

SOS POLITICAL SCIENCE AND PUBLIC ADMINISTRATION

MBA FA 202

**SUBJECT NAME: FUNDAMENTALS OF FINANCIAL
MANAGEMENT**

TOPIC NAME: FINANCING OF WORKING CAPITAL IN INDIA

Working Capital Financing in India

- Working Capital is a financial metric which represents operating liquidity available to a business.
- The goal of working capital management is to ensure that the firm is able to continue its operations and that it has sufficient cash flow to satisfy both maturing short-term debt and upcoming operational expenses.

Sources of Working Capital Finance in India

- There are some significant short-term sources of finance for working capital in India are
 1. Trade credit
 2. Accrued Expenses and Deferred income
 3. Bank Finance
 1. Overdraft
 2. Cash Credit
 3. Purchase or Discounting of Bills
 4. Letter of Credit
 5. Working Capital Loan

Trade Credit

- It refers to the credit that a customer gets from suppliers in normal course of trade. This deferral of payments is a short term financing which is called trade credit.
- It is a major source of finance for firms. In India, it contributes to about 1/3rd of the total short term financing.
- Particularly, small firms are heavily dependent on trade credit as a source of finance since they find it difficult to raise funds from banks or other sources.
- Trade Credit is also called Spontaneous Source of Financing.

ACCRUED EXPENSES AND DEFERRED INCOME

- **Accrued Expenses:** Accrued expenses represent a liability that a firm has to pay for the services which it has already received.
 1. Accrued Wages and Salaries.
 2. Accrued taxes and Interest.
- **Deferred Income:** Deferred income represents funds received by the firm for goods and services which it has agreed to supply in future.
 1. Advance Payments.

Bank Finance

- **Overdraft:** Under this facility, the borrower is allowed to withdraw funds in excess of the balance in his current amount, up to a certain specified limit, during stipulated period .
- **Cash Credit:** Commercial bank provides cash credit facilities to its customers/clients for meeting their short-term financing requirements against stocks or promissory notes bearing signatures of other persons.
- **Purchase or Discounting of Bills:** Under the purchase and discounting bills, a borrower can obtain credit from a bank against its bills. The bank purchases or discounts the borrowers bills.

Bank Finance

- **Letter of Credit:** Particularly the foreign suppliers, insist that the buyer should ensure that his bank will make the payment if he fails to fulfil its obligation. This is ensured through a letter of credit agreement. The bank opens an Letter of Credit in favour of a customer to facilitate his purchase of goods.
- **Working Capital Loan:** A borrower may sometimes require funds in excess of the sanctioned credit limits to meet unforeseen contingencies. Banks provide such accommodation through a “demand loan account” . The borrower is expected to pay high rates of interest in such exceptional cases

Working Capital Control and Regulation of Bank Credit

- Just to make bank credit facilities available equally and judiciously to all the sectors of the Indian economy, a number of committees had been set up.
- In this regard five reports submitted by five important committees are very significant. These reports are:
 - I. Dahejia Committee Report, 1969
 - II. Tondon Committee Report, 1975
 - III. Chore Committee Report, 1980
 - IV. Marathe Committee Report, 1984
 - V. Kannan Committee Recommendation, 1997

Dahejia Committee Report, 1969

- To determine the extent to which credit needs of industry and trade are likely to be inflated and how such trends could be checked and to go into establishing some norms for lending operations by commercial banks. (Shri V.T. Daheja)
- The committee was of the opinion that there was also a tendency to divert short-term credit for long-term assets.
- Although committee was of the opinion that it was difficult to evolve norms for lending to industrial concerns.
- The **committee recommended** that the banks should finance industry on the basis of a study of borrower's total operations rather than security basis alone.
- The Committee further **recommended** that the total credit requirements of the borrower should be segregated into '**Hard Core**' and '**Short-term**' component.

Dahejia Committee Report, 1969

- The 'Hard Core' component which should represent the minimum level of inventories which the industry was required to hold for maintaining a given level of production should be put on a formal term loan basis and subject to repayment schedule.
- The 'Short Term' component which represents short-term projects like increase in short-term stock/inventory, tax, dividends and bonus payments etc.
- The committee was also of the opinion that generally a customer should be required to confine his dealings to one bank only.

Tondon Committee Report, 1975

- Reserve Bank of India set up a committee under the chairmanship of Shri P.L. Tondon in July 1974.
- Term of References:
 - To suggest guidelines for commercial banks to follow up and supervise credit from the point of view of ensuring proper end use of funds and keeping a watch on the safety of advances;
 - To suggest the type of operational data and other information that may be obtained by banks periodically from the borrowers and by the Reserve Bank of India from the leading banks;
 - To make suggestions for prescribing inventory norms for the different industries, both in the private and public sectors and indicate the broad criteria for deviating from these norms;
 - To make recommendations regarding resources for financing the minimum working capital requirements;
 - To suggest criteria regarding satisfactory capital structure and sound financial basis in relation to borrowings;
 - To make recommendations as to whether the existing pattern of financing working capital requirements by cash credit/overdraft system etc., requires to be modified, if so, to suggest suitable modifications.

Tondon Committee Report, 1975

- Although the **Committee recommended** the continuation of the existing cash credit system, it suggested certain modifications so as to control the bank finance.
- The banks should get the information regarding the operational plans of the customer in advance so as to carry a realistic appraisal of such plans.
- the banks should also know the end-use of bank credit so that the finances are used only for purposes for which they are lent.
- The recommendations of the committee regarding lending norms have been suggested under three alternatives.
 - **Maximum permissible bank finance (MPBF):** Three methods for determining MPBF
 - Method 1: $MPBF=0.75(CA-CL)$
 - **Method 2: $MPBF=0.75(CA)-CL$**
 - Method 3: $MPBF=0.75(CA-CCA)-CL$

CA- Current asset, CL- Current liabilities,

CCA- Core Current Assets (Permanent Component of Working Capital).

Chore Committee Report, 1980

- The Reserve Bank of India in March, 1979 appointed another committee under the chairmanship of Shri K.B. Chore to review the working of cash credit system.
- With particular reference to the gap between sanctioned limits and the extent of their utilization and also to suggest alternative type of credit facilities which should ensure greater credit discipline.

Chore Committee Report, 1980

- The important recommendations of the Committee are as follows:
 - I. The banks should obtain quarterly statements in the prescribed format from all borrowers having working capital credit limits of Rs 50 lacs and above.
 - II. The banks should undertake a periodical review of limits of Rs 10 lacs and above.
 - III. The banks should not bifurcate cash credit accounts into demand loan and cash credit components.
 - IV. If a borrower does not submit the quarterly returns in time the banks may charge penal interest of one per cent on the total amount outstanding for the period of default.
 - V. Banks should discourage sanction of temporary limits by charging additional one per cent interest over the normal rate on these limits.

Marathe Committee Report, 1984

- The Reserve Bank of India, in 1982, appointed a committee under the chairmanship of Marathe to review the working of Credit Authorisation Scheme (CAS) and suggest measures for giving meaningful directions to the credit management function of the Reserve Bank.
- The recommendations of the committee have been accepted by the Reserve Bank of India with minor modifications.
- The principal recommendations of the Marathe Committee include:
 - (i) The committee has declared the Third Method of Lending as suggested by the Tanden Committee to be dropped. Hence, in future, the banks would provide credit for working capital according to the Second Method of Lending.

- (ii) The committee has suggested the introduction of the 'Fast Track Scheme' to improve the quality of credit appraisal in banks. It recommended that commercial banks can release without prior approval of the Reserve Bank 50% of the additional credit required by the borrowers (75% in case of export oriented manufacturing units) where the following requirements are fulfilled:
 - The estimates/projections in regard to production, sales, chargeable current assets, other current assets, current liabilities other than bank borrowings, and net working capital are reasonable in terms of the past trends and assumptions regarding most likely trends during the future projected period.
 - The classification of assets and liabilities as 'current' and 'non-current' is in conformity with the guidelines issued by the Reserve Bank of India.
 - The projected current ratio is not below 1.33 : 1.
 - The borrower has been submitting quarterly information and operating statements (Form I, II and III) for the past six months within the prescribed time and undertakes to do the same in future also.

Kannan Committee Recommendation, 1997

- In view of the ongoing liberalization in the financial sector, the Indian Banks Association (IBA) constituted a committee headed by Shri K. Kannan, Chairman and Managing Director of Bank of Baroda to examine all the aspects of working capital finance including assessment of maximum permissible bank finance (MPBF).
- The Committee submitted its report on 25th February, 1997.
- It **recommended** that the arithmetical rigidities imposed by Tandon Committee (and reinforced by Chore Committee) in the form of MPBF computation so far been in practice, should be scrapped.
- The Committee further **recommended** that freedom to each bank be given in regard to evolving its own system of working capital finance for a faster credit delivery so as to serve various borrowers more effectively.
- It also suggested that line of credit system (LCS), as prevalent in many advanced countries, should replace the existing system of assessment/fixation of sub-limits within total working capital requirements.
- The Committee proposed to shift emphasis from the Liquidity Level Lending (Security Based Lending) to the Cash Deficit Lending called Desirable Bank Finance (DBF).

Measures adopted by RBI

1. Assessment of working capital finance based on the concept of MPBF, as recommended by Tandon Committee, has been withdrawn. The banks have been given full freedom to evolve an appropriate system for assessing working capital needs of the borrowers within the guidelines and norms already prescribed by Reserve Bank of India.
2. The turnover method may continue to be used as a tool to assess the requirements of small borrowers. For small scale and tiny industries, this method of assessment has been extended up to total credit limits of Rs 2 crore as against existing limit of 1 crore.
3. Banks may now adopt Cash Budgeting System for assessing the working capital finance in respect of large borrowers.

Measures adopted by RBI

4. The banks have also been allowed to retain the present method of MPBF with necessary modification or any other system as they deem fit.
5. Banks should lay down transparent policy and guidelines for credit dispensation in respect of each broad category of economic activity.
6. The RBI's instructions relating to directed credit, quantitative limits on lending and prohibitions of credit shall continue to be in force. The present reporting system to RBI under the Credit Monitoring Arrangement (CMA) shall also continue in force.

THANK YOU