WORKING CAPITAL MANAGEMENT (Part-II)

Each business has its uniqueness and style which decides the nature and the form of working capital it require. An exporter for example will need packing credit limit instead to OD limit in compare to a trader who will ask for OD limit. In view of above and as per industry practices following are the possible forms of the working capital:

A. Fund Based Limits:

Fund Base Limit is a limit in which the Company gets the money from bank or financial institution in cash.

a. <u>Cash Credit (CC)</u> - To meet working capital requirements of the company the bank gives the CC limit against the hypothecation of Stock and Debtors. But while deciding the limit, the bank deducts the Trade Creditors also. Further a monthly stock and debtor's statement need to be submitted with the bank showing the position of the stock and aging of the debtors.

Client opens the Cash Credit Account which allows the withdrawal up to the limit sanctioned by the bank. Bank charges the prevailing interest and other bank charges as per norms. This facility is sanctioned for a year and need to review at the closing of the year for renewal subject to the requirement of client.

Bank normally asks for the collateral security for securing its hand in case of any default. A regular inspection is conducted on the factory and godowns of the client, to check the stock levels, by the bank officers along with a Stock Audit conducted by a Chartered Accountant on yearly basis.

- b. <u>Working Capital Term Loan</u>: Some time the borrower fails to bring immediately its own contribution as margin while enjoying the working capital limits. In that case the bank may sanction WCTL which need to be adjusted as soon as possible. It normally carry higher rate of interest in comparison to working capital limit.
- c. <u>Factoring</u>: The selling of a company's accounts receivables, at a discount to a factor that then assumes the credit risk of the account debtors and receives cash as the debtors settle their account. There is no need to open the Letter of Credit (LC)

There is specialize financial institutions such as SBI Factors, Global Trade Finance, IFCI Factors which gives services of factoring (Domestic as well as International).

Reverse factoring is also possible. In this case discounting of suppliers' bills is done by factor in respect of the client's regular purchases from them.

d. Ad hoc or Temporary Limit:

Ad-hoc limit is the limit fixed by the bankers to its existing clients in the following cases:

- i. Sudden Bulk order results additional working capital requirement created
- ii. The proposal of the working capital is either in the process of enhancement or renewal.
- iii. In any other case which the bank thinks is suitable justification for sanction of adhoc limit.
- e. Cash Credit Limit against Book Debts:

Book Debts of account receivables arise out of sale of goods or service on credit. Because of credit sales, the seller's available working funds become inadequate to support the scale of operation necessitating bank finance. The system of financing credit sales or receivables by bill finance i.e. purchases or discount of bills is quite common.

But another mode of financing credit sales is by way of cash credits against book debts. Under this system the bank allows the borrower to draw to the extent of the limit sanctioned to him provided the drawings are backed by adequate receivables.

Advance against book debts is made by way of cash credit or overdraft. The margin for advances is normally in the range 30-40% of the book debts accepted as security. The borrower should submit monthly statements showing the outstanding book debts party-wise. The statements should be scrutinized with reference to the age of the book debts and the drawing power.

f. Overdraft (OD):

It is a tool to aid cash-flow by a bank providing a reserve of easily accessible money to meet any shortfall in working capital. The facility is usually repayable "on demand" which means whenever the bank demands. Consequently, it is usually shown as a current liability on the balance sheet. It may be secured or unsecured.

Further, it is a type of revolving loan where deposits (credits) are available for reborrowing, and interest is charged only on the daily overdraft (debit) balance.

g. Drawee Bill Scheme:

i. Acceptance System: The seller may draw a bill on the bank of the buyer who shall accept it under an arrangement with the buyer. The seller can discount the bill with his banker. The seller bank will get the payment from the buyers bank on due date.

ii. **Bill discounting System:** Under this system, the buyer bank will itself discount the bills drawn by the seller and will the liability against the buyer.

h. Line of Credit:

An arrangement between a financial institution and a customer that establishes a maximum loan balance that the bank will permit the borrower to maintain. The borrower can draw down on the line of credit at any time, as long as he or she does not exceed the maximum set in the agreement.

The advantage of a line of credit over a regular loan is that interest is not usually charged on the part of the line of credit that is unused, and the borrower can draw on the line of credit at any time that it needs to. Depending on the agreement with the financial institution, the line of credit may be classified as a demand loan, which means that any outstanding balance will have to be paid immediately at the financial institution's request

i. Packing Credit

PC is available to exporters, for financing purchase, processing, manufacturing or packing of goods prior to shipment.

This is basically a loan or advance extended to exporter by the bank on the basis of:

- a. Letter of Credit opened in favour of exporter or in favor of some other person, by an overseas buyer.
- b. a confirmed and irrevocable purchase order for the export of goods from India.
- c. any other evidence of an order or export from India

B. Non-fund Based Limits

The credit facilities given by the banks where actual bank funds are not involved are termed as 'non-fund based facilities'

a. Letter of Credit:

A standard, commercial letter of credit is a document issued mostly by a financial institution on the request of the buyer in favour of supplier of goods which usually provides an irrevocable payment undertaking. It may be Inland LC or Foreign LC. In this case the buyer bank gives guarantee on behalf of its client to supplier for supplying of material or goods subject to that invoices, bill of lading, shipment documents will come directly to the bank. Bank will mark lien on the goods and will stand as lender/creditor in the books of the client (buyer).

The supplier could opt for discounting of LC. In this case he will approach his bankers/agent/factor that wills again approach to the buyer client. The buyer

bank will make payment (after deducting the margin) on behalf of its client for a fee.

The margin is normally in the range of 10 to 25%, and bank put the money in the form of FDR at prevailing rate till the settlement of the final claim.

LC could be at sight LC or usance LC.

A 'sight' LC means that payment is made immediately to the beneficiary/seller/exporter upon presentation of the correct documents in the required time frame.

A 'usance/time' LC will specify when payment will be made at a future date and upon presentation of the required documents

b. Bank Guarantee:

In BG the bank guarantees a sum of money to a beneficiary. The sum is only paid if the opposing party does not fulfill the stipulated obligations under the contract. This can be used to essentially insure a buyer or seller from loss or damage due to nonperformance by the other party in a contract.

The real estate companies for example normally need to furnish the BG to the Local Bodies or Authorities who sanction and approve the land for commercial/ residential or industrial use.

C. <u>Deferred Payment Guarantee</u>

That is paid a fixed number of days after shipment or presentation of prescribed documents. It is used where a buyer and a seller have close working relationship because, in effect, the seller (beneficiary of the L/C) is financing the purchase by allowing the buyer a grace period for payment. It differs from a sight draft or time draft in that no drafts are involved but the payment is guaranteed on the stated date. However, there being no draft, the beneficiary party's ability to discount or sell his or her right to payment is restricted.

For any query or assistance, kindly call or send a mail undersigned.

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