WORKING CAPITAL MANAGEMENT
(Part-1)

Introduction: Why a business need working capital

Any enterprise whether industrial, trading, or others generate three types of assets to run its business as a going concern.

1. Fixed assets to carry on the production/ business such as land, building, plant & machinery, furniture & fixtures etc. For going concern these are of permanent in nature and are not to be sold except in adverse conditions.

2. Current assets require for day to day working of the business/unit which are floating in nature and keep changing during the course of business at a rapid pace in comparison to the other assets. These are short term in nature such as inventory, receivables (outstanding less than six months), loan & advances, cash & bank balance etc.

3. Non- Current assets which are neither fixed assets not current assets such as Intangible assets, long term investments, FDR put in bank as margin money, security deposit (rent, government authorities etc), debtors outstanding more than six months

Further fixed assets are to be financed by owned funds and long term liabilities raised by a concern while current assets are partly financed long term liabilities and partly by current liabilities and other short term loans arranged by concern from the bank.

Nature of industry decides the requirement of concern about the investment in current assets. For example big industrial projects may require substantial investment both in fixed and current assets in comparison to trading unit or service sector. A trading unit needs to invest a huge amount in stock-in-trade in comparison to fixed assets.

Bank assessment of working capital

Reserve Bank of India had instructed to use strictly and adhere with the “second method of lending” to banks while lending for working capital.

As per this method the borrower should finance 25% of all current assets from owned funds and long term liabilities and the balance be financed by bank. By applying this method of lending one need to calculate the Maximum Permissible Bank Finance (MPBF) for deriving the maximum limit which the bank could extend to the borrower.

Format for calculating the MPBF is as follows:

(Fig in lakhs)

	Particulars	Year1	Year2	Year3	Year4
1	Total Current Assets				
2	Other Current Liabilities				
	(Other then Bank Borrowings)				
3	Working Capital Gap (Diff 1-2)				
4	Minimum Stipulated NWC				
	(25% of T. Current Assets)				
5	Actual/Projected Net Working Capital (T. Current assets – T. C. Liabilities)				
6	Item 3 minus item 4				
7	Item 3 minus item 5				
8	Maximum Permissible Bank Finance				
	(Lower of 6 or 7)				

Bank also considers the followings points while sanctioning the working capital limit to the concern:

1. Turnover size of the concern: The bank normally gives working capital limit upto 20-25 % of the turnover estimated (for the year under review) by the concern.

2. Current ratio should be 1.33: 1. In case of take over case the last three year CR average should be 1.33:1. Some relaxation may be given but subject to approvals from Circle Head or Head Office of bank.

3. Total Outside Liability/ Net Worth Ratio should be in the range of 2-3 times.

4. As a measure to incentive to export sector while calculating the margin i.e. 25% of current assets, export receivables are excluded from current assets.

5. Additional credit needs of exporters arising out of firm order/ confirmed letter of credit (which are not taken into account while fixing regular credit limits of borrowers) are to be met in full even if sanction of such additional credit limit exceeds MPBF

6. Credit limits of the borrowing concern in the sugar industry may be determined on the basis of a current ratio of 1:1.

7. Sick/weak units under rehabilitations will be exempted from the application of 2^{nd} method of lending.

8. Term loan Installments payable within the next twelve months time are excluded from current liabilities while calculating MPBF but included while calculating Current Ratio.

9. The Drawing Power (DP) should be equal to or more than the limit applied for. The calculation of same is as follows:

Particulars	**Year1**	**Year2**	**Year3**	**Year4**	**Margin**
Raw Material					25%
Other Consumable Spares					25%
Stock-in-process					25%
Finished Goods					25%
Domestic Receivables					40%
Export Receivables					40%
Total (A)					
Less:					
Creditors					40%
Total (B)					
DP {A-B}					

Note: The above margin depends on industry to industry. Some time margins may be nil.

10. The inventory holding period, time taken in realization of debtors, advance to suppliers and credit availed from suppliers are also taken into consideration. All the above factors are calculated in either days or months. It shows the requirement of working capital in months or days. In bank term it is called Working Capital Cycle of the concern.

    It is very important factor because it shows blockage of funds and how much time a concern takes to realize the same. It is the measure of capability of concern to manage the liquidity in the system.

Bank compare the holding period of borrowing concern current assets with the concern in same business and industry standards. If bank finds major differences than it may instruct to borrowing concern, to standardize the same with peers or industry standard, subject to necessary approvals from higher authorities.

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