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

Lecture - 08
Working Capital Management in Indian Business

Welcome students. So in previous class we were talking about the say norms of liquidity ratios. In other way around we call them the rules of thumb also. So rules of thumb we were talking about and we saw that say we have 3 important liquidity ratios.

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So I told you that earlier if you talk about the rules of thumbs till 1991 or a little after 1991 even so we were following these 3 rules and the reason I say explained in the previous class because say if nobody is bothered about the cost because only there is a single player in the market of manufacturing one product and now you think of most of the products in the market.

Steel was dominated by the SAIL, Steel Authority of India Limited, public sector company. Petroleum as I told you in the previous class also even today is dominated by the public sector companies. You talk about say other even the public sector companies are manufacturing the say bread, butter, biscuits the modern foods. Even the hotel industry we had many 5 star hotels which were owned by the government and many other sectors if you talk about.

Even the electronics, many public sector companies like Electronics Corporation of India and other they were manufacturing the colour TVs. So that sector was there. So it means and most of the say public sector companies they were in the very bad financial position despite exploiting the market fully huge market of the 1 million people and whatever the products they were manufacturing, whatever the price they were charging from us we were paying a huge price.

And after that also they were the say loss making companies and they had to be closed down after the this liberalization of Indian economy. So that is a different story. I will not go into that but as far as the working capital management is concerned it was very poor at that time and if you see that even the because the total business of this country was dominated with the public sector companies.

They never bothered about the cost and financial cost was just nothing for them, nothing to be considered as the part of the total cost of production. So they were enjoying the liquidity like anything and they were keeping this high level of the current ratios. Now the level of current ratios this norms have been revised. One reason was of having the high level of current ratios was the inefficiency of the firms.

Because they are not able to maintain and manage the liquidity and second reason was the requirement of the banks, second reason was the requirement of the banks. I have told you sometime in the past that in India the major most prominent and the most important source of working capital finance if you call it as the short term source of working capital finance it is the means the source is the bank finance.

Bank, the banks are bound to give the say funds for meeting the short term requirements of the Indian manufacturing sector whether it is a public sector or it is a private sector. Is the most profit, most convenient, and most easily available source of the fund. So everybody resorts to the bank finance and banks because there is a requirement or there is a you can call it as a stipulation.

There is a condition from the government also that as far as the working capital finance is concerned banks cannot ask for any kind of the security or any kind of the collateral normally from the borrowers because their total assets, their fixed assets, their long term assets are already hypothecated against the long term loans. So they do not have anything to give as a security, as a say pledge or anything. You can call it as a collateral. There is nothing to be given.

So if the banks are asking for the collateral or security for providing the working capital finance so firm will be at the say means in a very difficult state other than inventory they do not have any security to be given. So if the amount of the working capital is very large so banks sometime take control of the inventory of the firms but if other than inventory there is no security no collateral.

So since no collateral was possible to be taken for providing the working capital finance to the businesses or to the firms or to the companies so banks always use to say that the total your current assets, the level of the current assets should be double of the current liabilities so that any time when our funds become due to be paid by you or by the firm to be returned by the firm to the bank so in any case for example your cash is not sufficient.

Your marketable securities are not sufficient, your sundry debtors are not convertible into cash, your inventory is not convertible into cash so at least you have long term sources of the funds and if they are 100% of your current liabilities it means half of the funds are coming from the bank finance and half of the funds are coming from the your own other sources, long term sources.

So bank’s funds are safe so that any time when the bank’s funds are becoming due to be repaid by the firm back maybe the interest of the total amount so the bank has no problem in collecting the funds back or getting the funds back. So it was their condition that you have to keep the current ratio 2:1, quick ratio this much, and super quick ratio this much but after liberalization because of say many reasons.

First reason was that many sectors were opened up for the private sector participation and when the private sector participation was allowed and many companies private sector efficient best

companies came into the different sectors earlier reserved for the public sector then competition increased. When the competition increased then naturally the inefficient public sector players had to go out of the market or if not to go out of the market they were bound to lose a sizeable amount of the market.

And when they had to lose a sizeable amount of the market in that case there is a means there is a you can call it as the threat of sustenance. There is a risk of sustenance means if they are losing the market quickly in favour of the private sector players in the same sector so it means there are say so many stake holders and the first and the foremost stakeholders was the employees. If the company is closed if the business concern is closed then most of the people will come on the roads and unemployment will increase.

So they have to run the show somehow. So in some cases they try to compete with the private sector companies and when there is a question of competition, question of competition comes in terms of the 2 things. One thing is the quality of the product had to be improved and second thing is that the cost of production has to go down and so that the price is competitive because cost is the basis of price.

So if the price has to be kept low in the market of the finished product or the final product you have to first reduce the cost. So for reducing the cost, for reducing the cost everything is important, the financial cost, which was totally ignored earlier by the public sector companies. That is why they were having the luxury of keeping this much current ratios now they cannot afford to have the very high financial cost.

They have to bring the financial cost down and they realized that in the total cost financial cost plays very important role. In the total cost financial cost plays a very important role and when they realized this thing so they requested the banks. They requested the banks. They as well as all the borrowers including private sectors they requested the banks that now in the changed competitive scenario of the country, in the changed competitive scenario of the country it is not possible to have say huge current ratio that is 2:1.

So that means you have to have say level of current assets that is double of the current liabilities is not possible if the level should be brought down. We should be able to or we should be allowed to lower down the ratio if you want to have some cushion, if you want to have some security we are ready to keep it more than one. We do not want that the current ratio should be 1:1. We are ready to keep it more than 1 but not 2:1.

So banks agreed that okay you reduce the ratio but at least your current ratio, the satisfactory current ratio will be considered which is 1.33:1. So in today's scenario 33% of the current assets should be financed from the long term sources and remaining funds can come from the short term sources including bank finance. So now this is the reason that why the norm of the current ratio has been revised and now the new norm of the current ratio is 1.33:1.

This is the minimum threshold level. This is the minimum norm. Current ratio can be more than this. But if it is to be reduced from this level if you reduce from it goes down below 1.3 or 1.33 if it goes below this level firm cannot expect the bank finance. Firm cannot expect the bank finance. They if they depend upon the bank finance then it is up to them. They can have the current ratio that is 0.7:1 or 0.8:1 or 0.6:1. That is their wish. Then there is no problem.

This ratio is normally required by the banks. When we go the banks for seeking the working capital finance as the working capital say loans say limit or something then this ratio is a requirement of the banks that your current ratio should be this your quick ratio should be this and your super quick or the cash ratio should be this. So why banks want this 0.33 because it is a cushion.

Any time if the banks funds become due to be paid by the firm which they have borrowed for meeting the working capital requirements if they become due to be paid so maybe again the same situation can come that first they will use the cash, then the marketable securities, and then the sundry debtors and then the inventory. So after exhausting the cash and marketable securities if sundry debtors are not convertible into cash or the inventory is not convertible into cash at least they have a cushion of 33%.

The funds which have come from the long term sources they would always be available with the firm. So firm will not have the liquidity problem. That is why banks want because they do not have any collateral, they do not have any security. If the firm defaults in making the payment what the bank can do? They have this never taken any security. They cannot sell the security in the market and recover the funds.

When we borrow for the long term funds, for the long term say for the fixed assets even we borrow for buying a house. The house is pledged with the bank. We borrow money from the bank for buying a car. The car is pledged with the bank. When the moment you default repaying the loan back to the bank they would immediately take the control of your house. They will take the control of your car.

They will control take the control of the asset, any other asset which we have purchased by borrowing money from the bank. So in this case the working capital there is no security as such. There is no security so banks want to ensure the liquidity at least. Because if the firm is liquid if your firm is having sufficient liquidity then they would not default normally in making the payment.

So that is why this cushion is there that yes not 2:1 but 1.33 1 has to be there all the times. Now I will discuss with you one thing that say how the banks provide the working capital finance in India or what are the mods of providing the working capital finance because we are discussing this topic so in relation to this liquidity and the liquidity ratios let us know about that how the banks provide the working capital finance.

So it is because of the requirement of the banks the current ratios, norms were fixed at this level and now on the request of the industry because the financial cost is also now the important cost. So the banks have agreed that yes these norms can be revised and can be brought down but still the current ratio has to be positive ratio. It has to be more than 1 and the level is 1.33:1 but this is the minimum level, not maximum level.

You have to maintain minimum the level of current ratio that is 1.33:1. Then the quick ratio 1:1 and the super quick ratio or cash ratio that is 0.5:1. Now because we are discussing this topic and we are talking about the norms or the rules of thumb of the liquidity ratios so now I will discuss with you that how the bank finance is provided in India to fulfill the working capital requirement of the firms.

And I would again tell you that even today 80-90% of the working capital requirements of the Indian business or the business organizations is are fulfilled by the banks. It is the bank finance which is most popular for providing the working capital or fulfilling the short term financial requirements of the firms. So which is not the case in the other countries, which is not the case in the other countries.

So let us see first discuss that how the working capital finance is provided by the banks in India. So there are 3 ways.

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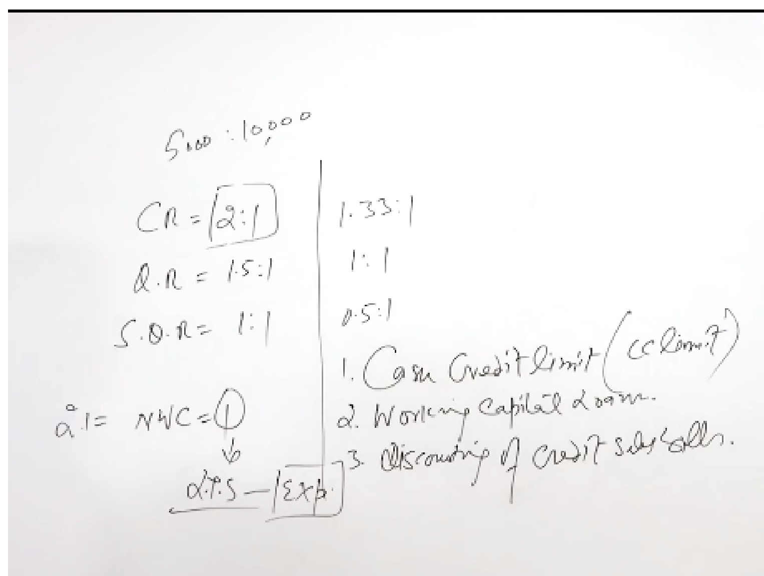

One is the CC limit which is means cash credit limit. In short we call this limit as the CC limit, cash credit limit. This is the one norm. This is one way of providing the working capital finance. Second is the working capital, second way is the working capital loans. And third is, this is 1, this is 2, and this is third is discounting of credit sales bills, discounting of the credit sales bills.

These are the 3 norms how the working capital finance is provided by the banks to the industry. CC limit, this is a very interesting concept. Under the CC limit how this limit works. First of all a company who needs the working capital finance from the banks they request, they send a proposal to the bank that we are a manufacturing organization and our total annual turnover is this much and our working capital requirements are this much.

So this out of the 100% requirements, maybe 10, 20% will come from our internal sources and remaining they apply to the bank that they should be provided the working capital finance by sanctioning a cash credit limit or the CC limit. Bank will analyze their financial position for the minimum for the past 3 years for which the companies are required to submit the their balance sheet, profit and loss account, and cash flow statement for the period of past 3 years to the bank.

Bank will analyze it and then both will mutually means arrive at some figure that yes this much of the working capital finance can be provided to the firm. Firm will demand more, bank would then analyze it. Bank will apply some cut and then they would say if the firm is asking for 100 Rs bank would say no we will be able to give you 80 Rs not 100 Rs. So finally mutually a figure is agreed upon that yes the total requirement of the firm is say 1 or 10 lakh rupees, 1 million rupees for a period of whole of the year.

That is 1 million rupees or 2 million rupees or 3 million rupees or 1 billion rupees depending upon the size of the firm. So once the it is mutually agreed then bank would say yes we can provide you the working capital finance. Now the question arises what mod will be followed by the bank for providing this finance. Firm’s approach remains that total funds should come under the first mod that is the CC limit.

But banks want the firms that okay partly we can give you the under the CC limit, partly we can give you say as the working capital loan and partly you have to use the bill discounting facility. But firms say tend to use the first mod to the extent possible that is under the cash credit limit. Now how the cash credit limit works? Cash credit limit and what is the benefit to the firm and what is the loss to the bank.

So cash credit limit how it works say for example 1million rupees limit is sanctioned by the bank to the firm. So in that case any time when the firm needs funds say for example they received a truck full load of raw material. After say 3, 4, 5 days they have to make the payment of say 2 lakh rupees to the supplier. So they will write a cheque against that CC limit account. That cheque will be sent to supplier and supplier will present it to the bank and the bank will clear the bill.

Condition here is that whenever the firm needs the funds they can withdraw the funds from the C limit account and if the firm receives the funds on account of sales from the say on account of the cash sales or on account of the credit sales then those funds should also be deposited in the same account. It is not the case that for withdraw borrowing the money you use this account and for depositing your say proceeds you use another account, no.

This is the condition by the banks that withdrawal will also be from this account and deposit will also be in this account. Total operations of the firm that is the borrowing as well as deposit will be through this account only. Firm will not maintain any other account in any other bank or any other branch of the same bank. So here the in the first case firm borrowed 2 lakh rupees to make the payment to the supplier.

And that 2 lakh rupees the firm has used for a period of say 15 days. After 15 days firm received some 2 lakh rupees from some credit buyer or maybe on account of the cash sales and those 2 lakh rupees were deposited in the bank and that 2 lakh rupees which were withdrawn by the firm 15 days back these are returned back to the bank so it means now again the account will come back to 1 million or 10 lakh rupees.

Because when they withdrew 2 lakhs account balance has gone down to 8 lakhs but when they received cash from some source, from sale, cash or credit then they deposited that 2 lakh rupees in the bank and now again the account balance has become 1 million rupees or the 10 lakh rupees. Now the question arises for how much period bank will charge the interest and for on how much amount.

Here the beauty of the CC limit is that the firm has used only 2 lakh rupees out of 10 lakh rupees. Firm has not withdrawn the remaining 8 lakh rupees. And that 2 lakh rupees have also been withdrawn or used only for a period of 15 days. So bank will charge interest only on 2 lakh rupees for a period of 15 days and on the remaining 8 lakh rupees and for the remaining period no interest will be charged from the firm, from the business.

So this is why the businesses prefer the working capital more and more working capital under the CC limit rather than the working capital loan. Because if it is a working capital loan it is the second mod, working capital loan then what will happen. Then what will happen? Bank has sanctioned 10 lakh rupees, 1 million rupees loan for the whole of the year.

Whether the firm uses entire 10 lakh rupees, whether the firm uses 1 lakh rupees, whether the firm does not use even a single penny of that, firm has to pay the interest on the entire amount of 1 million rupees and for a period of the whole of the year. So that is very difficult for the firms to manage and maintain the loan accounts, working capital loan accounts so they prefer the CC limits. Because under CC limit there is a flexibility.

Anytime you need the funds you withdraw it. For the period you are using the funds you use it and when you deposit the funds back the bank will calculate that this much amount was withdrawn and for this much period of time this much amount was used. So it means you have to pay the interest to us for this much period of time. So this is a big pressure on the banks.

This is a big pressure on the banks that their funds sometime large chunk of their funds remain unused. If that firm for example their actual requirement is half a million, 5 lakh rupees for the whole of the year they got a limit of 1 million that is 10 lakh rupees. It means half of the loan or half of the CC limit was unused by the firms. They have not used it at all and banks cost is increasing but there is no return available and finally bank has to pay the price.

So firms insist for the CC limits and banks insist for the loan but somewhere they have to have some common agreement that yes some proportion we will give you the CC limit. Some proportion we will give you the working capital loan and third is the bill discounting facility. Bill

discounting facility I told you in the previous class also that when the firms sell on credit so they can use those credit sales as a because credit sales are also an asset.

Those credit sales will be recovered after the expiry of the credit period and in India say for example the credit period normally ranges from 45 days to 2 months, 60 days. So some firm is given a credit of 2 months, 60 days and if the firm who has given the credit they require the funds. So first they will use the cash available with them in the hand or in the bank. Then they will resort to the marketable security. They will convert the securities into cash.

Then they see that inventory is also not convertible into cash because that is not saleable as and when we want it. So it means now we have only the sundry debtors that is the credit sales. So if firm urgently need the funds and there is no other source of getting the funds in that case what will happen. In that case what will happen. The firm will go with those credit sale bills to the bank that we have this much say we our bank will firm will work out that their financial requirement is how much, 2 lakh rupees right for a period of how many days, 1 month right.

They want 2 lakh rupees for a period of 1 month. Their CC limit is exhausted. There is no money left in the working capital loan. So only they have the credit sale bills. With these bills they will go to the bank and they would say that look we have the bills of say 3 lakh rupees. We are sold on credit. This money is coming to us after 2 months. But we need money now for a period of 30 days.

So you please keep the bills and give us amount maybe 3 lakhs or 2 lakhs or somewhere in between how much the bank can give as per the banks rules and regulations. Then bank may think about it. Bank may look at those credit sale bills and normally what happens. Banks divide those credit sale bills into 3 categories.

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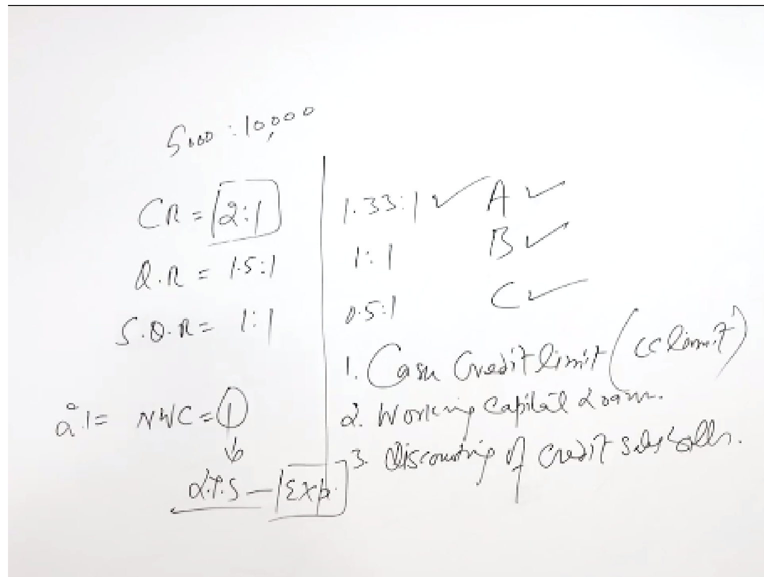

These 3 categories are A, B, and C. A category creditors, B category creditors sorry not creditors but debtors; A category debtors because of credit sales. A category, B category, and C category. Who are the A category or the debtors who have bought on credit, who have a very good financial reputation in the market. For example there is some supplier who is manufacturing say say some part of a car and he is a regular supplier to the Maruti Suzuki.

Suzuki Motors has a very good reputation in the market and if some supplier he is supplying to Suzuki also. He is supplying to say Hyundai also and he is supplying to some other company which is not that much creditworthy, for example General Motors. Now, total bills some sales to Suzuki, some sales to Hyundai Motors, some sales to the General Motors. So those bills will be or maybe he is not supplying to General Motors maybe some other company which is less creditworthy.

Now, those total bills will be divided into 3 categories by the banks. Bank would say for this A category of bills bank has no problem. Because bank knows that these are fully secured. On the due date after 2 months Suzuki can never afford to default because of their financial reputation and position in the market. So if we discount these which we buy these bills our investment or our loan is secured. Even in case of the B it is also secured.

Because this company is also very good company but there is some doubt in the C category of the bills. But here what happens? A category of the bills companies also do not want to discount because they are fully secured. C category of the bills banks do not want to buy. So finally the X lies on the B category of the bills. B category of the bills which are moderately secured banks buy.

And if there is still there is a requirement for the company funds are not sufficient under the B category of the bills then they would like to sell the A category of the bills also. But C category of the bills bank will never discount. So in this case under the bill discounting facility bank will purchase this B category and part of the A category of the credit sale bills. They will keep these bills as the security.

And up to 80% of the total amount of this B and A category of the bills bank will immediately give to the firm. 20% is kept by the bank and that will be settled on the due date when that credit buyer or the sundry debtor will make the payment to the company. In that case either the company will receive the payment and then they will make the payment to the bank.

Or sometime company informs the debtor that to directly make the payment to the bank we have already got the bill discounted so when the bank gets the payment from the debtor then bank will settle the account. Bank would say now the total seats are 100%. Say that bank had given for example 2 lakh rupees. So 2 lakh rupees is just the 80%. So they will get the bills for 100%. So out of the 100% bank would say 80% is already given to the firm.

Now out of the 20% bank would say deduct its first interest charges, commission and administrative charges and if any amount is left then that will be transferred to the main firm the seller. Otherwise that 20% will be used by the bank to recover their interest, their commission and their administrative charges. If some amount is left then still the firm will get so for example the 10% works out as the total interest, administrative charges and commission.

So it means the remaining 10% will be given by the bank to the firm. So in this case firm immediately could get 90% of the credit sales they could immediately get from the bank under

this facility. So it means they have to lose 10% but they could get the funds. They could save their reputation in the market and they could maintain the liquidity also.

So under this system under the discounting of the bills credit sale bills facility this is the third source of the working capital finance and first is the most preferred for the firms is this. Next one this and in between then they arrive at some common figure and these days now what is happening that partly the bank provide the CC limit. Partly bank provide the working capital loan and partly banks provide the bill discounting facility to the firms who need the working capital finance.

There is a instruction from the RBI to the banks that loans of 10 crores means working capital requirement of 10 crores and above. If the working capital requirement of any firm is of 10 crores and above then in that case 80% should be given as the working capital loan and bill discounting facility. Only 20% should be given as the CC limit. So it means 2 crores can be given as the CC limit.

8 crores worth of rupees or above if the total requirement is more has to be given by way of working capital loan or by as a bill discounting facility. But what is happening? If the firms if the banks start imposing this kind of the discipline on the on the business firms then what happens? They are say they expect to lose the good customers from their say account or means the good customers who have a good credit rating in the market.

They will shift from current bank to the new bank. So banks are not able to implement this threshold level of the 10 crores and above and this is not the 10 crore and above only. RBI says that over a period of time this threshold level of 10 crores should come down. It should be somewhere 7 crore. Then 6 crore, 5 crore, 2, 3. Slowly and steadily the approach of the RBI is the policy of the RBI is that total working capital finance from the banks going to the industry should be in the form of loan and the working capital loan and the bills discounting facility.

CC limit should be totally abolished because in most of the countries this CC limit is not there. This is largely in India. This is the most prevalent source of the working capital finance, most

popular source of working capital finance only in India not in the other countries. In other country for example I tell you the story of US. In US CC limit is not there. Working capital loan is there.

But under the working capital loan also if you want to borrow working capital loan from the bank there in US then what they say, what they do, what are the conditions that if we the total requirement, working capital requirement of the firm is say 1 million dollars. Then bank would say half of the amount. It means half a million 5 lakh rupees you deposit in the other account and that 5 lakh dollars will be kept as a collateral or as a security by the bank and no interest will be paid on that 5 lakh dollars.

Once you have deposited that 5 lakh rupees then bank would give the loan of the 1 million dollars. It means in fact what is that loan. In fact the bank has given only half a million loan not of the 1 million loan because half a million the firm has already given as a security to the bank. And as far as the interest is concerned the firm is not getting any interest on their 5 lakhs but bank is charging the interest on the total 1 million dollars.

So how expensive the working capital finance is in US. How expensive the working capital finance is in US? Hardly the firms resort to this source of the working capital finance in US. Businesses never use bank finance as the work source of the working capital finance in US. They use other sources. They use say financial other financial institutions they use the public deposits. They use the inter-corporate borrowings. They use the factoring.

Factoring is very popular source in US. They use the say forfeiting. They use the say nowadays we are talking about the derivative finance which is very popular. So they use the derivative finance. So different other sources firms use. That is why the other sources are very popular in US or in the other countries, not the bank finance. It is in India only the bank finance is the most popular source of working capital because it is the cheapest, safest, most secure, easily available source of the finance for fulfilling the working capital or the short term requirements of the firms.

In other countries normally the working capital comes in the form of the working capital loans, not under the CC limits. So here I would like to remind you that look at the efficiency of those companies. In India we never bother about the financial cost till 1991 even some years after that till 2000 even. Those companies who are paying very heavy financial cost they are say paying a very heavy labour cost and other kind of the cost also.

Taxes also are again high in those economies despite that they are the best say firms manufacturing the best products in their own country and they are distributing that product to the not to their own country's market but to the world markets. For example you talk about say General Motors. General Motors is not supplying cars to US only. They are in India. They are in the many countries of the world.

After means facing so much of the problems their financial cost is high, their labour cost is high, their other input costs are high. Despite that they are so competitive, they are so efficient that they are able to say sell the cars in the Indian market also and in the Indian scenario look at the business situation where finance is so easily available, labour is so cheap, raw material to a larger extent is easily available but still we are not able to compete in these markets.

So because of this reason, because of this problem the Indian business has not been able to come out of its shell. Could not grow, could not face the competition and because of that say we are still dependent upon the multinational companies for most of our day to day requirements. Our cars are coming from multinational companies, our electronics products are coming from the multinational companies. Our even steel is coming from multinational companies.

Our cement is coming from the multinational companies. So we have not been able to do much because of some defective business models which we followed in the past. But we expect that in future we will be able to improve the situation and many Indian companies would become the world players. So I will stop here in this class and remaining discussion on the different liquidity ratios of the steel sector companies like SAIL, like JSW, or JVSL or TISCO all their liquidity position, their current ratios I will discuss with you in the next class. Thank you very much.