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

Lecture-59
Recommendations of Tondon and Chore Committees

Welcome students, so we are discussing the bank finances 1 important source of providing working capital to the manufacturing sector by the banks and in the previous class we discuss the something that is the basics of the bank finance and Tondon committee's formation as well as their important issues they have raised and their 7 important recommendations apart from this as I said in my previous class.

Apart from this 4 issues and the 7 recommend, Tondon committee that is why it is known as a landmark in the history of Indian banking, they have suggested 3 important methods to the banks for working out the working capital finance to be provided by next to the banks to the industry right. So let us now have an idea about these 3 different methods that what was the correct of this committee and their recommendations.

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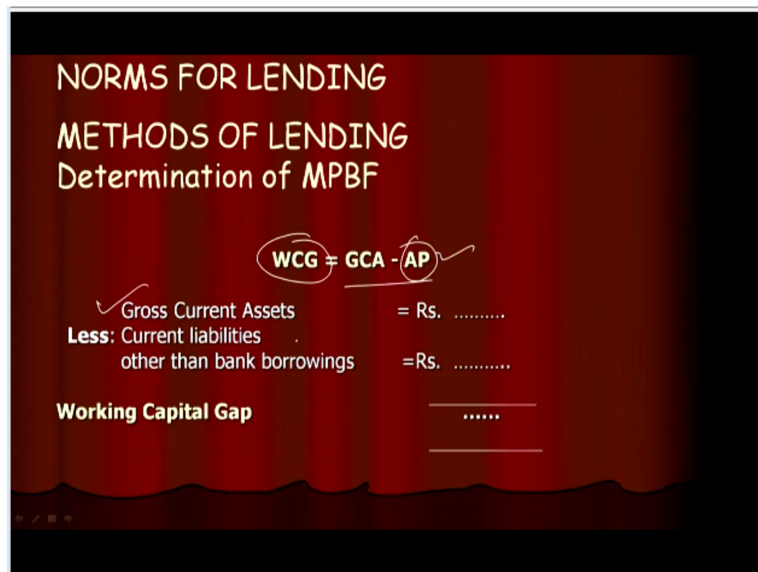

That how the working capital changes will be calculated should be worked out by the banks to be provided to the industry or to the manufacturing sector. They introduce the 2 important concepts, one important concept is the concept of term finding out working out the working capital gap WCG and second thing they point out kind of the concept was MPBF maximum permissible bank finance.

So they say Tondon committee says the first the bank should work out the WCG the working capital gap and on the basis of that gap and factoring some important components they should decide the maximum permissible bank finance to be provided by the banks to the industry or to the firms belonging to the manufacturing sector. Now how to calculate that or what is the process of determining the working capital finance by the banks.

So MPBF maximum permissible bank finance should be worked out by the banks on the basis of the working capital gap. So for calculating the working capital gap this si called as the WCG working capital gap, how to calculate the working capital gap, first of all the firm should be asked to present the level of current assets they want to build up that syllable of the gross current assets without subtracting the current liabilities.

That is called is gross working capital of the gross current assets. So 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 want to have, how much prepaid expenses they want to make. So all these current assets, gross current assets should be asked by the banks from the firm to be built up.

And on the basis of that the firm should be asked that out of this total requirement of GCA cross current assets how much funds they can reach from the spontaneous finance that is from the accounts payable. Because as I told you earlier that first and the foremost requirement is funds coming from the spontaneous finance that consider as a cheap almost free of cost source of finance and firms should make maximum use of the accounts payable.

So first of all they should be asked to tell the bank that what is the working capital gap means what is the level of current assets they want to build and how much funds are coming from the accounts payable, and in this case for calculating the working capital gap how did have done is number one gross current assets less current liabilities other than the bank finance, current liabilities other than the bank finance means in 1975 or 76 or even in the beginning of 80s.

Other than spontaneous finance only one source as the short term finance source available in India was the bank finance. So if you subtract the current liabilities other than the bank

finance we are subtracting only the accounts payable and expense credit nothing else was there, no factoring, no profiting, no derivative finance was there, so which means current liabilities other than bank finance have to be subtracted.

So gross current assets-current liabilities other than the bank finance you are left with something which is called as WCG or the working capital gap, this is the most important thing they have to work out that working capital gap has to be there for example you can say that your and total current asset.

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You wont to build up is for 100 rupees and thus accounts payable are available as 30 rupees. So, your working capital gap will be 70 rupees. So, you have to build up this gap you have to find out that how much gap is there right once that gap is found out.

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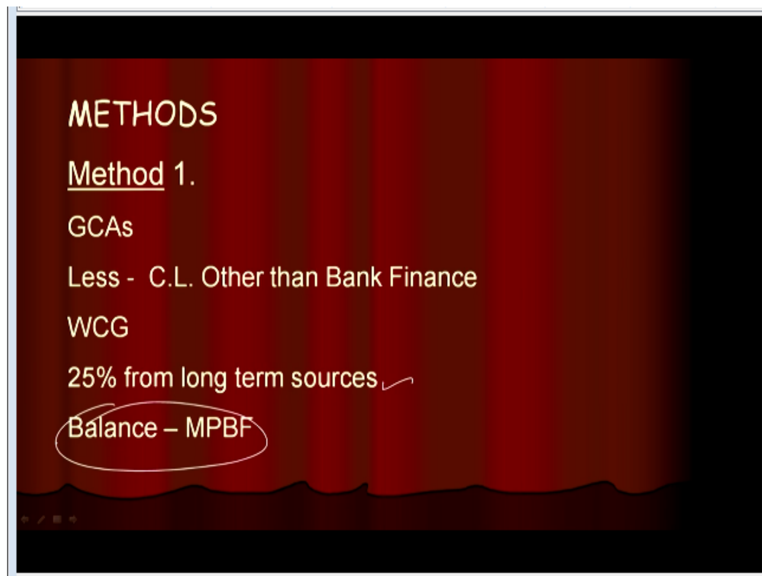

Then you have to follow either of the 3 methods first method is that is you can call it as that in this method maximum finance banks will be providing. If any firm is very good firm very good paymaster, very well disciplined financial, very well disciplined organisation, then they can be provided funds working capital finance by following the provisions is just under the method number 1.

And method number1 is what there that how to calculate maximum permissible bank finance under the method number 1 it is suggested here. Gross current asserts how much gross current assets you want to have in the next one year or one quarter or 16 months fine tell the amount less other current liabilities other than the bank finance. You subtract that so whatever you are left with this that is a working capital gap out of that working capital gap 25% should come from the long term sources.

And remaining amount will come from the working capital finance from the banks this is called as the MPBF maximum permissible bank finance 25% from the long term sources must be there. So, it means your requirement is 100 rupees and current liabilities other than the bank finance are 20 rupees. So, it means you have now the your gap is 80 rupees and out of that 25% means 20 rupees should come from the long term sources.

And bank can provide 60 rupees so, it means out of this total you can say that 60 rupees is the bank finance 20 rupees is a spontaneous finance. And 20 rupees is the long term finance that way the funds have to be provided under the first method suggested by the Tondon committee

for sectioning the working capital finance. But this method is considered as the most liberal method of calculating the maximum permissible bank finance.

And very few companies or firms are there in the market who are eligible to be considered under this method right, then the firms were moderately efficient moderately acceptable means maintaining acceptable level. Then that is the second shot of the firms and the second method of Tandon committee norms are suggested by the Tandon committee for working out the working capital finance should be followed.

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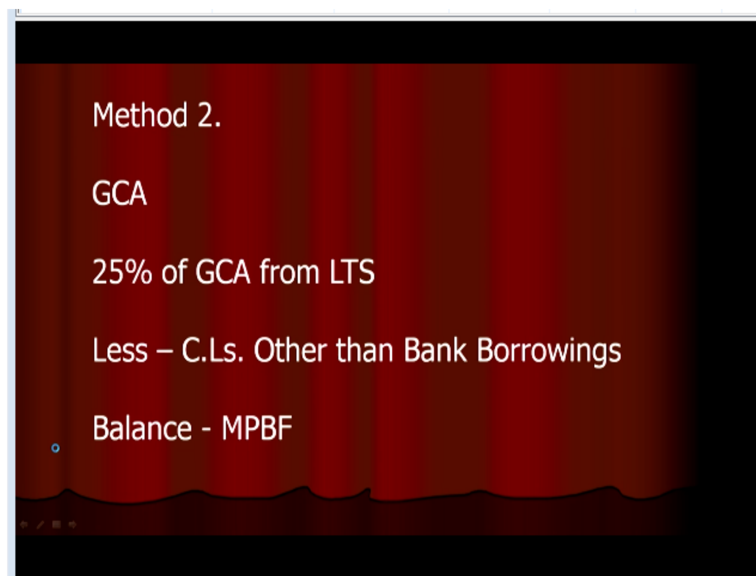

So, this is under this method what we do is normally GCA gross current assets we create the gross current assets and 25% of the gross current asset should come from the long term sources, first means earlier in the first method what was their GCM-current liabilities other than the bank finance. In this case 25% first have to be subtracted or brought in from the long term sources and then less current liabilities other than the bank borrowings.

And the balance will be considered as the maximum permissible bank finance. So, it is more strange because funds coming from the long term sources will be under this method both as compared to the funds long term sources under the method number 1. And then we talk about the third method this method is strange most and has to be followed by the banks for sanctioning the working capital finance.

In case of the firms who are not very very financial discipline who are not very good players in the market and whose liquidity as well as the credibility position is under doubt right. So,

under this method what we have to do is we have to know again take the level of GCA from the firm. And from that we will have to calculate RCA gross current assets and then-real current asset means we have to find out from the gross current assets.

We have to find out the real current assets. So, how to find out the real current assets from the gross current assets we will have to subtract something which is called as the core current assets which are considered as the core current assets, core current assets means which are always maintained by the firm. That much level of inventory always remains that much level of credit sales always remained that much level of cash always remains.

So, it means if you are maintaining that minimum level of the current assets it means why do we call them as current assets there almost as good as the fixed assets. So, they are called CCA core current assets. So for working out the MPBF maximum permissible bank finance from the gross current assets. You subtract the core current assets and then whatever is left with the says that is considered as the RCA real current assets which are now eligible for calculating the MPBF.

Now for this RCA for this level of RCA 25% of RCA should come from the long-term sources. After that you have to subtract the current liabilities without bank finance which are means available and after that whatever is left with us is that is MPBF maximum permissible bank finance right. So, under the first method if you see long term sources will be coming will be billed should be utilised where if you talk about long term funds should be coming as 25%.

But of what current gross current assets-funds coming from the current liabilities other than the bank finance should means that 25% will not be of GCA. But that will be of the gross current assets-current liabilities, second method if you see 25% coming from the long term sources should be of GCA so, certainly this 25% will be bigger than the 25% of the method number 1.

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Method 3.

GCA – CCA = RCA (Eligible for calculating MPBF)

LTS	=	25% of RCAs
***Less*:** CL w/o BF	=	As per availability
MPBF	=	The balance

(Total CL inclusive of BF will not exceed 75% of GCA)

And in this case 25% should be certainly of the RCA that is real current assets. So, it means you have to miss contribute from the long term sources first out of the GCA when you are talking about CCA, CCA should be funded from the long term sources because it is as good as a fixed asset not current asset 1 and out of RCA is also 25% should we coming from the long term sources.

So, it means very small amount is left which can come means after that you have to subtract the current liabilities not only very small amount is left which will be funded by the banks in the form of maximum permissible bank finance. So, these are the 3 methods suggesting by the committee Tondon committee.

And if you look at these three methods anyway you calculate you follow the method number one, you follow the method number 2, you are you follow the method number 3 maximum limit of the maximum bank finance to be provided will never exceed the 75% of the GCA gross current assets. And that was the basic recommendation corrupts of the recommendations Tondon committee that bank finance should be supplementing the existing sources that should not be complementary the existing sources.

And maximum bank finance that can be provided even to the best of the best firms operating in the market should be only 75% up to 75% not more than 75%. So, under these 3 methods also anyway you workout you maybe or follow the first method second method or third method maximum permissible bank finance will work out as only maximum 75% and that is their major recommendations also right.

So, these are 3 methods, so till now we have learnt about that Tandon committee has given us certain important things 4 important issues there is 7 recommendations they give and 3 methods of calculating the maximum permissible bank finance. They gave long back in 70s, now when we talk about when this committee was formed and on the basis of this recommendations of this committee.

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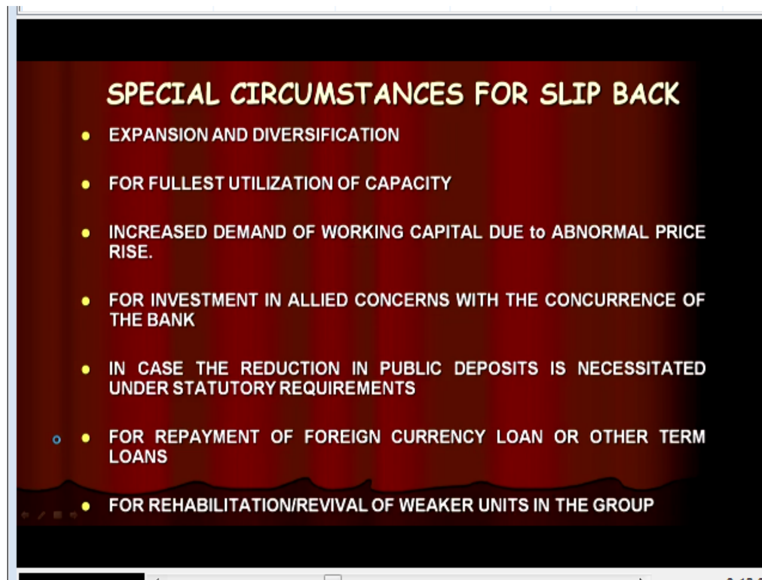

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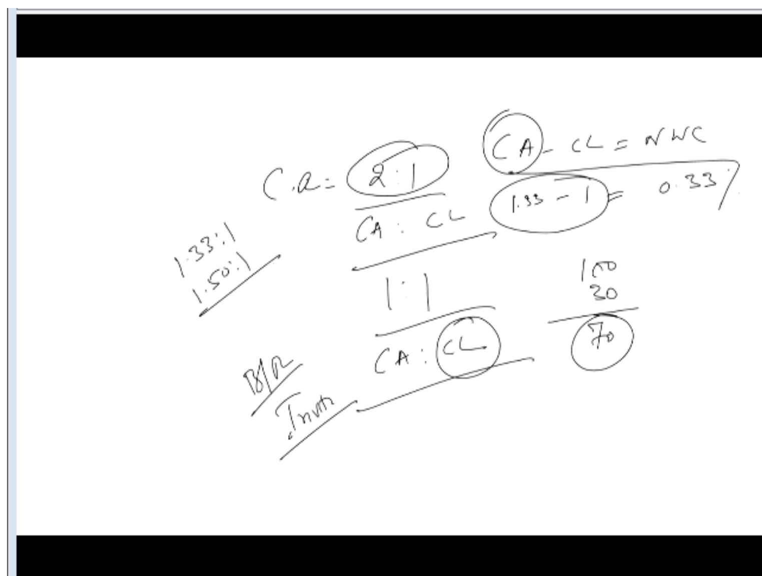

Banks had agreed to lower down the current ratio from 2:1 to the level of 1.33:1. So, it means on the date of sanctioning the working capital finance maybe CC limit or anything. If the level of current asset is not 1.33:1 but it is more than that for example it is 1.50:1. So, it

means on the date of sanctioning the working capital finance give the current ratio is 1.50:1 not 1.33:1 so after sanctioning the working capital finance.

This ratio should not be allowed to lower down to the level of 1.33 means that ratio the firm has to maintain all the times and no slip back of this level of 1.50 should be allowed to be brought down to 1.33 that is not permissible under any circumstances. So but some special cases they found out that normally it should not be allowed to be slipped back but if there are some certain important issues.

Then yes that limit can be brought down from the level of 1.50 to 1.33:1 in what case expansion and diversification. If the firm wont to expand and diversify their business then yes that level of current assets from the existing 1.5 it can be brought down to 1.33, second firm fullest utilisation of the capacity. If there is some capacity and utilised and firm out to make fullest use of this unutilised capacity even in that case also.

The threshold level can be brought down from the 1.50 to 1.33 of the current assets increase demand of working capital due to abnormal price rise, sometime when there is it changes in the prices in the economy and this more demand for the working capital in that case also it is not desirable to keep the high level of current assets. So, that limit or that ratio can be brought down from the existing 1.52 to 1.33.

For investment in the allied concerns with the concurrence of the bank if they want to invest some part of their funds in the sister concerns or in the allied concerns then also the slip back is allowed. In case the reduction in public deposits is necessitated under statutory requirements. If the firm has raised some working capital or part of the working capital from with the help of public deposits.

And if they have to be redeemed if they have to be paid back and firm needs liquidity firm needs funds. Then in that case also part of the current assets can be brought down and rather than keeping 1.5 the level can be brought down from 1.5 to 1.33, for repayment of foreign currency loans or other term loans. In this case also the limit can be brought down for rehabilitation revival of the weaker units in the Europe.

If there is a need to rehabilitate or revive the weaker units in the group even in that case also the threshold level of the 1.50 can be brought down from 1.50 or the existing level of the gross current assets which is existing means maintained by the firm that can be brought down to the level of 1.33:1. But in no case it will be allowed to be brought down from the 1.33 to any other lower minimum level of the current ratio.

The banks firms have to maintain all the times is that is 1.33:1 after that how to this Tandon committee second important level depend in the history of bank finance has for the working capital is concerned was another group which was called as chore group under the chairmanship of Mr K V Chore another group was just to review the situation created or maybe the position of the working capital finance by the banks.

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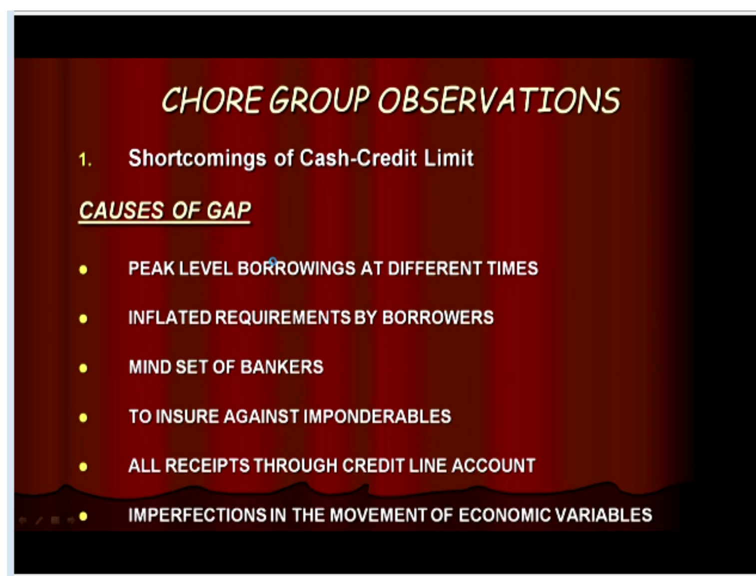

On the basis of the tender committee recommendation which came up in 1975 but immediately implemented, what has happened after that government established another study group under the chairmanship of Mr K V Chore which is popularly known as the chore group of observations Chore group of working capital finance. So, chore group studied that how the now the banks are providing the working capital finance, how the firms are utilising it.

And what is the working capital finance from the banks position in India. So, they started the committee was established in April 1979 and they give the report in August 1979. And their observations were also as follows number 1 shortcomings of the cash credit limit, cash credit

limit means that was the main observation of the Chore group that whenever the firms are applying for the cash credit limit to the banks.

They are assassinating their requirements actual requirement for example is of 1 million rupees they are asking for the 150000 or 1.5 million rupees and with the bank is sanctioning 1.5 million rupees. So, it means half of that limit is remaining unused and that amount is lying waste and that is a pressure on the banks. So, there are some limitations of the CC limit which need to be reviewed.

And they found this gap also the gap between the sanction amount and the used amount utilised amount why there is a gap they found some causes of that gap also and the causes of that gap was peak level borrowing at the different times that when firms present their requirement or their case to the bank. They portrait the requirement as well as the peak level requirements but all through the year the level is not at the peak.

And the requirements keep on changing so when we are not at the peak of our production and selling in the market. Then we need working capital much lower much lesser than the actual amount. So, it means there requirements are worked out for all through the year at the peak level where is the peak level is not being maintained or through the year. So, there is a gap between the sanction and utilised amount inflated requirements by the burrowers.

Burrowers are also asking more actual requirement is less but there inflating the requirements mind set of the bankers. Because the borrower knows that the banker will apply a cut. So already means had the time of application you apply for the more funds and even after banker applies the cut you will get the size of an amount of the funds still to ensure against in (()) (19:32) any kind of unforeseen situation in the market to deal with that situation.

We are the firms normally tend to ask for the higher levels of the working capital finance, all the seats through credit line account, this one important reason. Because when any bank sanction CC limit cash credit limit to the business, then they put a condition that whenever you need funds, you can have funds from us but when you have a surplus or your receiving the funds from your credit sales or any other source.

You have to again deposit in this account. So, some time that account rather than going into minus or withdrawing or maybe if 10,0000 are sanctioned and for example 500000 are withdrawn. So, it means the balance in the account should be 500000 but it may be possible that the balance was 500000 then the firm got collection of 600000 rupees. So, 5+6 became 110000 rupees. So, that amount became surplus rather than going down then to from the100000 rupees.

And then last one reason was imperfections in the movement of economic variables because of any economic change, economic variables maybe the demand supply position or sometime the availability of the raw material, sometime availability of the labour the working capital requirements and their use might change. Second thing they suggested was that working capital loan should be popularised.

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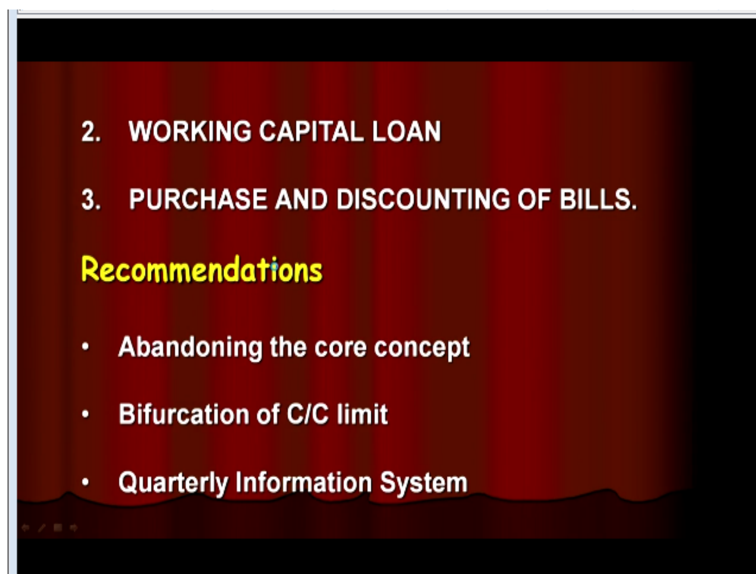

And it was their recommendation even RBI has also accepted after that it any working capital loan or any working capital requirement of any manufacturing concern which is of the order of 10 crores or above**.** Then 80% should be provided in the firm of the working capital loan and 20% should be provided in the firm of cc limit as well as the bill discounting facility.

And third thing is purchase and discounting of the bills they said chore committee said that yes this should be the very important way and popular way of providing working capital finance. But due to some reasons this is not getting popularized and people are not borrowing funds through this route. So, their recommendations what they gave 3 important

recommendations, abandoning the core concept that this core concert which was say suggested into the method number 3 by the Tondon committee.

They said that nobody has worked out the core level of the current assets, this concept has not been used. So, this concept should be dropped means there should be nothing like the core current assets only should be gross current assets and then the funding the gross current assets partly from the spontaneous finance, partly from the say short term finance including bank finance and partly from the long term sources.

And third thing is this suggested that banks must say initiate for start the quarterly information system. So, that banks are aware about what is actually the sanction amount of the working capital limit to 1 particular firm, how much of that they have used, what is the gap and how miss that gap has to be taken care of in the next quarter while sanctioning the limit for the next quarter of for the next 6 months.

So, these are the 3 major recommendations of the chore group. So these are important 2 committees in the working capital finance that first committee is that Tandon committee, second committee is the chore committee. And these 2 committees have really changed the banking capital finance in the area in the country and today when we talk about banking working capital finance.

We cannot even think of not talking about the recommendations of the Tondon committee and the recommendations of the Chore committee. But there are certain more recent developments after 1991. After 1991 economic policy are the liberalized economic policy, now it is no more mandatory for the banks to follow the Tondon committee norms are the methods of sanctioning the working capital finance.

New methods have been devised, new methods have been followed or found out and these new methods are also means to some extent are quite acceptable, quite scientific and quiet help the banks to say find out the working capital, say limits for the different industries units what you see that those these methods are there in boat or in practice or in existence. But even today most of the banks draw many clues while say sanctioning the working capital finance from the Tondon committee recommendations.

So official it is not required it is not compulsion till 1990 96, 97 sorry monetary policy Tondon committee was a compulsion. But after 96, 97 October this monetary policy was announced in October 1996, 97 after that it has been totally withdrawn. And after that this modern methods are available post liberalization you can say the methods of sanctioning working capital finance.

But apart from these methods some banks even today are also making use of the Tondon committee methods and most popular method of the Tondon committee is even today is the second method of working out and sanctioning the working capital finance. But anyhow let us have a discussion upon that what are the other methods which are now suggested which are post liberalisation for sanctioning the working capital finance.

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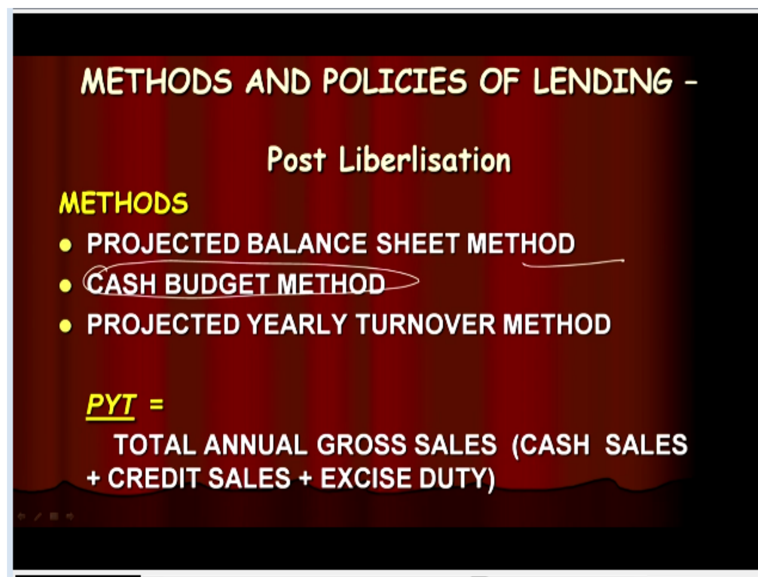

These are the 3 methods first method is projected balance sheet method, every firm should be asked to prepare a projected balance sheet for the next 1 year right by the banks means every firm by the banks should be asked to prepare a projected balance sheet for the next 1 year. And that next 1 year should be divided into 2 quarters quarter number 1, 2, 3 and 4 and then on the quarterly basis.

The firm should be asked to prepare the quarterly balance sheets and in the quarterly balance sheet it should be found out how much is there total asset requirement, how much funds are coming from the spontaneous finance and the other sources of the working capital finance including long term sources. And what is actually the requirement of the bank finance this is 1 important method.

Second method is a cash budget method, this is the second method of providing working capital finance cash budget method. The firm should be asked to prepare the cash budget and in the cash budget it should be clearly known that how much cash is required, how much cash is available and how much cash is actually expected to come from the banks. And third method is projected yearly turnover method, for calculating the projected yearly turnover method total annual gross sales that is cash sales+ credit sales+excise duty have to be taken.

So projected yearly turnover means that is the total annual gross sales including cash is credit sales and excise duty should be taken into account and as a percentage of the projected yearly turnover the working capital finance should be worked out and should be provided right. So, this is the methods of say lending by the banks has the working capital finance to the industry post liberalisation 3 methods are there.

Projected balance sheet method, cash budget method, projected yearly turnover method but again I would like to reemphasize that though these methods are there and many things have changed post liberalisation. But Tondon committee methods are even relevant today and many a times bank take a reference of those methods and most popularly second method is used by the banks for working out to the working capital finance of the different units.

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Then we talk about the policy of the providing working capital finance. So, we divide to learn about what are the policies of the banks to provide the working capital finance. Normally the burrowers are divided into 2 broad categories small scale borrows and the non small scale

borrows is large medium and large scale borrowers. In case of the small scale burrowers we talk about the limits up to 5 crores.

If the limit is up to 5 crores if the working capital requirement is of the 5 crore up to 5 crores then the simple assessment should be done means the same. When you talk about the total size of the, it is not the limit for the size of the firm. If the size of the firms asset is up to 5 crores then the simple assessment of the firm should be done if the form is of the size of the 5 crores.

Then the simple assessment should be done means by simply assessing the total availability of the assets and liabilities and requirement of the working capital finance can be done. And the funds can be sanctioned but if the size of the firm is more than 5 crores then projected balance sheet method should be followed by the banks. Firms should be asked to prepare projected balance sheet. And then there should be on the basis of the projected balance sheet the finance should be sanctioned to them.

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Now this is amaze I would talk about is that is the major important components of the bank finance so, we talked about the initial say discussion about the bank finance. And we talked about the 2 important committees Tondon committee, Chore committee and then the methods of sanctioning bank finance for fulfilling the working capital requirement which are devised post liberalisation and apart from these important things.

I will discuss certain 3, 4 important other things also that how and the how and in what way the bank finance can be provided to the different borrowers and to the different sectors. For example here is now another thing is that export credit. In case of the units who are working in the export sector, who are manufacturing the products in India maybe say governments, handlooms handicrafts anything.

If they are manufacturing in India and their production is being exported large it is being exported so they are considered as the export houses, they are manufacturing and they are exporting. So for them the export credit it is a suggestion of the RBI that out of the total working capital finance available with the banks are been provided by the banks 12% should be going to the export sector, 12% should be say provided to the firms who are involved into the export of products from India.

And 12% credits should be added should be given to the export sector units who are involved in to the exporting of the products known component. When we talk about the loan component, as I told you earlier that out in the say total loan, if you talk about if the working capital requirement of any unit is say 10 crores and above. Then 80% of that 10 crore should be provided as the working capital loan and only 20% should be provided in the firm of the cc limit right.

So, it means now say focus is that Indian industry on Indian industry units should be disciplined more they should try to learn how to generate funds for the working capital requirement from other sources rather than slowly depending upon the bank finance and within bank finance also through CC limit which is the least expensive source. But it is a very expensive and say a cause of cause of pressure on the banks also.

So, now RBI want to discipline the barrowers that if you want to have the working capital finance take more in the firm of the working capital loan rather than the CC limit. Then consortium indication, consortium means when the working capital requirements of any unit are very high in that case is not advisable for any single bank to fund their total requirement rather some more than 1 bank should form a consortium.

And they should fulfil the working capital requirements of that firm or that group right. And syndication means the difference between the consortium indication is under the consortium

the consortium partners will be decided by the one bank who is approached by the burrower. And how much what proportion and who other banks will be there the burrower has no say.

But that was not light by the barrower over a period of time and then the system was converted from the consortium to syndication. And in this case also the borrower will contact one bank that our requirement is this much and then the bank will consult the other banks they will form a syndicate. The barrower will be informed that these are the other participating banks to fulfil your requirements.

And you should have the freedom to look at it whether you are comfortable with these partners or not comfortable and how will be the total means what will be the terms and conditions of the total syndication. So, that difference is there that under consortium barrower has no say informing the consortium. But under syndication the barrower has the say informing the consortium the syndication and involving.

The Other banks into that syndication and then knowing about the terms and conditions that syndicate will be imposing upon the banks, exposure limit, now it is a very important question exposure limit is that out of the total bank funds how much should be provided as a working capital finance, how much can be provided as the working capital finance by the banks to the industry.

So, there is means different estimates can be there are practically the situation maybe different but as per the RBI guidelines that to 1 single 1 single firm, 1 single company not more than 25% of the bank funds should be provided as a working capital finance to 1 single company up to 25% of the capital fund of the bank. And what is the capital fund of the bank that is the equity capital+retained earnings without taking into account the revaluation reserve.

So, it means the equity capital+retained earnings why can call it as equity capital retained earnings+free reserves. I would say yeah so, it is equity capital+free reserves is the capital fund of the bank and 25% of that maximum can be used to provide the working capital finance to 1 single company. And if it is a group of companies in that case the maximum limit is 50% of the capital fund of the bank again that is the equity capital+all 3 reserves.

But normally it has been seen that banks exposure in Indian scenario is not more than 1 or not more than 10% of their capital fund to one industry. And that is also divided in one industry to the different number of firms. So, it means banks do not tend to lend 1 single firm or say few firms or maybe few group of firms rather their approach has been found as that they tend to cover many players.

And to help many small medium and the large firms as well as the say meeting their working capital requirements is concerned. And last but not the least is lending to priority sector, priority sector is a small scale units cottage and tiny units. So, as per the directions of RBI even the government is the directions are also there that 40% of the total working capital finance available with the banks should go to the priority sector that to the including agriculture sector.

Agriculture small and tiny units cottage industries that is a priority sector where which generate employment with generate more say not very large income. But more employment and create the units which are self sustaining. So, they are considered as units belong to small scale sector cottage and tiny sector as well as even the agricultural sector. So, 40% of the total working capital finance available with the Indian banking sector should go to the priority Sector though it is being means utilised.

I have told you sometime in the past that this is this finance through the short-term players it is going to the large scale company's players in the market. But this is still continuing many committees including very popular famous committee called as Narasimham committee has also recommended to the government that this limit of 40% should be brought down to 10%.

But nothing has happened and this is a guideline to the banks that out of the total finance working capital finance available or being provided to the different say manufacturing sector units in India or companies in India manufacturing sector companies in India 40% should be going to the priority sector. So, this is the means as per the extent limits are the guidelines for practically banks are looking at the comparative use of the funds.

And their providing the funds to the different units are looking at the requirements and as per the availability of the funds with the banks. So, with this I say some rise up on that the bank finance is the most popular source of providing working capital finance in India though we

have 7 at other sources also. But even today despite the existence of those sources bank finance is most popular source.

And it provides 80 to 90% finance to fulfil the short term or the working capital requirements of the industry or the manufacturing sector units. And other sources are there but not utilise to much larger extent. So, what are the other important sources of providing working capital finance to the manufacturing sector in India what are the other important sources means in this countries manufacturing sector that I will discuss with you in the next class, thank you very much.