WORKING CAPITAL ASSESSMENT

What is Working Capital?

Funds required for acquiring current assets to enable business/industry to operate at the expected levels.

Concepts of Working Capital

Gross Working Capital = Current Assets (CA) – These are in the system used/consumed on a day to day basis.

Net Working Capital = Current Assets – Current Liabilities (CA – CL) or

Share Holders Fund + Term Loans – Net Fixed Assets + Net Current Assets (SHF+TL) – (NFA+NCA)

Net Working Capital (NWC) is Entrepreneur's margin available in the system from Long Term Funds.

What are Current Assets?

Assets which normally get converted into cash during the Operating Cycle of the Firm

- Cash & Bank Balances
- Inventory
- Receivables
- Advances to Suppliers/Others
- Other Current Assets

What are Working Capital Sources?

- Own funds
- Bank borrowings
- Sundry Creditors
- Advances from customers
- Deposits due in a year
- Other current liabilities

OPERATING CYCLE

Begins with acquisition of Raw Materials and ends with collection of Receivables.

Stages:

1. Raw Materials (RM/RM consumption)
2. Work in Process (WIP/COP)
3. Finished Goods (FG/COS)
4. Receivables (Debtors/Credit Sales)
   Less: Payables (Creditors/Credit Purchases)

Length of Operating Cycle: - Business Category wise

Service – Cash > Receivables

Trading – Cash > Stocks > Receivables

Manufacturing – Cash > Raw Materials > Finished Goods > Semi Finished Goods (WIP) > Receivables

Factors influencing Working Capital Management

- Nature of business – service/trade/manufacturing.
- Seasonality of operations – peak/non peak

- Production Policy – Constant/seasonal
- Market conditions- competition/credit terms
- Conditions of supply of RM/stores/spares etc.
- Quantum of production/Turnover(level of activity)
- Operating Cycle
- Current Assets to be maintained

Data to be Obtained

- Application.
- Financial Statements of Previous years
- Estimates/ Projections (with quantitative details)

Working Capital Finance

- A) Fund Based
    - Inventory finance and
    - Bill Finance (Post Sales Finance).
- B) Non Fund Based
    - Letter of Credit (LC)
    - Bank Guarantee.

Assessment Methods

- Operating Cycle Method
    - Service Sector
    - Traders
    - Manufacturing Activity.
- Drawing Power Method.
- Turnover Method.
- MPBF method (II method of lending) for limits of Rs 6.00 Crores and above
- Cash Budget method (Reason: Based on procurement and cash inflow)

Seasonal Industries (Sugar/ Rice Mills/Textiles/Tea/Tobacco/Fertilizers)

Contractors & Real Estate Developers, Educational Institutions

Operating Cycle Method

Operating Expenses / No of Operating Cycles in a year

A. Length of Operating Cycle

i.	Procurement of Raw Material	: 30 days
ii.	Conversion/Process time	: 15 days
iii.	Ave. time of holding Finished Goods	: 15 days
iv.	Ave. Collection period	: 30 days

v. Operating Cycle (I +ii +iii +iv) : 90 days

vi. Operating Cycles in a year (365 days/v) : 4

B. Total Operating Expenses per annum : Rs. 60 Lakhs

C. Total Turnover per annum : Rs. 70 Lakhs

D. Working Capital Requirement = Total Operating Expenses (B)/ No of Operating Cycles (vi) ie.60/4: Rs. 15 Lakhs

Drawing Power Method

(for units with small limits) (Lac/Rs.)

Particulars	**Stock Value**	**Margin**	**DP**
Paid Stocks (RM Creditors)	4	25%	3
Semi Finished Goods	4	50%	2
Finished Goods	4	25%	3
Book Debts	4	50%	2
Total:	**16**		**10**

Turnover Method

(originally suggested by Nayak Committee for SSI units) - Applicable for limits up to 6 Crores

A	Sales Turnover	60 Lakhs
B	25% of Sales Turnover	15 Lakhs
C	5% of sales Turnover projected as Margin	3 Lakhs
D	Actual NWC existing as per Financial Statements	2 Lakhs
E	B – C	12 Lakhs
F	B –D	13 Lakhs
G	MPBF (E or F, whichever is less)	12 Lakhs
H	Additional margin to be brought in (C – D)	1 Lakh

MPBF Method

(Tandon’s II method of lending)

A	Current Assets	16 Lakhs
B	Current Liabilities other than Bank Borrowings	6 Lakhs
C	Working Capital Gap (A – B)	10 Lakhs
D	Minimum stipulated NWC 25% of CA excluding Export Receivables	4 Lakhs
E	Actual Projected NWC	5 Lakhs
F	C - D	6 Lakhs
G	C - E	5 Lakhs
H	MPBF (F or G, whichever is less)	5 Lakhs
I	Excess Borrowings / Shortfall in NWC (D – E)	-1 Lakh

Justifications of the Performance Projection

(Inventory/Receivable Norms – Comparison)

- Intra firm Comparison
- Comparison of estimates with previous years Actuals

<u>For New Units</u>

- Comparison of estimates with similar units in the area of operation
- Higher projections shall be justified.
- Excess borrowing (short fall in NWC) shall be ensured by additional funds to be brought in by the applicant or by additional bank finance over MPBF.

Important Aspects of MPBF method

- Production/Sales estimates
- Profitability estimates
- Inventory/receivables norms
- Build up of Net Working Capital

Cash Budget

Statement showing forecast of Cash Receipts, Cash Payments and net Cash Balance over a period of time.

Months - >	1 2 3 4 5 6 7 8 9 10 11 12
Cash Receipts	
Cash Payments	
Surplus/Deficit	
Cash Credit - OB	
Cash Credit - CB	

Peak deficit is financed and drawings regulated by monthly budgets.

Advantages:

- Suitable for Seasonal Industries, Contractors and Software Exporters etc.

Limitations:

- Will not reflect changes in various Current Assets and Liabilities.
- It gives a clue whether a company is earning a profit or not.

Funds Flow statement is required to detect any diversion of Funds.

BIFURCATION OF LIMITS

Fund Based Limits

- Inventory : OCC/KCC/PC/COD/SOD
- Bills : CBP/DBP/SBP/FBP/CUBD/DUBD/FUBD
- Inventory Limit :
  A. Total Inventory
  B. Creditors
  C. Margin
  D. Paid Inventory (A-B)
  E. Inventory Limit (D-C)
- Bills/Book Debts Limit:
  A. Receivables/Sundry Debtors
  B. Margin
  C. Bills Limit (A-B)
- Loan Delivery System (FB – WC limits of 10 Crores and above from Banking System)
  Cash Credit : 20%
  Demand Loan : 80%

Loan Delivery System

- Objectives
- Loan Delivery System (FB – WC limits of 10 Crores and above from Banking System)
  Cash Credit : 20%

Demand Loan : 80%

- Domestic credit portion to be bifurcated into Loan Component and Cash Credit.
- Relaxation

Bill Finance - Post Sales Finance

(For Genuine Trade & Manufacturing Transactions)

A. DBPs : Bills of Exchange accompanied with,

B. I) Invoice and

ii) Documents of title of the Goods - LRS/RRS

C. DUBD : Invoice /LRS / RRS – Maximum Tenor of 180 days

D. CUBD : Bill of Exchange / Promissory Notes.

- Eligibility Carved out of MPBF

E. Export Bills : FBP/FUBD

- Security – Export Documents drawn against confirmed orders / LCs.

F. Book Debts Finance:

i. Service Industry/ Contractors

ii. Margin 50%

iii. Age not more than 90 days

iv. Collateral Security – 200% Urban/ Semi Urban Security.

Non Fund Based Limits

- Letter of credit

  ILC/FLC

  Usance/Sight

- Bank Guarantee

  Performance

  Financial – Bid Bonds/Security Deposits/ Mobilization advance/retention money

- Deferred Payment Guarantee

LC Assessment

1	Annual Purchase/ Imports	FLC/ILC
2	Out of (1) on Credit basis	
3	Out of (2) on usance LC basis	
4	Average of (3) per month	
5	Lead time (No. of months)	
6	Usance period (No. of Months)	
7	Usance LC requirement (5+6)x(4)	

Guidelines to be followed

- For constituents borrowers with regular sanctioned credit facilities for genuine transactions.
- LCs shall not be opened with clause without recourse to drawer.

Bank Guarantees:

- Performance and Financial Guarantees
  - Purpose / Difference

- Security: Cash Margin +Counter Guarantee +Collateral Security (Immovable / Liquid Security)
- Restrictive Clause.

Important Ratios

- Current Ratio (CA/CL)

  (Norm – 1.15 up to Rs.6 crores/1.33 for above)

- Adjusted Current Ratio

  (Reduce export bills discounted from BB & CA)

- Total debt equity (TOL/TNW)

  (Maximum Norm: 6)

- Gearing Ratio **(for NFB Limits)**

  Total outside Liabilities + 100% of NFB Limits / Net Worth – (NCA + Investments in associate concerns)

  Notes: TOL (excluding Sundry creditors representing stocks procured under LC/BG and Mobilisation advance outstanding against BGs)

  NW (excluding Intangible Assets)

  NCA (excluding advances given for capital goods for business purpose)

Exposure Norms for some Categories

Category	Ceiling on Borrowings
Construction Contractors	FB + NFB limits shall not exceed 15 times of Net Owned Funds
Housing Finance Institutions	Borrowings shall be restricted to 3 times the Net Owned Funds

CREDIT LIMITS FROM BANKS

The terms Fund based limits and Non fund based limits are used in connection with working capital requirements of a Company.

FUND BASED LIMITS

Fund based limits include those where actual funds are proposed to be given. Ex. Cash Credit Limits. In case of Non Fund based limits funds are not required directly. Ex. Bank Guarantee given by a bank in favour of a Company. Another example is Letter of Credit opened by banks.

In addition to these Corporate Companies also enjoy Standby Line of Credit.

NON FUND BASED LIMITS

Deferred payment Guarantees

- For acquisition of Capital goods (Plant & Machinery including Generators) where there is provision for Suppliers Credit by the Manufacturer/Supplier
- Terms of payment in tune with Credit extended by the manufacturer/Supplier
- Security: Primary security: 1st charge on fixed assets financed. Collateral security and Third party guarantee as per Bank policy.

Bank Guarantees

- Guarantees in lieu of Earnest money Deposit, Security Deposit, Bid Bonds, Advance payment, Performance, Retention money etc
- Depending upon nature of business requirement
- Margin, Security, Commission, period of guarantee as per Bank norms

Letters of Credit

- For purchase of Raw materials/inputs and Capital goods
- LC issued will be as per terms of suppliers of the goods/services
- Margin, Security, Commission shall be as per Bank norms