



# Module-C Unit-3

## CAIIB PAPER-1

### **Advanced Bank Management (ABM)**



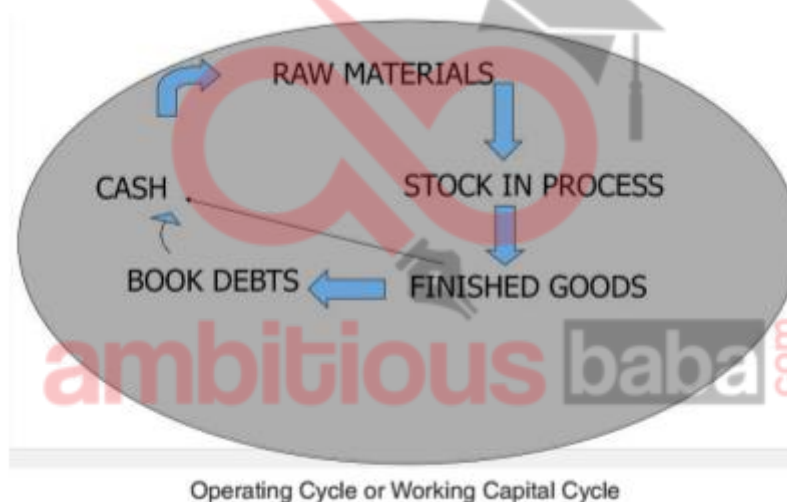
## CAIIB Paper 1 (ABM) Module C Unit 3: Working Capital Finance

### Working Capital

Whenever a **business enterprise is started**, some **fixed assets like office, furniture, machines/computers etc**, depending upon the **need, are acquired**. But this alone may **not be sufficient for running the business of that enterprise, except for a few activities like broking/commission agent**, etc. Most of the business enterprises, in the course of their business, have to carry some current assets like raw materials, finished goods, receivables etc. The money blocked in these current assets is **called working capital**.

### **Working Capital Cycle**

The **normal operations of a business enterprise consist of some or all of the actions like, purchase of raw materials, processing and conversion of raw materials into finished goods, selling these goods on cash/ credit basis**, receive cash on sale or end of credit period and again purchase raw materials. This is called **working capital cycle**. The length of this cycle depends on:



- The stocks of raw materials required to be held
- The work in process, which in turn depends on the process involved in manufacturing and processing the raw materials
- The credit required to be provided to the purchasers

### **Importance of Liquidity Ratios**

- **For a banker, providing working capital finance**, the liquidity ratios, specially the current ratio, play a very important role in assessment, sanctioning decision, and monitoring.
- The assessment involves stipulation of a minimum Net Working Capital (NWC) to be brought in by the enterprise from its long term sources. This results in a

minimum current ratio (more than one) which the bank wants the enterprise to maintain at all the times. This is, normally, mentioned in the terms and conditions of sanction and becomes an important tool for the bank to monitor the use of funds by the enterprise.

### **Method of Assessment of Bank Finance**

**Deciding on the level of Turnover of the Enterprise:** This is a very important step in any method of assessment of **working capital limits**. In case of existing enterprises, the past performance is used as a guide to make an assessment of this. In case of new enterprises, this is based on the production capacity, proposed market share, availability of raw materials, industry norm etc.

**Assessment of Gross or Total Working Capital:** This is the sum total of the assessment of various components of the working capital.

- Inventory
- Receivables and Bills
- Other Current Assets

**Sources for Meeting Working Capital Requirement:**

- Own Sources (N W C)
- Suppliers' Credit
- Other Current Liabilities like salaries payable, advances from customers, etc.
- Bank Finance

### **Calculation of Bank Finance**

Though **banks are now free to formulate their own policies, the methods of lending**, mentioned there, still find place in the calculations followed by the banks. **The methods are;**

- **First Method of Lending:** Under this, the enterprise was required to bring in at least 25 per cent of the working capital gap (total current assets minus total current liabilities excluding bank finance).
- **Second Method of Lending:** Under this, the enterprise was required to bring in at least 25 per cent of the total current assets.
- **Third Method of Lending:** Under this, the enterprise was required to bring in 100 per cent of those current assets which are considered 'core assets' and at least 25 per cent of the remaining current assets.

### **Cash Budget Method of Assessment**

Any economic activity, however small it may be, involves outflows (expenditure) of money for procurement of inputs and inflows of money (income) from the sale

of output The nature, amount and periodicity of outflows and inflows is peculiar to the type of activity, level of operations, market conditions and the policies adopted by the owners/managers etc.

**A normal statement / budget, will look as under:**

**Inflows**

1. Opening balance
2. Term loan from Bank
3. Sales (Total sales-credit sales + realization for earlier sales)
4. Other cash inflows

**Total inflows**

**Outflows**

1. Capital expenditure
2. R. M. Purchase
3. Labor
4. Power and fuel
5. Payment of Interest
6. Repayment of Term loan installment
7. Other cash outflows

**Total outflows**

**Cash surplus or (deficit)**

- Bank finance needed
- Closing balance

**Bills / Receivables Finance by the Banks**

**Receivables are part of the current assets of a business enterprise.** These arise due to sales on credit basis to the customers. The bank provides finance against these in a fashion similar to that for inventory.

**Another method of sales is through Bills of exchange drawn by the seller on the purchaser in the following manner;**

- If no credit is to be provided to the customer, a demand bill is drawn.
- If the credit is to be provided on the sales, a bill of exchange, called usance bill, mentioning the period of payment, is drawn on the purchaser and is accepted by him The outstanding amount is shown in the accounts as 'bills receivables'.

The **terms used in bills finance are purchase, discount and negotiation**. Normally, 'purchase' is used in case of demand bills, '**discount**' in case of usance bills and '**negotiation**' in case of bills which are drawn under letters of credit opened by the purchaser's bank.

### **Non-Fund-Based Working Capital Limits**

- Guarantees
- Co-acceptance of Bills
- Letters of Credit
- Commercial Paper (CP)
- Unsecured money market instrument
- Issued in the form of a promissory note
- Introduced in India in
- Cost of borrowing through CP is normally lower compared to other sources of short term finances

### **Guidelines of RBI for Discounting / Rediscounting of Bills by Banks**

- Banks may sanction working capital limits, as also bills limit, to borrowers after proper appraisal of their credit needs and in accordance with the loan policy as approved by their Board of Directors.
- Banks should open letters of credit (L Cs) and purchase / discount / negotiate bills under L Cs only in respect of genuine commercial and trade transactions of their borrower constituents who have been sanctioned regular credit facilities by the banks.
- If a beneficiary of the LC wants to discount the bills with the LC issuing bank itself, banks may discount bills drawn by beneficiary only if the bank has sanctioned regular fund-based credit facilities to the beneficiary.
- Bills purchased/discounted/negotiated under LC will be treated as an exposure on the LC issuing bank and not on the borrower.
- While purchasing / discounting / negotiating bills under LCs or otherwise, banks should establish genuineness of underlying transactions/documents.
- The practice of drawing bills of exchange claused 'without recourse' and issuing letters of credit bearing the legend 'without recourse' should be discouraged because such notations deprive the negotiating bank of the right of recourse it has against the drawer under the NI Act.
- Accommodation bills should not be purchased/discounted/negotiated by banks.

- Banks should be circumspect while discounting bills drawn by front finance companies set up by large industrial groups on other group companies.
- Bills rediscounts should be restricted to usance bills held by other banks.
- Banks may exercise their commercial judgment in discounting of bills of the services sector.

### **Letters of Credit**

The genesis a letter of credit lies in the fact that a seller of good is worried about receipt of money from the buyer if she supplies the goods first, and the buyer is worried about non receipt of contracted goods if she makes the payment first. The bank acts as an intermediary between the two by using its credibility, as it is acceptable to both buyer and the seller. Letter of Credit (LC) is an undertaking by the bank, at the request of the buyer (applicant, who is customer of the bank), to the seller, to pay her the contracted amount if she supplies the goods as per the terms specified and submits the required documents, including the documents of the title of the goods. The conduct of LC business is governed by the publication no. 600 of the International Chamber of Commerce (ICC), commonly known as UCPDC 600.

#### **Appraisal of LC Limit**

An LC is used for purchase of goods either through imports or local purchase. ***For assessing the LC requirement of an enterprise, we have to know the following:***

- Average Amount of Each LC: This is dependent on the monthly consumption of goods and the economic order quantity. Economic order quantity (EOQ) is estimated by examining the sources of supply, means of transport, discount, etc. In case of imports, the EOQ is often larger in comparison to indigenous purchases.
- Frequency of LC Opening: Once EOQ is estimated, the number of LCs to be opened in a year can be calculated by dividing annual consumption by EOQ. Frequency of opening LCs will be 12 divided by the number of LCs to be opened in a year.
- How many LCs will be outstanding at a particular time: The time taken for one LC to remain in force depends upon the lead time (time taken from the date of opening LC to shipment of goods), the transit time and the usance available to purchaser from the date of receipt of goods. If the frequency of opening LC is less than this, bank will have more than one LC outstanding at any point of time.

### **Other Issues Related To Working Capital Finance**

#### **Commercial Paper**

- Commercial Paper (CP), an unsecured money market instrument issued in the form of a promissory note, was introduced in India in 1990 with a view to enabling highly rated corporate borrowers to diversify their sources of short-term borrowings. Subsequently, primary dealers (PDs) and all-India financial

institutions (FIs) were also permitted to issue CP to enable them to meet their short-term funding requirements.

- A company would be eligible to issue CP provided its tangible net worth is not less than Rs. 4 crores, it has been sanctioned working capital limit by bank/s or FIs; and the account is classified as a Standard Asset by the financing bank/institution.
- The minimum credit rating for issuance of CP is 'A3' as per rating symbol and definition prescribed by **SEBI CP shall be issued for maturities between a minimum of 7 days and a maximum of up to one year** from the date of issue. The maturity date of the CP shall not go beyond the date up to which the credit rating of the issuer is valid.

### Factoring

- Method of financing the receivables of a **business enterprise**.
- The financier is called '**Factor**' and can be a financial institution.
- Banks are not permitted to do this business themselves but they can promote subsidiaries to do this. **Under factoring, the factor not only purchases the book debts/receivables of the client**, but may also control the credit given to the buyers and administer the sales ledger.
- The purchase of book debts/receivables can be with recourse or without recourse to the client.
- If without recourse, the client is not liable to pay to the factor in case of failure of the buyer to pay.

### Forfaiting

- This is similar to factoring but is used only in case of exports and where the sale is supported by **bills of exchange/promissory notes**.
- **The financier discounts the bills and collects the amount of the bill from the buyer on due dates**. Forfaiting is always without recourse to the client. Therefore, the exporter does not carry the risk of default by the buyer.
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