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Computation of Maximum Permissible Bank Finance for Working Capital

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Abstract - Current assets are generated along the pipeline of productive-distributive system of the enterprise. These gross current assets (GCA) capture fund, or in other words, they need financing. The first source of the financing is creditors. When creditors are deducted from GCA, what is left is purely called working capital gap (WCG) in Indian banking parlance. Funding of this gap comes from three sources viz. Bank Finance (BF), Short-term Finance (SF) and the long term fund of enterprises, known as margin or net working capital (NWC).

In India, banks would not like NWC to become zero or negative. They insist that the current ratio, which is an expression of NWC level of the enterprise, be positive. The banker views even a slip back in current ratio unfavorably. This ratio, which was invented by the bankers as far as back as 1890, continues to occupy the percentage in the credit appraisal system of any commercial bank in India. Liquidity of any businesses enterprise is still determined by current ratio, though notion of liquidity has substantial change in modern day financial management. Current assets are considered in the decreasing order of their liquidity or stability. Quick ratio, which is the more refined form of the current ratio, is calculated on the first three current assets, which according to ruling notion provide most liquidity to a business1. Inventories are considered to be the liquid among them. The above concept of the liquidity is found to be narrow, because it does not take into consideration total operations of the business. Generally speaking, the purpose of liquidity is to ensure smooth operation of the business.

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INTRODUCTION

Liquidity is viewed as something that can remove the bottleneck in the respective functions of financial manager. The manufacturing managers on the shop floor and the marketing mangers at various distribution points do not have use of much use for cash or for that matter, any other current assets, except inventories, to maintain continuity of their respective operations. A firm may have plenty of cash in the bank, but if there is a shortage of the material in the market the any amount of the cash will not able to provide liquidity to manufacturing managers. Production will stop and consequently, the line of distribution will also come to halt for want of finished goods. The firm as well as a whole will suffer from a dearth of the liquidity, which incidentally, is not due to absence of the cash but of inventories. Since the focus of liquidity management is maintenance of smooth flow of inventories, a finance manager faces a financial bottleneck when he does not have money to acquire inventories. There may be large quantities of the materials available at the market, but if the firm does not have enough cash, then in the ultimate analysis, the problem lies in the financial structure or more particularly in the working capital. It is noted that the firm has a zero NWC and the current ratio is just 1. That is, the firm has financed all the current assets from trade creditors. The policy, which has given rise to such a working capital structure of the firm, is neither usual nor unreasonable. The important requirements of such a policy are creditworthiness with suppliers, moderate command over them, and strict collection and monitoring system are receivables.

But in India, such a balance sheet would not be acceptable by a commercial bank if the firm desires to seek loan for any expansion or diversification, where similar working capital structure may not be feasible to continue. The reasons ascribed by the banks are that, the browser must have its own stake in every assets that are financed and that, all the firms which come for bank finance do not have the kind of market command envisaged in the above example, hence they must have some elbow-room in the form of NWC to fall back upon the creditors in time including the bank.

The principle behind the balance sheet in figure is that, long-term fund of an enterprise should not only finance the whole of fixed assets, but leave something towards financing current assets also, which is nothing but NWC or margin as indicated by the underlined box on the right hand side of the balance sheet. If we look at the balance sheet from the bottom we find that NWC is nothing but the positive difference between current assets and current liabilities including bank finance.

RELATIVE FINANCE LIQUIDITY

Relative finance liquidity is measured by short term borrowings to total borrowings ratio. In the total borrowings of company, if company has higher proportion of short term borrowings, it can improve on its profitability aspects as short term borrowings are less costly and more flexible compare to long term borrowings but at the same time company has risk of renewing borrowings again and again. On the other hand more use of long term borrowings reduced the risk of renewing but it can adversely affect on profitability as long term borrowings are more costly and less flexible.

Cement Industry on aggregate basis has on an average 930.47% of short term borrowings in their total borrowings. This shows that its short term assets are finance by long term borrowings which is conservative working capital financing policy. The mean short term borrowings to total borrowings ratio range from 306.41% to 1509.07% for all the companies.

LIQUIDITY VS PROFITABILITY

Companies like A C C Ltd., Ambuja Cements Ltd, and Birla Corporation Ltd.and Gujarat Sidhee Cement Ltd. Mangalam Cement Ltd.and Prism Cement Ltd with very high SB to TB ratio have comparatively very high Return (PAT) on total assets. This is because of use of short term finance which is flexible and less costly. On the contrary companies like Binani Cement Ltd., Birla Corporation Ltd, K C P Ltd., O C L India Ltd, and Mangalam Cement have very high SB to TB ratio means high level of long term borrowings which is less flexible and more costly results into low profitability in terms of low Return (PAT) on total assets. A C C Ltd. has a declining trend in the short term borrowings to total borrowings ratio. In the year 2003-04, it was 3.09%, which declines gradually to 0.00% in 2008-09. This shows it has increased long term borrowings proportion in the total borrowings and enhanced its liquidity position. The company has not gained liquidity as the cost of profitability as its return on total assets ratio has also improved during the said period. It had profit of 10.78% in 2003-04, which increased and in the 2008-09, it has reported 23.6% of return on total assets. Ambuja Cements Ltd. has only 0% to 0.09% of short term borrowings in the initial two years of study. It had highly relied upon long term borrowings to have more liquidity but its return on total assets ratio was positive showings the gain. Then for subsequent three years, it had raised the proportion of short term borrowings and reduced its liquidity that helped it in more increasing their gain also. Andhra Cements Ltd has short term borrowings in the range of 20.75% to 6.14% over a period of six years of study. Its profitability ratio is negative were rising up to 2003-04 but in subsequent years it increased to around -5.47% to 12.99%.Binani Cement Ltd. had declined its short term borrowings proportion from 6.27% in 2003-04 to 25.36% in 2008-09. It has reduced its liquidity but it has gained on its profitability and its profitability ratio has turned out to positive figure during the study period. Birla Corporation Ltd has mixed trend in the SB to TB ratio. In the initial three years of study, it shows rising trend but in subsequent years it declined and it increased the use of long term borrowings. Its profitability aspect shows that it has declined its losses on total assets ratio over a period of six years. Overall it had benefited on the aspects i.e. increase in liquidity and profitability. Century Textiles & Inds. Ltd. has reduced its short term borrowings proportion from 38.48% to 18.52 % in last six years. The rising trend of its long term borrowings has resulted in to more favourable impact on its profitability the last five years.

Dalmia Cement (Bharat) Ltd. has downward trend in short term borrowings to total borrowings ratio. It shows that company is becoming very aggressive and increasing its short term fund, which help it in improving its profitability. From the profit ratio of 9.35% in 2003-04, it had converted in to profit on total assets of 11.06% in 2008-09.Gujarat Sidhee Cement Ltd.has declined its short term borrowings proportion in the total borrowings and increased long term borrowings. It has increased its liquidity but it had much suffered in terms of profitability. Heidelberg Cement India Ltd.. has 16.4% of short term bank borrowings to total borrowings ratio in Heidelberg Cement India Ltd., in the same year, its return on total assets ratio was 15.64%. In the year 1999-2000, its short-term borrowings to total borrowings ratio has increased to 7.41% expecting rise in profitability but its profitability was reduced to -1.01% in terms of return on total assets.

In the subsequent year 2003-04, it has reduced its short term borrowings to just 5.27% of total borrowings and its return on total assets ratio has shown a little rise and became 12.87% so it is very contrary behaviour of said variables not generating expected result. This is because of other economic and market related variables. India Cements Ltd. has downward trend in the proportion of short-term borrowings in the total borrowings. The increase in long-term borrowings that is very costly leads to decline in profitability. In 2003-04, it had gain of 2.01% of its total assets that increase to the level of 12.51% in the year 2008-09 but in subsequent year company enables to incline them. India Cements Ltd. has shown mixed trend in short-term borrowings to total borrowings ratio. In the initial years, SB to TB ratio was declining but in subsequent years it has upward trend. The profitability of India Cements has downward trend reporting loss of 10.51% of return on total assets in the year 2002-03.J K Lakshmi Cement Ltd. has shown mixed trend in short-term borrowings to total borrowings ratio. In the initial years, SB to TB ratio was declining but in subsequent years it has upward trend. The profitability of India Cements has downward trend reporting gain of 18.44% of return on total assets in the year 2008-09.

SOURCES OF WORKING CAPITAL FINANCE – CURRENT PRACTICES

Executives are asked to fill up the attached questionnaire with a view to examining the practices followed by cement manufacturing companies under study. All the companies under the study use the combination of short term and long term funds for the working capital finance. Seven companies named A C C Ltd, Gujarat Sidhee Cement Ltd, J K Lakshmi Cement Ltd, Mangalam Cement Ltd, O C L India Ltd and Madras Cements Ltd have 75:25 ratio of short term to long term finance for the working capital purpose. Six companies named Shree Digvijay Cement Co. Ltd, Madras Cements Ltd, Birla Corporation Ltd, Binani Cement Ltd, and Dalmia Cement (Bharat) Ltd. companies have 80:20 ratio of short term to long term funds. Andhra Cements Ltd, Heidelberg Cement India Ltd, N C L Industries Ltd and J K Lakshmi Cement Ltd have the said ratio of 60:40.Mangalam Cement Ltd and Binani Cement Ltd has 70:30 of said ratio for working capital finance. All the companies are using trade credit and bank borrowings as first preference for current assets financing. Some of the companies are using Commercial Paper, Public Deposits and Factoring for the short term finance. Andhra, ACC, Birla, Century, Mangalam Cement Ltd. and J K Lakshmi Cement Ltd use Bill Discounting in the form of bank finance along with Cash credit and working capital loan. Working capital loan is very popular form of bank finance. Executives were asked to state the problems in getting the bank finance. Very common and frequent problem is Lot of paper work and delay in sanction of loan amount. All the companies are satisfied with norms of Raw-material and work in process given by Tandon committee but they were not satisfied with norms of finished goods and debtors. 4 weeks period was very less. They also preferred first method of determining maximum permissible bank finance. A C C Ltd., Ambuja Cements Ltd. and Ultratech Cement Ltd. are using mixture of short term and long term finance for the working capital requirements. The proportion of short term finance to long term finance is 75:25.These companies generally prefer cash credit and working capital loan in form of bank finance. Andhra Cement has 80:20 ratio of short term finance to long term finance for the working capital requirement. It has raised fund through trade credit, bank borrowings and public deposits. It uses all the forms of bank finance to raise the working capital fund.

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