Working Capital Management
Prof. Dr. Anil K. Sharma
Department for Management Studies
Indian Institute of Technology-Roorkee

Lecture-58
Bank Finance-Introduction

Welcome students, so where the process of learning about say working capital finance and now we have discussed that after we access the current SSC requirement in terms of inventory that credit sales that's accounts receivables and cash then we mobile the part that from where these current SSC requirements be funded and transfer the funds will come. So we saw that first and the foremost are the most important or you can call it as the most credited source of finance should be the spontaneous finance.

We should try to generate maximum funds are we should try to reach maximum working capital with the help of spontaneous finance where we learn about the management of accounts payable as well as express credit after we in the spontaneous finance now we will be talking about the next part other the next source of finance and that is the short term finance, next source is the short term finance that was the spontaneous finance is over.

And we actually made use of it and there is no other possibility to expand the source of to make use of it that we should resort to the source of fiancé in the order of priority and that second source of finance is the short term finance. When you talk about the short term finance should we have 8, 9 sources of the short term finance, but in the Indian scenario in India the most important source of the short term finance for the manufacturing sector especially is the bank finance.

Bank finance in India so easily available that other 7, 8 sources or other say remaining resources they are not that important for the borders of the manufacturing sector and they do not pay and he towards the sources all the sources for if you talk about the 1991 scenario the liberalized economy scenario at that time only bank finance for the most prevalent. Because it was only available source of working capital finance.

But after 1991 we have number of other sources is drawn from the others say economies like developed economies and in the other economies bank finance is the least popular source as

compared to India is unlike India it is least popular source . In other countries or other important sources are the popular sources of the short term finance of the working capital finance are your commercial paper factoring, then force feeding then say investment finance institutions.

Similarly the derivative finance all these are the different inter corporate deposits then the public deposits all the sources are important popular in the other countries . For example when you talk about US bank finance is the least popular source of providing the working capital finance as most expensive also. Their terms and conditions of the bank to lent the industry for the short term requirements or in the short term basis of a meeting their current asset financing requirements or source in it.

That industry do not like to an industry never likes to go to the banks and they resort to the other sources the used commercial paper the use factoring the use for fitting the use public diplomacy use inter corporate deposits they use now even derivatives, but they means you would like to go to the banks but in India contraction to the say global scenario in India bank finance is the most popular sources. Other sources are available.

But if you look at the total quantum and the say the amount of the value of the funds that have been drawn by the different place in the industry that is not very high, is not very big. So you can say that other sources in the bank finance are not very very popular. So bank finance is the most popular source in India, quite is most popular source in India and how firms are making use of it for meeting the short-term requirements.

(Refer Slide Time: 04:36)

Notion of Liquidity

1. Cash
2. Marketable securities
3. Accounts receivables
4. Inventories

Long-term liabilities	Fixed Assets NWC
Short-term liabilities	Current Assets

I will discuss with you in this class, so as we see that when you talk about the say liquidity to be maintained right. We should see that because liquidity is very important factor to maintain the credibility, to repay the short-term finish back to the source and when you talk about the liquidity part we first of all talk about the cash, how much cash be had then how much back couple equality means in terms of marketable securities we have how much accounts receivables we have and how much is inventory.

Ant lending source including the banks when they lend to the manufacturing sector to fulfil their short term funding requirements they look at the liquidity of the firm and they are more concerned about whether the firm will be able to repay their funds back on time or not and that is only possible if the form is maintaining sufficiently quality correct. So we see here dense normally see here that when we apply for the working capital finance may be any other means any way maybe one is one most popular station days the cash credit limit.

Then is the say working capital loan and third is the another popular source is a discounting of the credit sale bills. So under these 2 sources banks are more concerned about that we are ready to give some funds to the industry, but since it is being given for the short-term very short time period of time same time for a few months or maximum for a period of 12 months 1 year.

So the question is that whether the firm will be able to repay to the bank or not for that banks check the liquidity, at the notion of the liquidator for the banks is in this form first of all the check the cash marketable securities accounts receivables and then they see the inventory.

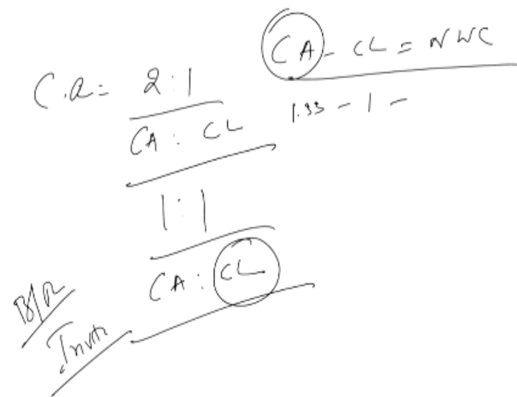
Because inventory is the least liquid source social is liquid assets the lead lesson the inventory where is accounts receivable marketable security and cash they are much light ways of looking at the liquidity of the firms by the banks and second important thing is that apart from setting the liquidity banks would like to make sure the security of their funds right, banks would like to make sure the security of their funds.

And for that purpose I have told you many times in the past also that it is the banks requirement that the current ratio is required to be 1.33:1 that is the banks requirements for anybody else requirement. So the current ratio has to be 1.33:1 and why that 1.33:1 because banks want question after this 1991 even after the 1975 banks in India are not supposed to ask for any kind of security or collateral formed from the industry while providing the short term finance.

So it means if no central is being taken no securities been taken then how to ensure that the funds given for the short-term requirements will back banks, so for that reason banks want to see that firms all the borrowing unit must have sufficient current assets that is all these four current assets this should have sufficient cash, they should have marketable securities, they should have accounts receivable.

They should have inventory and that level of current assets must be more than the level of current liabilities must be more than current liabilities. So earlier if you talk about the 1991 scenario current ratio 2:1 right current ratio was 2:1 the requirement of the current ratio was that is current ratio was 2:1.

(Refer Slide Time: 08:06)



So it means that is the requirement of the banks was that the current assets should be 2 times of current liability, current assets should be 2 times of the current liabilities why because they see that part of the current assets should be in the form of cash, current assets must be the form of cash then part of the current assets must be in the form of the that is in the form of cash.

Then part of the current assets must be in the form of marketable securities and then part of the current asset will be in the form of the accounts receivables and then part of this will be in the form of inventories right. So number one is any form when any loan becomes due to be paid for would like to make use of the available cash. Once that cash is fully utilised and it is fully exhausted then the firm would like to go for use of the marketable securities and was the marketable securities are also over then firm would like to raise funds from the another asset current asset that is the accounts receivables.

Either they would impress upon the credit buyers or buyers on credit to pay the bills at the earliest possible or otherwise they can discount this credit sale bills to the banks and at the fourth level the inventory is there with it was all four sources are exhausted, then the fourth one inventory is the one which has to be used to pay back the bank's loan. So please in this case banks wanted that if the current assets are more than the current liabilities.

And in any case if some of the current asset is not convertible into cash as an unsupported then there should be some other alternative asset available which can be easily converted into cash. So for that they want a question and if for example if a current ratio is just 1:1 right if

you just 1:1 it means your current assets are the equal to the current liabilities and if all the current liabilities become due to be paid at the same point of time then.

And if current some of the current essay for example we have seen the current asset is inventory and that inventory is not convertible to the cash as and when we wanted. Similarly that your bills receivables are not convertible into cash as and when we want it. So what to do in that case, so in this case means if you are keeping the current asset more than the current liabilities, if one is not convertible into cash other will be converted into cash.

And even 100% of the current liabilities become due to the paid at the same point of time still the firm has more than the 100% level of the current liabilities means a level of current asset is more than the 100% level of current liabilities. So it means question of a liquid does not arise means all the time firm will have sufficient liquidity and the firm has sufficient liquidity then the form will be able to pay off his debts as and when they become due.

So for that purpose this question is required and you look at this question this is the reason you look at this region if you talk about this is a region where we can say that your level of the current asset is this is a current asset is total assets and this is the level of the say that current liabilities right. This is a level of current assets, we also have the fix assets and the current assets this is a level of the current this we can call it as the long term sources of the fund, short term sources of the funds.

And we are saying that this is the level of the current asset, total this is the level of current assets I would say that is not at below yellow line this is the current assets and above this is the fixed assets right. So it means we have seen here that this particular part if you talk about this is the level of current assets from this line to this line up to yellow line this is the level of current assets and wish up to this we have the total current asset decide if you look at this is a level of current liabilities sweet means current liabilities of an part of the current assets and remaining current assets are being fired from the long term sources where form the long term sources.

So it means that the current assets are more than the current liabilities and part of the current assets are only funded from the short term sources from the current liabilities and then remaining is refunded from the long term sources. So it means when you are investing the

long term sources to fund the short-term requirements. So firm liquidity is more because long term sources will not become due to be paid immediately right by the firm.

They will be sometime will be available to the firm and after that period of time this funds repaid back for that the sufficient arrangements can be paid, but current liabilities because we have the level of current assets more than the current liabilities. So it means any time any asset is becoming not convertible to cash other will be available. So it means this region if you talk about if you see that how is the current assets adjust equal to the current liabilities.

So what will happen your current ratio is one is 1:1. So it means net working capital how we calculate net working capital current assets-current liabilities is the net working capital right, this is the ne2rking capital and where it is going to happen when the current assets are 1.33-current liabilities are 1. So it means this is 0.33 is the level of the current assets or percent of times is a level of current assets.

And this is this region that this is region that particularly that this is the excess amount and this region from this line to this line this is called as the net working capital, this is end we are seeing ne2rking capital. Ne2rking capital is that part of the current affairs which is funded from the long term sources**.** Because up to this level when you talk about the short term liabilities it means small spontaneous as well as the short term sources of the fun VII fully utilised up to this point.

And we are finding this much level of current assets, from this much level of current asset to this much level of current assets we are funding from the long term sources. So we are investing long term funds to fulfil the short-term requirements and in that case all the current liabilities are secured and they can be paid as and when because current assets are more than the current liabilities.

So liquidity of the firm is not at all at risk, but problem to the firm is that when they are investing the long-term chance to meet the short-term requirements in that case what is happening the cost of long term funds is very high return from the short of the current assets is very very negligible or sometime nil 0. So in that case say financial pressure on the firm that they are using the expensive source of funds to meet short term requirement, the current requirement.

So the cost is very high return is either very negligible or nil, so it means firms profits will be affected negatively. So we should try to maintain the current ratio, but see we can even run the show with the negative working capital also with the current liabilities are more than the current assets but that will not be possible if you want to make use of the bank finance and 90% of the firms in India are using the bank finance to fulfil their working capital requirement.

So in that case you have to maintain the current ratio that is 1.33:1 otherwise backspace not entertained the request of the firm for providing the working capital finance. In that case the ne2rking capital has to be certainly 33% of the total current liabilities. So it means that is why the xx 1.33 when we are talking about, so that is 0.33 is the ne2rking capital and that part of the current assets is be funded from the long term sources.

So this is a requirement of the banks can otherwise also it is popularly said that current ratio is invented by the banker's because they want to make sure that their funds are safe and secured and they have sufficient reason to believe that anytime our funds will become due to be paid by the firm, firm has a sufficient liquidity because your maintaining the level of current assets more than the current liabilities.

Earlier this was this ratio was required to 2:1 where the current asset should be 2 times of the current liabilities, but now this ratio has been brought down 1.33:1 right. Now we talk about the say some recent development in the say bank finance in India, see when you talk about the bank finance or financing the working capital requirement by requirements by the banks in India till mid 70s.

So getting the working capital finance from the banks was very very difficult job in India for the firms because most of the banks work for 1969, most of the banks for private banks and they were all the transfer asking collateral or security. If you want to have the short-term boring you have to give the security ok later and is the form doesn't have anything to give the security of little later then you would not get the working capital finance.

So just not because of that but this was also one important purpose in 1969, 14 big public private sector banks were nationalized by the government of India, they were brought under

public sector and public sector umbrella and government owned these banks after 1969. So one reason was nationalising this 14 big banks was to provide easy finance, easy working capital finance to the industrial to the manufacturing sector.

But that process even continued even after the national of the banks asking for the security collateral and no funds will be available to the industry, if they do not give any security little later, so then on the complaint or maybe of the suggestions I would say rather of the manufacturing sector in India government of India appointed 1 ministry of finance appointed 1 study group under the chairmanship of Mr P.L Tandon in 1974.

And that task of group was to study the present state of working capital finance in India from the banks what is the current state, what is the current charges and how it can be improved right. So this working good for this committee which is popularly known as a Tandon committee, that was formed in 1974 this committee submitted its report in August 1975 and that committee is after the recommendations of that committee which was totally accepted by the government of India.

The bank there was total change in the bank say banking finance or the say bank finance or providing the bank financial the manufacturing sector. There is a landmark changed it was a landmark say development or change and you can call it as this Tondon committees, say setting up and the recommendations are considered as landmark recommendation in the history of the working capital finance.

And history of working capital finance and after that the banking salary has totally changed as far as the walking after finish to the manufacturing sector is concerned right. So let us discuss now how it has changed then how the Tondon committee has helped the manufacturing sector to get liberal finance from the banks in India. After studying the say that then prevailing scenario in the Indian manufacturing sector.

(Refer Slide Time: 20:06)

Important Issues Raised by Tandon Committee

- Replacement of Net worth based collateralized financing by need based financing
- Best security for the loan is a well functioning organization
- Bank finance only for a part of borrowers working capital needs, not whole of it
- Borrowers should depend less and less on banks to fund their working capital needs

And Indian banking sector Tondon committee started it thoroughly during 1 full year and they observed four important things the raised four important issues was that replacement of the ne2rk base catalysed financing by need based financing there lies themselves that till days working after finishing provided by the banks to the industry on the basis of the collateral on the basis of security.

And if any industries not able to any form is not able to give any kind of traitor other ne2rk is not sufficient in that case there are there been denied the liberal working capital finance right. Second issue there is was best security for the known as a well functioning organisation, they said that why should be asked for a security in terms of some fixed asset or maybe some current asset.

When firm is a well functioning organisation and banks are going to lend money only for a few months are maximum for a period of one year 12 months not more than that. So whether the form will repay the funds back within that period of time or not is not very difficult to understand of to know, it can be done so why there is a need for the collateral. So it means and the best security should be in the committees view that the bank should ensure by different kind of analysis of parameters or at the form is well functioning organisation.

And if the firm is existing sustaining in certain they will return back your working capital finance they will not say no not to pay to their will not be any kind of liquidity problem. Third issued there is once bank finance only for a part of barrow working capital requirement, they themselves also agreed. They also agree Tondon committee also agreed that we also not

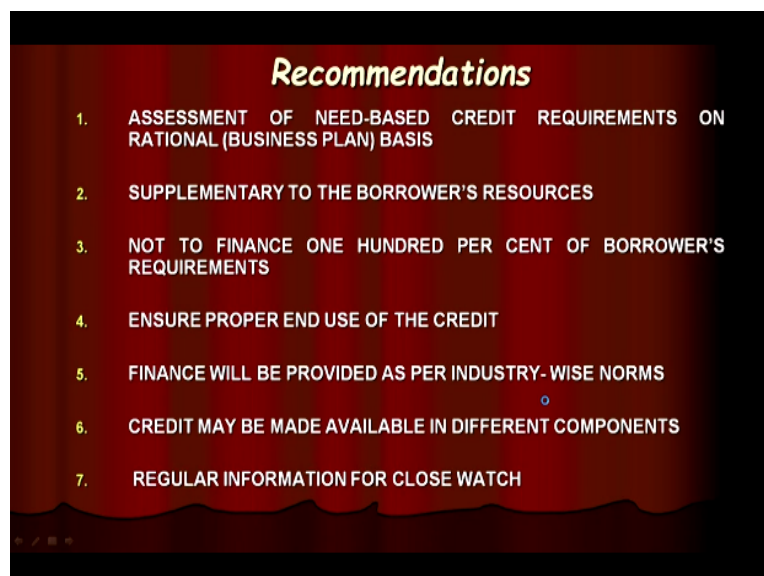
recommend that 100% of the working capital finance to the manufacturing sector should come from the banks.

It may be partly coming from the banks and that should not exceed in any case more than 75% of the total working capital requirement of the total say the building up of the current assets maximum 75% should be funded by the banks. Fourth issues the rate was borrow should less and lesser on the banks to find their working capital needs means currently you provide the liberal finance for 75%.

But at the same time borrow should be taught a lesson also that they should depend lesser lesson the working capital finance from the banks and slowly and steadily this should resort to the other sources also and other sources are like inter corporate deposits public deposits funds from the investment finance institution and maybe that time commercial paper was not allowed in India.

At that time factoring was not allowed in India at that time say 4 fitting was not allowed in India even the derivative finance was also not exist day but there was over the other things that have the working capital finance not only from the banks may be inter corporate deposits, maybe public deposit part of the long term funds to be the short-term requirements that should be done by the industries.

(Refer Slide Time: 23:23)



So these were the four important issues raised by the Tondon committee after these 4 important issues and studying the banking sector as well as the visible the manufacturing

sector and their working capital requirement, Tondon committee give the four, seven important recommendations, first recommendation was assessment of the need based credit requirements on a rational basis that is on the business plan basis.

That banks should assess the firms requirements based upon their needs or based upon their actual requirement and they should be asked the borrower the potential border should be asked to submit a business plan to the bank that how they want to use the funds provided by the banks in providing by the bank and what is their business plan for the next maybe one quarter or maybe for next 6 months for next 1 year what they want to do.

How much production they want to have, how much cash they want to keep, how much credit sales they want to have, how much inventory they want to have, how much marketable securities they will be having. So it means what is your business plan that should be asked by the bank from the potential borrower and made the make the analysis of the needs of the financial needs of the borrower.

Number 2 supplementary to the borrowers resources means it is not that 100%percent of the funds coming from the bank is not ultimately the banks responsibility, it is a borrower responsibility and borrowed needs can be to some extent fulfilled by the banks also. So bank should be providing the supplementary finance not as a complementary finish. First firm has to raise the funds from the other resources like spontaneous finish like inter corporate deposits, like public depositors.

And at the same time if there is any then banks also gets supplement that provide some part of the total requirements they can expect something from the banks also, not to finance 100% of the borrowers requirement. I already said that one of the important after the four issues they said that maximum funding from the banks to the manufacturing sector should be up to the extent of 75% of the borrowers total requirements right. In no case the funding should be 100%.

That should not be that habit develops among us the banks that you are providing the 100% lessons I am not good habit develops from amongst the borrowers that banks are providing 100% working capital finance and borrow has not to look for any other alternate, ensure proper and use of the creditors, that is another requirement of the banks this should check

from time to time that the funds provided by the banks have been properly utilised by the borrower.

And there is no access points lying in the account which workout sanction but not utilised at all. Finance will be provided as per industry wise norms, banks should develop industry wise norms, Tondon committee also develop their industry some industry wise norms and this suggested the banks but banks issued themselves also device industry wise norms and this should decided that how much credit should be given to the industry.

And to one particular industry and how it has to be distributed among us the different borrows working in one or in the same industry right and next week important recommendation was carried it may be made available and different components I have told you sometime in the bag that there can be 2 components of providing the working capital finance by the banks to the industry to the manufacturing sector.

One is the true CC limit cash credit limit, second is by working capital loan and third one is a discounting of the credit sales bills, just I am recalling it that CC limit means and amount is sanctioned and an account is opened in the branch of the bank in the name of the borrower and a certain amount sanctioned and transfer to that account and within that sanction amount the borrowed is given a permission that as and when they need the funds formation and payment of any order or any process of material of payment of salary and wages.

That will withdraw funds from this account and whenever they receive the sale of their finished product or any other source that should be deposited in the account and interest is charged only for the amount borrowed by the firm and for the period the firm has borrowed the amount. This is a CC limit account. In the loan part loan is also sanction amount and is sanctioned for the borrower for meeting the short-term requirements at certain rate of interest.

But in that case the difference is that once the loan is sanctioned whether the loan is utilised by the borrower or not utilised by the borrower fully or maybe in any proportion he or the firm has to pay the interest of the entire amount, that will not be like CC limit that you are going to pay the interest only on the amount which you have utilised and other amount you are not paying than interest on.

Here in case of the loan can have to pay the interest on the total loan amount which is sanctioned irrespective of the loan is weather the loan is utilised by the firm not utilised by the firm once it is sanction the firm has to pay the interest on that and third is a discounting of the credit sale bills that if you sell on credit you will have invoices credit sales bills and anytime if you need funds you can discount this bills with the banks.

And raise the finance for the temporary requirements for the short while and as and when you get the first you can you tell the funds back to the bank and get your invoice back. So that the means these are the 2 important sources how the bank finance can be provided to fulfil the working capital requirements of the industry and then the last one is regular information for the close watch.

Tondon committee also suggested that banks should be keeping a close watch and regular information should be shot from the industry with regard to that how much funds was sanction to them in the form of CC limit of the loan as well as say credit sale discounting of bills especially in case of the CC limit the banks should keep a proper record that how much funds was sanctioned.

How much for the use, but what part of which part of the CC limit was unutilized by the firm and if there is no proper reason for not utilising the funds then next time for the next quarter when you are sanctioning the CC limit then or making the CC limit operative out of the total limit, then that which part of the fund which remained unutilized in the previous quarter that should be withdrawn or that should not be allowed to be withdrawn.

Because in that case the firm has got sanctions the funds more than their requirements and today not utilising it so banks father going based and bank is not getting any in interest on those funds. So these are the seven important recommendations and after these recommendations this committees or this recommendations are considered as a landmark in the history of bank finance for fulfilling the working capital department of the industry by the banks.

And after that most of the banks accepted is started say falling the recommendations of the community and after raising the 4 issues and giving second recommendations 7 recommendations, third important thing that in a committee has done is that is that they have

suggested 2 methods of sanctioning working capital finance, providing working capital finance by the industry, by the banks to the industry.

So they suggested that banks should follow either of the 2 methods while providing the working capital finance to the industries. So what are these 2 methods and how they can be utilised by any bank that I will discuss with you in the next class, thank you very much.