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WORKING CAPITAL ASSESSMENT (INCLUDING FACTORING, BILL FINANCING)

CCP CHAPTER 13B PART 1

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🏦 What is Working Capital?

✓ Working capital is the **amount of money** a business has available **for its daily operations**.

✓It is calculated as the difference between current and current liabilities.

✓ It represents the **short-term financial resources** needed to run a company **on a going concern basis**.

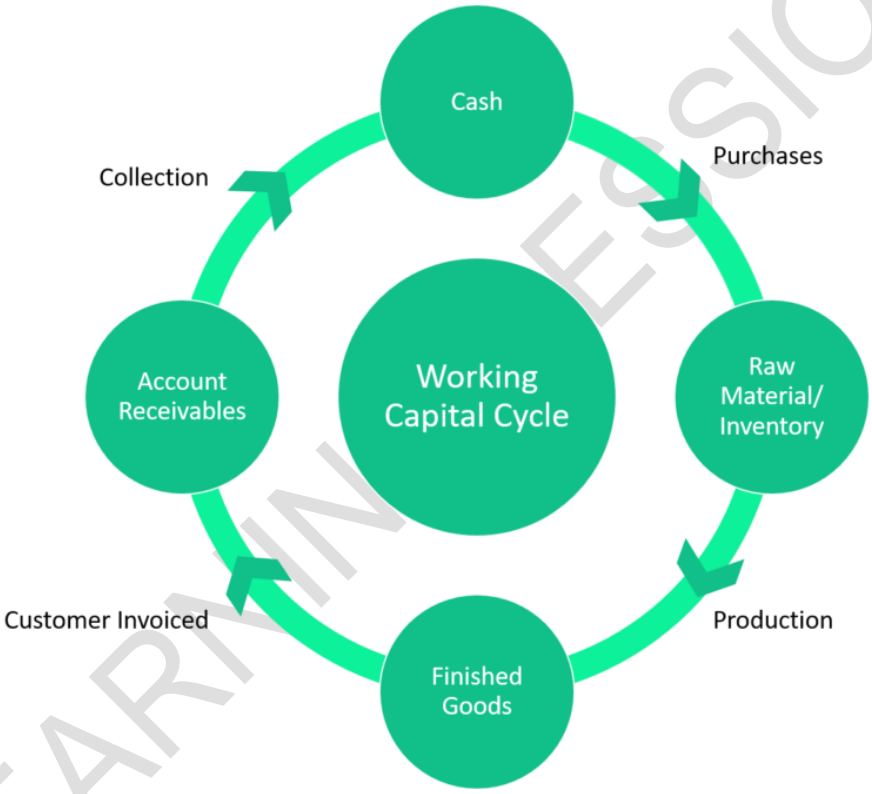
✓ Effective **working capital management** ensures smooth operations by maintaining a balance between **current assets and current liabilities**.

📌 Long-Term vs. Short-Term Financial Management

Aspect 📊	**Long-Term Financial Management** ⏳	**Working Capital Management** 🔄
Focus 🎯	Investments in **fixed assets** (e.g., land, machinery, buildings).	Managing **current assets & liabilities** (e.g., inventory, receivables, payables).
Timeframe ⏳	More than **1 year**.	Typically **within the**

		operating cycle.
Cash Flow Management 💰	Concerned with **capital structure, debt issuance, and long-term investments**.	Ensures **short-term liquidity & operational efficiency**.

🔄 Working Capital Cycle: Flow of Funds



1 **Cash → Raw Materials** 🎯

2 **Raw Materials → Work in Progress (WIP)** 🏭

3 **WIP → Finished Goods** 🏗️

4 **Finished Goods → Accounts Receivable (on credit sales)** 📄

5 **Accounts Receivable → Cash** 💰

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📌 13.2 Types of Business Capital

📌 Capital Requirements in a Business Can Be Categorized As:

Type of Capital 🏛	Definition 📜	Examples ☑
Fixed Capital 🏗	Funds invested in **long-term assets**.	Land, buildings, machinery, furniture.
Working Capital 🔄	Funds required for **daily operations**.	Raw materials, wages, electricity, rent.

📌 13.3 Concepts of Working Capital

There are **two main concepts** of working capital:

1 Gross Working Capital (GWC)

✓ The total **capital invested in current assets**.

✓ Includes **cash, inventory, receivables, and other short-term assets**.

📌 Key Benefits:

✓ Helps in **providing the correct amount of working capital at the right time**.

✓ Enables management to track **total investment in current assets**.

2 Net Working Capital (NWC)

✓ **Net Working Capital (NWC) = Current Assets – Current Liabilities**.

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✓ Indicates the **liquidity surplus** available for daily operations.

📌 NWC Interpretation:

NWC Value 📊	Interpretation 📜
Positive NWC ✅	Current assets **exceed** current liabilities – indicating **strong liquidity**.
Negative NWC ❌	Current liabilities **exceed** current assets – signaling **liquidity constraints**.
Ideal Ratio 📉	**NWC should be >1:1** to ensure smooth operations.

📌 Importance of Net Working Capital (NWC)

📌 Why is NWC Important?

✓ **Ensures liquidity** – Helps the firm **meet its short-term obligations**.

✓ **Provides a cushion for financial shocks** – Reduces dependence on short-term loans.

✓ **Improves creditworthiness** – A healthy NWC **boosts investor & lender confidence**.

📌 Key Indicators of Effective NWC Management:

✓ **Quick Turnover of Inventory** 📦 – Ensuring **optimal stock levels**.

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✓ **Faster Receivables Collection** 💰 – Reducing **delayed payments**.

✓ **Managing Payables Efficiently** 📝 – Extending payment terms without affecting supplier relationships.

📌 **Strategies for Effective NWC Management**

1 Optimize Inventory Management 📦

📌 **Why?**

✓ Holding too much inventory **ties up cash** 💰.

✓ Holding too little **risks stock shortages & lost sales**.

📌 **Strategy:**

✓ Implement **Just-in-Time (JIT) inventory management**.

✓ Use **demand forecasting** to optimize stock levels.

2 Improve Accounts Receivable Collection 💰

📌 **Why?**

✓ Delayed payments **increase financial strain** 📉.

✓ Speeding up receivables **improves cash flow**.

📌 **Strategy:**

✓ Offer **early payment discounts** 📉.

✓ Establish **clear credit policies** for customers.

✓ Implement **receivables sales & financing programs**.

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3 Manage Accounts Payable Efficiently 📝

📌 **Why?**

✓ Delaying payments **improves cash flow**, but **late payments can hurt supplier relationships**.

📌 **Strategy:**

✓ **Negotiate longer payment terms** with suppliers.

✓ Use **vendor financing & dynamic discounting programs**.

4 Leverage Data & Analytics 📊

📌 **Why?**

✓ Data-driven decisions **enhance cash flow optimization**.

📌 **Strategy:**

✓ Use **AI-powered analytics tools** to predict working capital needs.

✓ Monitor **real-time cash flow trends**.

5 Ensure Sustainability in Working Capital 🌱

📌 **Why?**

✓ Sustainable finance improves **business continuity**.

📌 **Strategy:**

✓ Align **working capital policies with ESG (Environmental, Social, Governance) criteria**.

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✓ **Optimize cash conversion cycle** for **long-term sustainability**.

📌 13.4 Working Capital Gap (WCG)

🏦 What is Working Capital Gap (WCG)?

✓ **Working Capital Gap (WCG)** is the **excess of total current assets over trade creditors and other current liabilities**, excluding **bank borrowings**.

✓ It was initially introduced in **Indian banking** following the **Tandon Committee reforms** and later adopted in other countries.

✓ **WCG is primarily funded by:**

- **Net Working Capital (NWC)** term uses.
- **Bank borrowings** – If NWC is insufficient.

🔍 Example Calculation of Working Capital Gap

Current Assets	Amount	Current Liabilities (excluding bank finance)	Amount
Inventory	200,000	Accounts Payable	80,000
Accounts Receivable	100,000	Other Current Liabilities	20,000
Other Current Assets	50,000	Total Current Liabilities (excluding bank finance)	100,000

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Total Current Assets	350,000		

📌 13.5 Components of Working Capital

📌 Working capital includes the following current assets:

Component 🏛️	Description 📝
1 Raw Materials	Essential inputs for production.
2 Work-in-Progress (WIP)	Semi-finished goods under production.
3 Finished Goods 📦	Ready-to-sell products in stores & transit.
4 Consumable Stores 🏭	Indirect production materials (e.g., lubricants, spare parts).
5 Trade Receivables / Debtors 📜	Outstanding payments from customers.
6 Cash & Bank Balances 💰	Liquid assets available for immediate use.
7 Other Current Assets 📊	Includes **prepaid expenses, advances to suppliers, etc.**

🏦 How Banks Finance Working Capital Gap?

🔹 Banks extend **"need-based financial assistance"** to cover the WCG.

🔹 **Why?** To **avoid fund diversion** and **ensure just-in-time**

financing.

🔹 **Risk: Inadequate financing** can lead to **production disruptions & business failure** 📉.

📌 **Factors Influencing Working Capital Requirements**

1 Nature of Business 🏢

📌 **Different businesses require different levels of working capital:**

Business Type 🏛️	Working Capital Needs 🔍	Why? 🤯
Public Utilities (Water, Electricity, Railways) ⚡🚆	**Low** ⬇️	Services are sold **on cash basis**, and **no inventory is held**.
Manufacturers 🏭	**Medium to High** 📊	Requires **investment in raw materials, WIP, finished goods, & receivables**.
Traders & Retailers 🛒	**High** 📈	Need large inventories & credit facilities for customers.

2 Size of Business 📈

✓ **Larger businesses require higher working capital** to support **larger-scale operations**.

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3 Production Policy

📌 **Impact of Production Strategy on Working Capital:**

Production Policy ⚙	Working Capital Impact
Steady Production (Even in Off-Peak Season)	Requires **larger working capital** to **hold excess inventory**.
Seasonal Production	Requires **flexible working capital** that adjusts to demand fluctuations.

4 Seasonal Variations

✓ **More working capital is needed during peak seasons** due to **higher demand & inventory buildup**.

5 Operating / Working Capital Cycle

✓ The time taken to **convert raw materials into cash** through sales.

📌 **Impact of Operating Cycle on Working Capital:**

Cycle Duration	Working Capital Requirement
Short Cycle (Fast Cash Conversion)	Lower working capital needs.
Long Cycle (Slow Cash Conversion)	Higher working capital needs.

📌 **13.6 Sources of Working Capital**

How is Working Capital Financed?

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📌 **Sources of working capital financing can be categorized as:**

Source 💰	Description 📝	Impact on Business 📊
Trade Payables (Credit from Suppliers) 📜	Working capital financing through **credit purchases** of raw materials & services.	✅ **Cost-effective** source of financing.
Net Working Capital (NWC) 🔄	Surplus of **long-term funds over long-term uses**.	✅ **Indicates financial stability**.
Institutional Borrowings (Banks/NBFCs) 🏦	Loans & credit facilities **specifically for working capital needs**.	✅ Flexible financing; ❌ Requires repayment with interest.
Short-Term Borrowings (ICDs, Unsecured Loans) ⚠️	Emergency financing from **friends, relatives, or inter-corporate deposits (ICDs)**.	❌ **Risky & expensive**; Used as a **last resort**.

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📌 **13.7 Operating / Working Capital Cycle**

🔄 **What is the Working Capital Cycle?**

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✓ The working capital cycle represents **the time taken to convert raw materials into cash** from sales proceeds.

✓ It includes **raw material procurement, production, sales, and payment realization**.

✓ A longer cycle **increases working capital needs**, while a shorter cycle **improves liquidity**.

📌 **Key Stages of the Working Capital Cycle:**

1 **Purchase of Raw Materials** 🛒

2 **Processing into Work-in-Progress (WIP)** 🏭

3 **Completion as Finished Goods** 📦

4 **Sales (Credit Sales Lead to Receivables)** 📃

5 **Cash Realization from Receivables** 💰

📜 **Definition Under Companies Act, 2013**

📌 **Operating Cycle is defined as:**

"The time between the **acquisition of assets for processing** and their **realization in cash or cash equivalents**."

✓ If the cycle duration is **not clearly identifiable**, it is **assumed to be 12 months**.

📌 **Key Learning:**

✓ **Businesses with longer cycles require higher working capital** 📉.

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✓ **Faster cycles improve cash flow & reduce borrowing needs** 📈.

📌 13.7.1 Formula for Operating Cycle Calculation

🔢 Operating Cycle Formula

Operating Cycle=Inventory Conversion Period+ Receivable Realization Period

To be more accurate, we may calculate the inventory holding period as the **sum of the holding periods of each of the components**, viz. the raw materials, WIP and finished goods.

📌 Breakdown of the Components:

Method 1

1 **Inventory Conversion Period** 📦

$$\text{Inventory Conversion Period} = \frac{\text{Average Inventory Held}}{\text{Cost of Sales}/365}$$

Method 2

2 **Raw Material Holding Period** 🏭

$$\text{Raw Material Holding Period} = \frac{\text{Avg. Raw Material Stock}}{\text{Annual Raw Material Consumption}/365}$$

3 **Work-in-Progress (WIP) Holding Period** 🔄

$$\text{WIP Holding Period} = \frac{\text{Avg. WIP Stock}}{\text{Cost of Production}/365}$$

4 **Finished Goods Holding Period** 📦

$$\text{FG Holding Period} = \frac{\text{Avg. Finished Goods Stock}}{\text{Annual Cost of Sales}/365}$$

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5 **Receivables Holding Period** 💰

$$\text{Receivable Holding Period} = \frac{\text{Avg. Receivables}}{\text{Annual Sales}/365}$$

📌 Why is the Operating Cycle Important?

Benefit ☑	Description 📊
1 Identifies Cash Flow Efficiency 💰	Measures the time taken to **convert raw materials into cash**.
2 Helps in Financial Planning 📄	Determines the **exact amount of working capital required**.
3 Improves Liquidity Management 💳	Optimizes **inventory, receivables, and payables**.
4 Enables Seasonal Adjustments 🌦	Helps plan **working capital needs for peak & off-season cycles**.
5 Enhances Profitability 📈	Reduces **dependence on external borrowings**.

📌 13.8 Assessment of Working Capital Requirements

🏦 How is Working Capital Requirement Assessed?

✓ The Indian banking system has moved towards **greater operational freedom** in assessing working capital requirements.

✓ The **Mandatory Maximum Permissible Bank Finance (MPBF)** framework from the **Tandon Committee** is no longer compulsory.

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✓ **Banks now have the flexibility** to develop their own methods within **prudential guidelines**.

📌 **Key Methods Used by Banks:**

Method 🏦	Applicability 📊	Key Features ☑️
1 Operating Cycle Method 🔄	Small businesses	Calculates working capital based on **number of operating cycles in a year**.
2 Traditional Method 📊	Medium & large enterprises	Uses a **scientific approach** to assess each component of working capital.
3 Projected Annual Turnover (PAT) Method 📈	MSEs (Micro & Small Enterprises)	**Working capital = 25% of projected annual turnover**.
4 Tandon Committee Methods (MPBF) 📜	Large industries	Earlier method, still used by some banks for detailed assessment.
5 Assessed Bank Finance (ABF) Method 🏛️	Corporate borrowers	Involves **risk-based assessment of working capital**.
6 Cash Budget Method 💰	Seasonal businesses	**Working capital is computed based on**

		cash flow projections.

📌 13.8.1 Operating Cycle Method

📌 What is it?

✓ **Simple method** for assessing **working capital needs**.

✓ Used primarily for **small businesses** & **working capital limits for micro enterprises**.

✓ The **total annual operating expenses** are divided by the **number of operating cycles per year**.

$$\text{Working Capital Requirement} = \frac{\text{Total Annual Operating Expenses}}{\text{Number of Operating Cycles}}$$

📌 Example Calculation:

Component	Days Required
Raw Material Stocking	**60 days**
Processing Time	**10 days**
Finished Goods Holding	**20 days**
Receivable Collection Period	**30 days**
📌 If Total Operating Expenses = ₹30 lakh	

📌 Total Operating Cycle Length:

60+10+20+30=120 days60 + 10 + 20 + 30 = 120

📌 Number of Operating Cycles Per Year:

Number of cycles per year = **360 ÷ 120 = 3**

📌 **If Total Operating Expenses = ₹30 lakh:**

If **Total Operating Expenses = 30 ÷ 3 + 10**

📌 **13.8.2 Traditional Method**

📌 **Why is this used?**

✓ A more **scientific approach** than the **Operating Cycle Method**.

✓ Used for **medium to large enterprises**.

✓ Requires detailed calculations of **each working capital component**.

Formula:

$$\text{Working Capital Requirement} = \sum(\text{Holding Period} \times \text{Average Cost Per Day})$$

📌 **13.8.3 Projected Annual Turnover (PAT) Method (Nayak Committee Method)**

📌 **Applicability:**

✓ **Micro & Small Enterprises (MSEs)** with working capital limits **up to ₹5 crore**.

✓ **Banks finance 20% of the projected annual turnover**.

✓ **Borrower contributes 5% as Net Working Capital (NWC)**.

📌 **Formula:**

Component	Calculation	Amount (₹ Lakh)

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Projected Turnover	Given	**₹300 lakh**
Working Capital Required	300×25%	**₹75 lakh**
Bank Finance (80%)	300×20%	**₹60 lakh**
Borrower's Contribution (20%)	300×5%	**₹15 lakh**

📌 **Post-Demonetization Relaxations in PAT Method**

📌 **Revised working capital assessment for digital transactions:**

Digital Transactions (%) 📊	Working Capital % of Turnover	Bank Finance (%)	Margin Requirement (%)
>25% turnover digital 💳	**37.50%**	**30%**	**7.50%**
<25% turnover digital 📜	**31.25%**	**25%**	**6.25%**

📌 🔍 **Final Summary Table: Working Capital Assessment Methods**

Method 🏦	Used For 📊	Formula 🧮	Key Features ☑️
Operating Cycle Method 🔄	Small businesses	**Operating Expenses / Number of Cycles**	Simplest method; based on production cycle.

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Traditional Method 📊	Medium to large enterprises	**Summation of individual working capital components**	More scientific, precise.
Projected Annual Turnover (PAT) Method 📈	MSMEs (₹5 crore limit)	**Turnover × 25%**	Bank finances **20% of projected turnover**.
Tandon Committee (MPBF) Method 📜	Large industries	**MPBF Norms**	Earlier RBI standard, still used by some banks.
Assessed Bank Finance (ABF) Method 🏦	Corporate borrowers	**Risk-based working capital assessment**	Focuses on **financial stability**.
Cash Budget Method 💰	Seasonal businesses	**Cash flow-based estimation**	Best for **fluctuating working capital needs**.

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