proposal is for a renewal of the existing limit of working capital, the projected enhanced turnover should be studies from the angle of previous years’ performance and the possible trend that could be extrapolated.

As per the extant guidelines from the RBI, the banks are advised to follow turnover method of assessment of working capital requirement as mentioned for limits upto Rs. 2 crores in the case of other than SSI borrowers and upto Rs. 5 crores for SSI borrowers. In respect of the loans beyond this limit, the banks have been given discretion to choose any method like MPBF (maximum permissible bank finance) method or cash budget method, etc. Even while applying MPBF, the level of current ratio to be maintained has been left to the discretion of the individual bank. In terms of the guidelines of RBI, the working capital limit sanctioned to all borrower accounts with fund based working capital limit of Rs. 10 crores and above from the banking system, funds are to be disbursed as demand loan and cash credit in the ratio of 80 : 20. The demand loan portion of the working capital is called ‘Working Capital Demand Loan’, which is repayable in minimum of six installments as per the directions of the RBI. The outer limit of repayment has been left to the discretion of the banks. This was brought into and introduced more discipline among the borrowers availing the working capital finance.

E] Factoring:
Banks have been given more freedom of borrowing and lending both internally and externally and facilitated the freer functioning in lending and investment operations. From 1994, the banks are allowed to enter directly leasing, hire purchasing, and factoring services, instead through their subsidiaries. In other words, banks are free to enter or exit in any field depending on their profitability, but subjected to the RBI guidelines. The bank provides working capital finance through financing receivables, which is known as
“factoring”. It is a financial institution, which renders services relating to the management and financing of sundry debtors that arises from credit sales. Factoring is yet at the formative stage in India. Only four public sector banks that offer services by RBI are State Bank of India (subsidiary State Bank of India factoring and Commercial Services Ltd.), Canara Bank, Allahabad Bank, and Punjab National Bank.

Factors select the accounts of the receivables of his client and set up a credit limit, for each account of receivables depending on safety, financial stability and credit worthiness. After that factor takes the responsibility for collecting the accounts receivables selected by it. Factor advances money to the client against the selected accounts that may be not-yet, collected, and not-yet-due debts. Generally, the amount of money as advances to 70 per cent to 80 per cent of the amount of the bill. However, factor charges interest on advances, that usually is equal to or slight higher than the landing rate of commercial banks.

F] Letter of Credit:
Letter of credit is opened by a bank in favour of its customer undertaking the responsibility to pay the supplier in case its customer fails to make payment for the goods purchased from the supplier within the stipulated time. Unlike in other types of finances, where the arrangement is between the customer and the bank, and the bank assumes the risk of nonpayment and also provides finance; under the letter arrangement the bank assumes the risk while the supplier provides the credit.

Dev Strischer (2001) rightly pointed out that the banker’s philosophy can be summarized in triple trinities – purpose, repayment ability and structure. First is the purpose of a loan legal, ethical and within the bank’s policy. Second, can the loan be repaid from flow, collateral and guaranties? Third, can the loan be structured so that it is repaid on time, in full, as agreed? Of the three trinities, the banker is drawn most to the repayment ability,
which in turn, leads the lender into cash flow evaluation from the operations.\footnote{A Banker’s perspective on working capital and cash flow management, Dev Strischek, Strategic Finance, October 2001, pg. 38.} CFO Magazine’s survey report (2001) further reveled that, efficient working capital management is particularly important to bankers. Good management means more cash flow to repay loans. The banks continue to offer the firms new ideas, product, and services for improving the working capital management. Improving collection practices, inventory controls, and trade credit practices are beneficial for the company, the firm’s lenders, and their investors.

A common technique that the bankers used to measure the appropriateness of working capital investment is to compare the company’s working capital ratio with industry statistics published by Risk Management Associates (RMA).\footnote{CFO Magazine’s “Working Capital Survey”: Do selected firms work for shareholders? By Greg Filbeck, Thomas Krueger, Dinna Preece, Quarterly Journal of Business Economics, Spring 2007, Vol. 46 Issue 2.} According to the pecking order theory, a company short of funds will tend to raise capital inside before issuing new stocks or borrowing money from outside(Myers, 1984).\footnote{Myers S.C., The capital structure puzzle, Journal of Finance, 1984, pg. 575-592.}
Dr. Jeng-Ren Chiou and Han-Wen Wu (2006) opined that to raise capital via new securities will bring more outside monitoring and limitations besides incurring issuing cost. Hence, the firm will keep its own capital, if any, for internal use and/or to pay debts. More debts means less internal capital available for operations and the expected debt ratio is negatively related to Net Liquid Balance (NLB), indicating a capacity to raise money. As to linkage between debt ratio and WCR, a higher debt ratio is due to less capital for daily operations. Under such circumstances, the firm may have to raise capital from outside in response to the lack of funding, plus exercise caution in working capital management so as not to aggravate the shortage of funds. Working capital will be used most efficiently at this time.

Ben Franklin had great insight when he wrote in his Poor Richard’s Almanac, “If you would know the value of money, go and try to borrow some.” It is still true today.

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