UNIT 23

APPRAISAL AND ASSESEMENT OF CREDIT FACILITIES

STRUCTURE

23.0 OBJECTIVES

After studying this Unit, you will:

- Understand the concept of Credit Appraisal
- Know about the components of credit appraisal
- Learn the modalities of credit appraisal
- Understand the credit assessment activity
- Learn the techniques of credit assessment

23.1 INTRODUCTION

Credit is a loan or a debt of whatever form sanctioned by a bank to its customer. The word appraisal is synonymous with assessment, evaluation, judgment, review and consideration. Credit Appraisal is the process by which the lender asses the credit worthiness of the borrower. The process revolves around character, collateral capability and capacity, etc. It takes into account various factors like income of the applicants, number of dependents, monthly expenditure, repayment capacity, employment history, number of years of service and other factors which affect credit rating of the borrower. In the unit we shall discuss the process in brief to be carried out while appraising any credit proposal.

23.2 CREDIT APPRAISAL

Credit appraisal is a process of critical evaluation of a loan request by a prospective borrower. The primary objective of evaluation is safety and liquidity of funds lent and profitability from the credit extended. The lender uses certain standard tools like analysis of the borrower's financial statements, weighing the prospects of the applicant's product in the market juxtaposed to the industry, viability of customers business and if the credit will remain as a performing asset. In this connection appraisal means something more than the verification and validation of the data and information that the applicant submits to the bank. An appraisal is undertaken for ensuring that a credit is good.

What is good credit? For convenience sake let us define a 'good credit' is one which is not a Non-Performing Asset. An account will not be a NPA if repayments in the account are regular (not overdue), the interest payments are in time and regular, the account is not over drawn and the funds are used for the intended purposes. If the objective of appraisal is 'good credit' then it should focus on evaluating the proposal to see if the above conditions are feasible and if the proponent or the borrower has the skill and inclination to keep the credit 'good'.

The essence of credit appraisal is that it measures the risk inherent in the proposal and comes to judgment to sanction or reject the proposal based on the assessment of the information, the applicant and the project. Credit appraisal which was mostly a matter of judgment some years ago has undergone changes in two dimensions. One, it has become credit risk appraisal rather than credit appraisal in that the emphasis has shifted from a subjective evaluation of the quality of credit to appraising the risk inherent in the proposal and if the proposal will be acceptable given the risk appetite of the lender. Second, the appraisalor measurement of the quality of the credit and risk has become more objective than judgmental.

23.3 CREDIT APPRAISAL TECHNIQUES

Credit appraisal is a continuous process that starts when an applicant walks into the branch and that culminates in credit delivery. Verification and validation are necessary to check out the facts. The essence

of credit appraisal is that it measures the risk inherent in the proposal and comes to a judgment to sanction or reject the proposal based on the assessment.

23.3.1 Validation of Proposal

In credit appraisal, beginning means not only getting all the facts right, but also getting all the facts, information and data before getting them right. Information should be well defined and it is important to ask for information that is essential for decision making. Bank should be able to distinguish between relevant and irrelevant pieces of information. An information overload is not a real help in decision making and often derails appraisal process. This involves several measures:

(i) Information provided by the applicant is verified with the supporting documents, where possible. For instance in case of a company the information about its incorporation, the powers of the company and its management can be verified from its certificate of incorporation and the memorandum of articles. Similarly, its financial details can be verified through its financial statements.

(ii) Another important modality is field verification. This requires visiting the factory and/ or office of the applicant. The objective is to verify the status of the activities of the applicant – both in respect of its nature and also its level. It is also an opportunity to learn about the management skills of the applicant or the quality of management of the enterprise.

(iii) Also, important part of validation process is verifying all the required approvals and licenses both on record and on display at the premises.

(iv) Another hygiene factor is the applicant's capacity to borrow. The banker must be sure that the person requesting credit has the authority to request a loan and the legal capacity to sign a loan agreement. For example, in case of a company a resolution of the Board of Directors would establish the authority to borrow.

23.3.2 Credit Risk

Credit risk is defined as the possibility of borrower/counterparty default. Default can occur because of business failure or because the borrower's wilful actions. The latter is a question of integrity of the borrower. While in the past lenders relied on market reports (credit reports from bankers and others) to take a call on this issue, the present day lenders rely on credit reports for individual borrowers and credit rating of companies/firms by the rating agencies and their own credit rating.

A default event can be triggered by external, internal or a combination of both external and internal factors. Internal to the firm (borrower) are issues such as inefficient management, bad financial decisions, marketing failures etc. The lender assesses the quality of management by looking at the composition of the promoters, Board of Directors, experience of the Directors in the industry, the CEO's experience and expertise in the industry and other key technical and managerial personnel. Poor financial management could be caused by poor cash flow management and bad collections. At times less than optimal financial assistance by the lender or over financing could all lead to problems.

23.3.3 Credit Risk Rating

Credit risk rating or credit rating is one of the credit appraisal tools. In this method credit risk is assessed in the form rating by assigning marks to different parameters and evaluating on the basis of some threshold preset standards/marks. A credit risk rating model assigns grades/marks to known risk components. Each risk component is assigned weights relative to the importance of the item in arriving at a credit risk score for the borrower. The borrower's financial standing and performance are rated for scoring. Additionally the management, quality of maintenance of accounts and similar factors that do not lend themselves to statistical measurements are also rated.

23.3.4 Criteria for Decision

The credit decision for sanction or rejection of a proposal basically is based on:

(i) Credit rating score of the applicant and is a primary criteria for decision making. If the credit rating score is below the cutoff point stipulated by the management of the lending bank the credit proposal will not be taken up for further processing.

(ii) The lender will also check if the purpose of the loan fits in with the credit policy of the bank and the proposed activity of the borrower is not on the banned or restricted list of the lending bank.

(iii) The lender will also need to check if the sanction of the loan will breach any of the concentration limits prescribed by the bank in respect of group, industry or limit for individual exposure.

The proposal would be rejected if it does not pass any one of these tests.

23.3.5 Aspects of Appraisal (7 C's)

There are four cardinal parameters of lending. These are as follows:

(a) Evaluation of creditworthiness of the borrower,
(b) Considering the purpose of the loan,
(c) Verifying the cash flows and source of repayment, and
(d) Assessing the security/collateral security.

For satisfying these parameters holistically, it is important to look into following aspects:
Creditworthiness, Character, Capacity, Capital, Collateral, Conditions, and Cash flows.
These are called as 7 C's of appraisal.

(i) *Evaluation of Creditworthiness:* The first thing that a lender would look at is the applicant's creditworthiness. If the applicant is an individual applying for a personal loan or home loan, his/her credit history is checked up with credit information reports provided by Credit Information Companies like CIBIL. The lender will also perform the due diligence exercise and examine the individual's character capacity etc. through market enquiries, In case of partnership concerns, Private Limited and Public Limited companies, the financial soundness is assessed from their financial statements. Cross verification of data can be made, among other things, by undertaking discrete enquiries/search in CERSAI records, ROC, RBI defaulters' list, CRILC etc.

Repayment of loan depends not only on the intentions but also on the ability to pay. Thus the financial condition of the borrower is evaluated based on the income and net worth in case of an individual. In case of businesses, however, their past financial statements are analysed.

Till about 1990, bank credit was considered a scarce commodity and, therefore, there was a strong focus on the need to optimally use this resource towards the creation of primary assets, which are known as primary security charged in favour of the lending bank. With gradual liberalisation, commercial banks have begun providing credit to other sectors and even for those commodities which are not in the manufacturing sectors. In the monetary policy of 1997-98, RBI declared the MPBF method as optional and suggested that commercial banks may evolve their own rational methods for financing. RBI suggested 'Cash Budget' method as an alternative option. Due to non-performing asset norms, credit appraisal techniques are increasingly focused on the assessment of repayment capacity of the borrowers, which in turn depends on their cash generating ability.

(ii) *Purpose of the Loan:* Purpose of establishing a business enterprise may differ. Purpose is different from the line of business. A person may start business for making it prosperous and selling it to

someone else and make venture profit. Another person may start a business with a long term interest in it and grow it. People may be interested in starting a business induced by the success of other persons. Clearly, the first two are business strategies whereas the last one is rather speculative. For all the three purposes whether the proponent has the core competency for the given line of business will be a pointer towards success.

Business related loans are required for different purposes, depending on the circumstances and the stages of the business. For starting or expanding a business enterprise capital investment is required for acquiring land/ building, plant and machinery, etc. The entrepreneur at this stage needs funds for long term investment. For running a business, funds are required for purchase of raw material/ goods and other consumable goods and services, payments for labour and staff, other working expenses, and for extending credit to the buyers. Thus, for running the business the entrepreneur needs loan for meeting the working capital requirements. The banker must be convinced that the customer has a well-defined purpose for requesting credit and a serious intention to be in business.

Individuals also need loans for meeting different types of requirements arising during their lifetime. Category of requirements include loans for marriage, major illness and education. These are high expenditure events and often loans are required to meet these requirements. Another purpose is to acquire a house, for which individuals require loans that facilitates persons to leverage their savings potential for this purpose. Lastly, in today's times individuals aspire to acquire consumer durables and lifestyle goods like vehicles, air conditioners, consumer durables, etc. Acquiring these goods through loans helps an individual to enjoy the comforts of these while they repay loans out of future earnings. The purpose for which the customer is requesting a loan must be clarified to the lender's satisfaction.

(iii) *Security/ Collateral:* Collateral does not add to the financial viability of a proposal. Collateral does not affect the quality of the credit and is not part of the external or internal factors that have a relationship with the quality of the credit. Yet collateral has a very definite place once an event of default occurs. It is an exit option. Thus if the business and/or the principal security has failed to produce the cash flows to service the loan and the account has become overdue or non-performing, collateral offers a way out for the lender to recover through enforcement of security. The assets obtained as collateral should satisfy certain criteria to be of value to the lender. Enforceability and enforcing of collaterals are important. The legal system is so designed and so misused that by the time - if at all- a judgment to enforce the security is obtained a long period of time would have already passed. Certain factors that are relevant are: age, condition, and degree of specialization of the assets. Technological obsolescence is an important factor to be considered.

(iv) *Cash Flow:* The key feature of any loan application centers on one issue: Does the proposed business have the ability to generate enough cash to repay the loan? In general, business firms have only four sources to draw upon to repay their loans:

(i) cash flows generated from sales or other income,
(ii) the sale or liquidation of assets, or
(iii) funds raised by issuing debt or equity securities (borrowing)
(iv) additional capital infusion.

Any of these sources may provide sufficient cash to repay a loan. However, lenders would prefer that repayment comes from the cash flow from business activity or in other words profits generated. This is because asset sales can weaken the business capacity. Banks would not like the repayment out of

borrowing as it impacts the firm/company's leverage and moves the firm into a higher debt whereas it is not able to manage a lower debt. Normally fresh capital is insisted at the time of reworking the terms of credit as the infusion is a clear indication of difficulties in the venture. The cash flow analysis is useful in understanding clearly the sources of a borrower's cash flow. As far as bankers/lenders are concerned it would be ideal if most of cash comes from operations (sales oriented). Evidently if a substantial proportion of cash inflow happens due to sale of assets (investing activities) or borrowing or issuing debt (financing activities), the borrower may find it difficult to generate cash in the future which will make the bank loan exposed to more risk.

In case of individuals too the lenders need to look into the source of repayment. This should normally be a regular source of income like salary, professional earnings, rent or interest income. Adequacy and sustainability of these incomes need to be looked into.

23.4 METHODS OF ASSESSMENT OF LOANS

Commercial loans, including project loans (having long repayment period), require specialised skills for assessment, disbursal and monitoring. Such loans are usually handled by specialised branches or specialised teams at central/ nodal points. On the other hand, retail loans, which have been largely standardised by banks, form a prominent part of the activities of branches. These loans are substantially technology driven because of their large volume and small ticket size. The standardisation covers not only in respect of application form, information required from the customer, terms and conditions, legal documentation, etc., but also the processing of loan proposals, where the data are fed into the system which generates the score card for decisions to be taken by the sanctioning officer. The monitoring of such loans is also computerised.

Assessment of loans for different purposes is done in different manner as the factors affecting these differ in several respects. Broadly, these can be categorised in the following types:

A. *Loans for business enterprises*:
   (i) For Working Capital Purposes
   (ii) For Capital Expenditure

B. *Loans for individuals*:
   (i) For Housing Purposes
   (ii) For Vehicles/ Consumer Durables

23.5 ASSESSMENT OF WORKING CAPITAL

Funds required to sustain working cycle/ production cycle of any unit is called working capital. Working capital for any manufacturing unit means the total amount of circulating funds required for the continuous operations of the unit as a going concern. The working capital management or short term financial management which is concerned with decisions relating to current assets and current liabilities with major thrust, of course, is on the management of current assets.

The key difference between long term financial management and working capital management is in terms of timing of cash. While long term financial decisions like buying capital equipment or issuing debentures involve cash flow over an extended period of time (5 to 15 years), short term financial decisions typically involve cash flows within a year or within the operating cycle.

23.5.1 Working Capital

The capital required for a business enterprise can be classified under two main categories viz.
(i) Fixed Capital
(ii) Working Capital

Every business requires funds for setting up of the enterprise and for day to day operations. Acquisition of items such as Land, Plant & Machinery, building, furniture, etc. requires capital or long term debt.

Investments in these assets represent that part of firm's capital which is blocked on permanent or fixed basis and is called fixed capital. Business also needs funds for short-term purposes such as purchase of raw material, payment of wages and other day-to-day expenses etc. These funds are known as working capital.

In simple words, working capital refers to that part of the firm's funds that is required for financing short-term or current assets such as cash, debtors & inventories. Working capital for any manufacturing unit is the total amount of circulating funds required for the continuous operations of the unit on a going basis. The funds used in production are recouped from sale of final products at the end of the production cycle and are available for use in the next production cycle. Working capital can therefore be called operating capital or short term capital as well.

There are two concepts of working capital:
(i) Gross working capital
(ii) Net working capital

(i) ***Gross Working Capital:*** It is the capital invested in total current assets of the enterprise. Current assets are tangible movable assets that are recoverable in cash or sold or consumed or turned over during the operating cycle usually not exceeding one year. The gross working capital concept is financial or going concern concept whereas net working capital is an accounting concept of working capital. Both the concepts have their own merits.
The gross concept:
   (a) Enables the enterprise to provide correct amount of working capital at the right time.
   (b) Helps management to know the amount invested in total current assets with which it has to operate.

(ii) ***Net Working Capital:*** It tells the business about how the assets are funded. In a narrow sense, the term working capital refers to the net working capital (NWC) or liquid surplus which is the difference between current assets and current liabilities. It is the excess of long term funds over long term uses. When the current assets exceed the current liabilities, the NWC is positive and when the current liabilities are more than the current assets, it would become negative. The net working capital should be higher than 1:1 to ensure sufficient liquidity and availability of working funds.
The net working capital concept, however, is also important for following reasons:
   (a) It is qualitative concept, which indicates the firm's ability to meet to its operating expenses and short-term liabilities.
   (b) It indicates the margin of protection available to the short term creditors.

(iii) ***Working Capital Gap:*** It is a concept used in the Indian banking sector to determine the amount of working capital limits the bank would make available to the borrower. It is the difference between total Current Assets and Current Liabilities, other than bank borrowings.

23.5.2 Components of Working Capital

Working capital is the aggregate value of:

i. Raw material
ii. Stock in process
iii. Finished goods in stores and in transit
iv. Other consumable stores
v. Receivables or sundry debtors
vi. Other expenses

Working capital is not something static. It changes with the size of the company, the phase of operations, profits accrued and retained and a host of other factors. As a general rule, banks try to fund the gap or extend what they call need based financial assistance. The premise is that with need based financing there is little scope for diversion or misuse of funds as financing is just adequate and not in excess of requirements. And if the finance is inadequate it leads to production problems and eventually leads a company to sickness.

Various factors influence the need of working capital in a business. These are mainly: Nature of business, Size of business, Production Policy, Seasonal variations, Operating/ Working Cycle.

23.5.3 Operating/ Working Capital Cycle

The duration from the purchase of raw materials through production to finished goods to sales and sales realisation is the time period for which working capital funds are required. Once sales proceeds are received in cash, this money is available for purchase of raw materials and continuing production. The whole process is repeated again. Because of the cyclical nature of this entire process, the production period is called the operation cycle. This is shown in Figure 23.1.

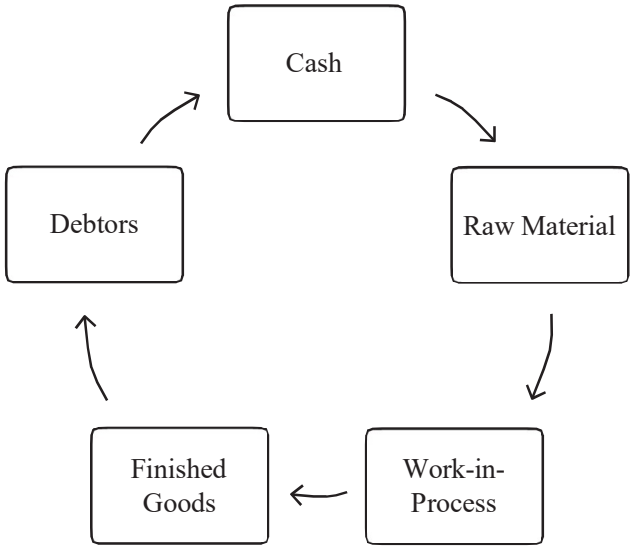

Figure 23.1 Operating Cycle

23.5.4 Computation of Operating Cycle Components

In the operating cycle, in actual practice, there is always a time gap between one stage to another. There will be time gaps between purchase of raw material and production; production and sales; sales and realization of cash etc. There will always be some time before and after order is issued before the raw material is received. Hence, there is a need to keep stock of goods at every stage. This requires purchase of raw materials ahead of their need for production. Similarly, there is a build-up of stock of finished goods before these are despatched to the customer. There is certain process time for conversion of raw materials to finished goods. That results in certain stock of work-in-process. Realisation of sales proceeds after delivery of finished goods also takes time due to processing of payment at the customer's end and transit period, apart from the credit period as per the sales terms.

Let us look at the mathematics involved in calculation of the duration of each component of the operating cycle.

Component	Computation
(i) Raw Material (RM) Storage Period Where: (a) Average Stock of RM (b) Average Daily RM Consumption	$\frac{Average\ Stock\ of\ RM}{Average\ Daily\ RM\ Consumption}$ $\frac{Opening\ Stock\ of\ RM\ +\ Closing\ Stock\ of\ RM}{2}$ $\frac{Annual\ Consumtion\ of\ RM}{360}$
(ii) WIP Conversion Period Where: (a) Average stock of WIP (b) Annual Cost of Production (c) Average daily Cost of Production	$\frac{Average\ Stockof\ WIP}{Average\ Daily\ Cost\ of\ Production}$ $\frac{Opening\ Stock\ of\ WIP\ +\ Closing\ Stock\ of\ WIP}{2}$ *Opening stock of WIP + Annual Consumption of RM + ManufacturingCosts (such as wages salaries, power & Fuel, etc.) + Depreciation - Closing stock of WIP* $\frac{Annual\ Cost\ of\ Production}{360}$
(iii) FG Storage Period Where:- (a) Average stock of FG (b) Annual Cost of Sales (CoS) (c) Average daily CoS	$\frac{Average\ Stock\ of\ FG}{Average\ Daily\ Cost\ of\ Sales}$ $\frac{Opening\ Stock\ of\ FG\ +\ Closing\ Stock\ of\ FG}{2}$ *Opening stock of FG + Annual Cost of Production + Excise Duty + Selling & Distribution Costs + General Administrative Costs + Finance Costs - Closing stock of FG* $\frac{Annual\ Cost\ of\ Sales}{360}$

(*Continued*)

Component	Computation
(iv) Average Collection Period Where: (a) Average balance of Sundry debtors (b) Average daily Credit Sales	$\frac{\textit{Average Balamce of Sundry Debtors}}{\textit{Average Daily Credit Sales}}$ $\frac{\textit{Receivables (Opening Balance)} + \textit{Receivables (Closing Balance)}}{2}$ $\frac{\textit{Annual Credit Sales}}{360}$
(v) Average Payment Period Where: (a) Average Balance of Sundry creditors (b) Average Daily Credit Purchases	$\frac{\textit{Average Balamce of Sundry Creditors}}{\textit{Average Daily Credit Purchases}}$ $\frac{\textit{Creditors (Opening Balance)} + \textit{Creditors(Closing Balance)}}{2}$ $\frac{\textit{Annual Credit Purchases}}{360}$
Abbreviations:	RM = Raw Material; WIP = Work –in – Process; FG = Finished Goods

23.5.5 Assessment of Working Capital Requirements (Fund Based)

If the overall appraisal is satisfactory, the bank will finance only the residual gap in the customers' resources, after taking into consideration the expected availability from all other sources of funds. Banks have the freedom to evolve appropriate system for assessing the working capital needs of borrowers within the existing prudential guidelines and exposure norms. Bank Boards are also expected to lay down transparent policy and guidelines for credit dispensation in respect of each broad category of economic activity. Banks may adopt one of the following four methods for assessment of working capital requirements of their clients.

(i) Turnover Method;
(ii) Operating Cycle Method;
(iii) Maximum Permissible Bank Finance (MPBF) Method (Projected Net Working Capital);
(iv) Cash Budget Method.

The assessment of the working capital requirements of a firm must be preceded by a detailed appraisal of the past and future viability of the firm's planning, operations and financial position. It is implicit that the firm will have to submit an acceptable business plan, in the form of projected financial statements, to the bank. Thereafter, the assessment of working capital needs is made based on the past trends, the end use of funds and the estimated requirement of additional funds as revealed by the firm's business plan or the cash budget, in cases of those firms which have a marked seasonality of operations. These methods require the preparation of:

(a) Projected financial statements
(b) Projected fund flow statements
(c) Projected cash flow statements/cash budgets

Banks are free to evolve appropriate system for assessing the working capital credit needs of borrowers. These may be explained in their loan policy. The method to be adopted in a specific case may be determined taking into account the total working capital (fund based) requirements of the borrower.

(i) Turnover Method

MSE units having working capital limits of up to ₹5 crore from the banking system are to be provided working capital finance computed on the basis of 20% of their projected annual turnover.Under this method, the working capital requirements of the borrower is computed at 25% of the projected annual turnover of which normally four-fifth i.e. 20% of the projected turnover is provided by the bankas working capital finance and balance one-fifth i.e. 5% of the projected annual turnover is contributedby the borrower, as margin towards working capital. This means that 20% of the total working capital requirements is met by the borrower as margin money.

The basic premise underlying the level of working capital to be fixed at 25% of the turnover is that an operating/business cycle will be of 3 months. In practice the operating cycle duration varies depending on several factors. If the operating cycle is shorter or longer the working capital requirement may be lower or higher. In such cases where the working capital cycle is significantly longer or shorter, it may be necessary to determine the operating cycle duration and hence the working capital requirement.

While the working capital limits are fixed based on the assessment exercise, the actual drawings are permitted based on the level of current assets viz. stock and debtors less the security margin fixed for the respective assets.

Illustration:

M/s. ABC is a manufacturer of moulded plastic household goods like buckets, mugs etc. The annual turnover for FY2021-22 was `80.00 lakh, and it has targeted 25% growth in FY 2022-23. The working capital requirement and the bank finance for it are estimated as follows.

(a) Growth in turnover during FY2022-23 @ 25% over FY2021-22: `80.00 lakh * 0.25 = `20.00 lakh
(b) Projected turnover during FY2022-23: `80.00 lakh + `20.00 lakh = `100.00 lakh
(c) **Working capital requirement** @ 25% of turnover: `100.00 lakh* 0.25 = `25.00 lakh
(d) Bank finance for working capital @ four-fifth (i.e. 80%) of (c) = `25.00 lakh * 0.8 = `20.00 lakh
(e) Borrower's contribution for working capital @ one-fifth (i.e. 20%) of (c) = `25.00 lakh * 0.2 = `5.00 lakh

Alternatively, the bank finance and the borrower's contribution for working capital are directly determined from the projected turnover as follows:

(a) Bank finance @ 20% of projected turnover = `100.00 lakh* 0.2 = `20.00 lakh
(b) Borrower's contribution@ 5% of projected turnover = `100.00 lakh* 0.05 = `5.00 lakh

Illustration**:**

M/s. PQR is a manufacturer of toys. The projected annual turnover is `120.00 lakh. The available net working capital (NWC) is `5.00 lakh.

(a) Projected annual turnover: `120.00 lakh
(b) **Working capital required** (25% of a): `30.00 lakh
(c) Minimum margin from the borrower (20% of b): `6.00 lakh
(d) Maximum bank borrowing (80% of b): `24.00 lakh
(e) Actual NWC available: `5.00 lakh
(f) Margin stipulated (Higher of c or e): `6.00 lakh
(g) Permissible limit (b-f): `24.00 lakh
(h) Additional Margin to be brought in by borrower (c – d): ₹6 lakh - ₹5 lakh = ₹1 lakh

(ii) Operating Cycle Method

Traditional method of assessment of working capital is based on operating cycle method. It requires estimation of the holding periods of major current assets and current liabilities. If part of raw materials is available on credit, then bank finance will be required only for that portion of the raw materials which represents fully paid purchases. Similarly, if advance payments are received against orders, only that part of the finished goods net of the advance payment will require bank credit.

Borrowers in the small and medium enterprises segment face a problem in collecting dues from their customers, particularly from the corporate sectors. In order to provide a relief to borrowers who face such a situation, the banks adopt following practices:

- While assessing working capital requirement, creditors are not set-off against stock.
- The borrowers will submit detailed age-wise lists of sundry creditors and sundry debtors as well as the stock statement.
- Only those debtors whose outstanding is up to a specified period (180 days maximum) are considered.
- The total outstanding creditors are netted from the total outstanding eligible debtors. If creditors are in excess, the excess portion is deducted from the value of stocks. If debtors are in excess, the bank considers the surplus debtors for financing.

Illustration:

M/s. ABC is in ready-made garments manufacturing activity. The average holding periods for stocks and duration of creditors and debtors are as given below. Its annual turnover is `70 lakh and annual operating expenses are `60 lakh. The working capital requirement is computed as shown below.

(a) Procurement of raw material: 30 days
(b) Conversion/process time: 15 days
(c) Average time of holding of finished goods: 15 days
(d) Average collection period: 30 days
(e) Total operating cycle (a + b +c + d): 90 days
(f) No. of operating cycles in a year (360/e): 4
(g) Total operating expenses per annum: `60 lakh
(h) Total turnover per annum: `70 lakh
(i) **Working capital requirement** (g/f): `15 lakh

(iii) Maximum Permissible Bank Finance Method

In order to suggest methods for improving the delivery of industrial credit based on the performance and projections of the borrower rather than security, RBI had constituted a Working Group headed by Shri P.L. Tandon, the then Chairman of PNB, in July 1974. The main recommendations of the Committee are as follows:

(a) A borrowing company should be discouraged from accumulating too much of stocks of current assets and it should move towards lean inventories and receivable levels.
(b) It suggested the maximum levels of Raw Material, Stock-in-process and Finished Goods which a corporate operating in an industry should be allowed to accumulate. These levels were termed as inventory and receivable norms.

(c) It specified these norms for 15 industries initially. These norms are specified in terms of:
For Raw Material: *Average Monthly Consumption*
For Stock-in-Process: *Monthly Cost of Production*
For Finished Goods: *Monthly Cost of Sales*
For Receivables: *Monthly Gross sales*

RBI does not prescribe detailed norms for each item of inventory as also of receivables. The classification of current assets and current liabilities is not mandatory. The banks may decide on their own as to which items should be included for consideration as current assets or current liabilities.

(d) It enunciated the concept of Maximum Permissible Bank Finance (MPBF) for assessment of working capital.

(e) It suggested different methods of funding current assets to be adopted depending on the size of credit required.

(f) *First Method of Lending*: In this method, the contribution by the borrowing unit is fixed at a minimum 25% of the working capital gap from long-term funds. The bank finances a maximum of 75% of the gap; the balance amount should come from long-term sources. This would reduce the reliance of the borrowers on bank borrowings by ploughing back of more internal cash generated. This method of lending gives a current ratio of only 1:17, evidently on low side. This approach was considered suitable for relatively new units set up by first time entrepreneurs and for sick/weak units as supportive measure.

(g) *Second Method of Lending*: In order to graduate the borrowers to enhance their contributions to working capital, they are placed under the second method of lending recommended by the Tandon Committee. This would give a minimum current ratio of 1.33:1. Under this method, the borrower is required to provide for a minimum of 25% of total current assets out of long-term funds. A certain level of credit for purchases and other current liabilities will be available to fund the build-up of current assets and the bank will provide the balance (MPBF). However, total liabilities inclusive of bank finance would never exceed 75% of gross current assets. In case a borrower is not in a position to work under the second method of lending immediately, the excess borrowing is segregated and treated as a working capital term loan repayable in instalments over a period of time. To induce the borrowers to repay this loan, bank may charge higher rate of interest on it.

(h) *Third Method of Lending*: Under this method, the contribution from long term funds would be to the extent of the entire core current assets (which was defined by the Committee as representing the absolute minimum level of raw materials, process stock, finished goods and stores which are in the pipeline to ensure continuity of production) and a minimum of 25% of the balance current assets. The balance current assets only would be financed through bank finance for working capital after netting off other current liabilities meeting the current assets. In other words this method envisaged funding of additional requirement due to fluctuations in current asset levels due to various factors seasonal or occasional.

(This Method was not accepted for implementation and hence is of only academic Interest.)

Illustration:

(Amount - ₹ in lakh)

Current Liabilities	Amount	Current Assets	Amount
(a) Creditors for purchases	100	(f) Raw materials	200
(b) Other current liabilities	50	(g) Stock-in-process	20
(c) Current Liabilities (Other than Bank Borrowings) (a + b)	150	(h) Finished goods	90
(d) Bank borrowings including bills discounted with bankers	200	(i) Receivables including bills discounted with bankers	50
		(j) Other current assets	10
(e) Total Current Liabilities (c + d)	350	(k) Total Current Assets (f + g + h + i + j)	370
First Method		**Second Method**	
A. Total Current Asset (k)	370	G. Total Current Asset (k)	370
B. Less: Current Liabilities (Other than bank borrowings)(c)	150	H. Less: 25% of Current Asset (k*0.25) (Round off)	92
C. **Working Capital Gap** (A - B)	220	I. Balance Current Assets (G-H)	278
D. Less: 25% of Working Capital Gap (C*0.25)	55	J. Less: Current Liabilities (Other than Bank Borrowings) (c)	150
E. Maximum Permissible Bank Finance (C - D)	165	K. Maximum Permissible Bank Finance (I – J)	128
F. Excess Borrowing (d - E)	35	Excess Borrowing (d - K)	72
Current Ratio	1.17	Current Ratio	1.33

Observations

(i) Under the first method: MPBF is `165 lakh, thus excess borrowing is of ` 35 lakh.
(ii) Under the second method: MPBF is `128 lakh, thus excess borrowing is of ` 72 lakh.
(iii) Current Ratio (after funding excess borrowing through long term sources) is 1.17 (under first method) and 1.33 (under second method)

The following Table below gives a comparative position of salient parameters under the three methods of lending.

(Amount - ₹ in lakh)

First Method	Amount	Second Method	Amount	Third Method	Amount
Total CA	370	Total CA	370	Total CA	370
Less: OCL	150	Less: OCL	150	Less: Core CA	95
WCG	220	WCG	220	Balance CA	220
Less: 25% of WCG	55	Less: 25% of TCA	92	Less: OCL	150
	-		-	WCG	125
	-		-	Less: 25% of Balance CA	69
MPBF	165	MPBF	128	MPBF	56

(i) *CMA Data*: Many banks continue to follow the method of MPBF based on CMA (Credit Monitoring Arrangement) formats. Various banks use CMA formats with certain variations to suit the requirements of particular industry segment. For example, the CMA formats used for finance to NBFCs are different than those prescribed for a manufacturing company. CMA formats consist of the following forms:

FORM I – Particulars of the existing limits from the Banking System/Financial Institutions

FORM II – Operating Statement

FORM III –Analysis of Balance Sheet PartA- Balance Sheet Spread -Analytical and Comparative Ratios.

FORM IV – Comparative statement of current assets and current liabilities

FORM V – Assessment of Maximum Permissible Bank Finance for Working Capital

FORM VI – Funds Flow Statement

In addition, the banks also obtain data on the following two formats:

- Format for Salient Financial Indicators
- Format for Additional Information/Additional Data

FORM I (Particulars of the existing/proposed limits from the banking system)

Particulars of the existing credit from the entire banking system as also the term loan facilities availed from the term lending institutions/ banks are furnished in this form. Maximum and minimum utilisation of the limits during the last 12 months and outstanding balances as on a recent date are also given so that a comparison can be made with the limits now requested for and the limits actually utilised during the last 12 months. Bankers may use this to verify:

(a) Whether the limits have been adequately utilized during the last 12 months?
(b) Any overdrawing of limits and reason thereof;
(c) Compliance of bill culture i.e. borrowers enjoying aggregate fund based limits of Rs. 5 crore and above, limits against book debts should not be more than 75% of the limits and 25% of the aggregate limits for financing inland credit sales should be provided by way of bills, etc.

FORM II (Operating Statement)

The operating statement is the breakup of Profit & Loss Account. The data relating to gross sales, net sales, cost of raw materials, power and fuel, direct labour, depreciation, selling, general and administrative expenses, interest, etc., are furnished in this form. This form would provide several information about the unit-management, the inherent strength and weakness, the likely future through the trend analysis techniques, etc. It also covers information on operating profit and net profit after deducting total expenditure from total sale proceeds. The following information may be verified from the data provided in the form:

(a) Reasonableness of the projected turnover in relation to installed/licenced capacity, availability of input, environmental conditions, marketing prospects, etc. as working capital is directly linked to the projected turnover.
(b) For existing units, the trend analysis as to whether it is realistic or over ambitious, realistic, etc.
(c) Any modernization/diversification/expansion on cards and its impact on turnover.
(d) Reason for any declining trend to be ascertained.
(e) Valuation of inputs as per current ruling price.
(f) Consumable stores and other items used in the process of manufacture are only included in RM.

(g) Other overheads as per the past trend or not.
(h) Adequacy of depreciation and adopted method thereof.
(i) Trend in operating profits,
(j) Retention of profits, etc.

FORM III (Analysis of Balance Sheet)

A complete analysis of various items of last two years' balance sheet, current year's estimates and following year's projections are given in this form. The details of current liabilities, term liabilities, net worth, current assets, fixed assets, other noncurrent assets, etc. are given in this form as per the classification accepted by the banks. While analysing the Form III, the following points are to be looked into:

(a) Proper classification of CA and CL (as per RBI guidelines).
(b) It may be ascertained whether the levels of raw materials, stocks-in-process, finished goods and receivables are in conformity with the stipulated norms.
(c) Justification for any increase in level of inventory and receivables.
(d) Level of projected stock spares i.e. imported and indigenous not to exceed 12 months' and 9 months' consumption. Spares beyond the period to be treated as NCA.
(e) Maintenance of level of inventory and receivables and any upward variance, the reason may be sought.
(f) Details of inter-corporate investments and advances and reason for not liquidating.
(g) Level of creditors and reason for projecting at lower level.
(h) Adequacy of provision requirements in respect of taxes, dividends, statutory liabilities, etc., and classification of any shortfall as CL.
(i) It must be ensured that intangible assets over a period of time must be written off.
(j) Trend of Net Worth, NWC, etc.

It is pertinent to mention that, while estimating/projecting Net Worth, the Capital Reserves, and Revenue Reserves are examined. Also, it should be ensured that the company has created specific reserves as required by law. For instance, Debenture Redemption Reserve. Similarly, we can stipulate covenants pertaining to creation of Dividend Equalisation Reserve, when the company is doing well, and has plans to continue declaring dividends at certain rates.

FORM IV (Comparative statement of current assets and current liabilities)

This form gives the comparative study of CA and CL and holding levels of inventory and receivable, and creditors' payment period. The figures given in this form should tally with the figures given in the Form III where details of all the liabilities and assets are given. This form is used to indicate all the current assets and current liabilities at one place. In case of inventory (raw materials, consumable spares, stock-in-process and finished goods) receivables and sundry creditors, the holding/levels are given not only in absolute amounts but also in terms of months so that a comparative study may be done with the prescribed norms/past trends. They are indicated in terms of number of months in brackets below their amounts.

FORM V (Computation of Maximum Permissible Bank Finance)

On the basis of the details of the current assets and current liabilities given in Form- IV, MPBF is calculated in this form to find out the credit limits to be allowed to the borrowers. The following points may be looked into while analysing the data.

(a) Method of computation of MPBF (weak/sick units First Method of Lending).
(b) Treatment of Export bills whether export bills are excluded from total sales and export receivable from total current assets?
(c) Treatment of third party outstation cheque/draft purchase limit. The limit should be within the MPBF.
(d) Co-relation between the projected increase in production/sales and increase in limits, etc.

FORM VI (Funds flow statement)

This form helps to understand how short and long term funds are utilized by the borrower. This will also indicate whether long-term funds are sufficient for meeting the long-term requirements. In additionto long-term sources and uses, increase/ decrease in current assets is also indicated in this form. While analysing the fund flow statement, the following factors may be looked into.

(a) Adequacy of long term sources to cover long term uses and to leave surplus towards working capital margin (NWC).
(b) In case long term funds are less than long term uses, it can be inferred that short term funds are diverted for the purpose other than working capital needs and such cases to be properly examined.
(c) Increase in inventory disproportionate to the percentage of rise in sales.
(d) Matching of increase in short term borrowing with that of increase in current assets.

Form VII - Statement showing the total cost of the project and source of finance

This form is obtained only when there is term loan request from the borrower.

It may be noted that obtaining the abovementioned statements is not an end in itself. It only indicates the broad aspects to be examined by banks and helps in analysis and interpretation of the data furnished by the borrowers for taking judicious decisions.

(iv) Cash Budget Method

Most banks now for assessment of the working capital needs of a borrower who enjoys or requires fund based limits in excess of `10 crore, adopt the cash budget system. This method requires that the borrower has necessary infrastructure in place to submit the required information periodically in time. The scope of internal MIS should be satisfactory and commensurate with the level of operations. The borrower must have a finance professional and computerised environment. Cash Flow based lending method is popular in developed countries.

A cash budget is a statement of cash receipts and cash payments. It is distinct from the cash flow statement, in as much as the latter deals with both cash and non-cash funds, while the cash budget deals with cash transactions only. Also, a cash budget is a projection into the future, as against a cash flow statement that is usually historical in nature. Cash budget is a substitute for the operating cycle method for the assessment of working capital.

Cash-budget statement typically would comprise of projected receipts and payments grouped under following four categories based on their purpose:

(i) Business operations;
(ii) Non-business operations;
(iii) Cash flow from capital accounts; and
(iv) Sundry items.

For the purpose of determining the requirement of working capital finance, the cash-budget statement for business operations is relevant.

Cash-budget statement may be drawn up for the next 12 month period or for smaller period i.e. 6 months or 3 months. A cash budget is usually prepared for short periods, i.e. a week/ a fortnight/ a month or a quarter. For a more precise assessment determining working capital requirement on quarterly basis is preferred.

Cash - budget statement projection consists of the following steps in sequence when prepared for a quarter.

- Expected receipts and payments during the first, the second and the third month are recorded.
- Position of the cash surplus/ deficit is computed for monthly intervals. A surplus is generated if the receipts exceed the payments, and a cash deficit occurs if payments are more than the receipts during the month.The opening cash balance for the first month is adjusted against the cash surplus/ deficit during that month. The adjusted figure is the closing balance at the end of the first month, which becomes the opening balance for the next month, viz., the second month.
- A cash surplus generated during a month results in higher closing cash balance vis-à-vis the opening balance of the month. Conversely, a cash deficit during the month would cause lower closing cash balance as compared to the opening balance.
- If the enterprise has a net position on borrowed funds (i.e. the company maintains a cash credit/ overdraft account), a cash surplus generated during a month brings down the level of the borrowed funds at the end of the month.

Cash budgets are essential for assessment of working capital needs in situations like those mentioned below:

(i) Opening Letter of Credit,
(ii) Ad hoc working capital facility,
(iii) Bill financing,
(iv) Financing construction activities,
(v) Financing seasonal industries,
(vi) Financing tea/ coffee/ rubber plantation,
(vii) Financing sugar manufacturing,
(viii) Financing software development activities,
(ix) Financing cardamom processing, rice milling, etc.

Under this method the peak cash deficit amount is the total working capital finance to be provided to the borrower by the bank. The peak cash deficit amount is ascertained from the Projected Cash Budget Statement submitted by the borrower. The deficit is financed subject to availability of chargeable assets. The required borrower's contribution (NWC), which should be at least 25% of the peak deficit, is also worked out based on the values of Current Assets and Current Liabilities as at the peak deficit period. Actual drawings are allowed to the extent of monthly cash deficit.

Illustration:

Cash Budget Statement of M/s. ABC for the next three months is given below.

Receipts	Amount ` in lakh	Payments	Amount ` in lakh
First Month			
Cash sales	3	Cash Purchases	5
Collection from Debtors	8	Other Manufacturing expenses	4
Others	2	Administrative expenses	2
		Interest - business borrowings	1
		Others	2
Total Receipts (A)	13	*Total Payments* (B)	14
Net Surplus (C = A - B)	-	Net Deficit (C = A - B)	1
Opening Cash Balance (D)	3		
Closing Cash Balance (E = D + C)	2		
Second Month			
Cash sales	4	Cash Purchases	6
Collection from Debtors	5	Other Manufacturing expenses	5
Others	1	Administrative expenses	2
		Interest - business borrowings	1
		Others	1
Total Receipts	10	*Total Payments*	15
Net Surplus	-	Net Deficit	5
Opening Cash Balance	2		
Closing Cash Balance (Deficit)	3		
Third Month			
Cash sales	4	Cash Purchases	4
Collection from Debtors	9	Other Manufacturing expenses	5
Others	2	Administrative expenses	2
		Interest - business borrowings	1
		Others	1
Total Receipts (A)	15	*Total Payments* (B)	13
Net Surplus (A - B)	2	Net Deficit (A - B)	
Opening Cash Balance (Deficit)	3		
Closing Cash Balance (Deficit)	1		

(*Continued*)

Assessment of Working Capital Limit for the Quarter	
Position at the Peak Deficit (i.e. Second Month)	**Amount ` in lakh**
(a) Total cash outflow from Business Operations	15
(b) Total cash inflow from Business Operations	10
(c) Cash Deficit	5
(d) Less: Net Working Capital (Current Asset – Current Liabilities) at month-end	1
(e) Net Cash Deficit (To be financed by the bank)	4

Advantages of Cash Budget System

Short-term lending on the basis of cash budget offers a viable alternative to the existing security oriented pattern of credit allocation by banks. The main advantages of cash budget system are:

1. The customer plans his cash requirements in advance and in case his bank is unable to sanction additional funds, the customer can seek alternative sources well in advance.
2. The banker is in close touch with his customers. He would, therefore, be able to spot any danger signals quickly and initiate corrective action in time.
3. The banker can plan his resources to meet expected credit demands. Credit planning would thus become a meaningful exercise.

23.5.6 Assessment of Non-fund Based Facilities

While ascertaining the credit needs of the borrower, the banker should assess both the fund based and non-fund based limits required by him together and sanction them as a package. The non-fund based limits are normally of two types: (i) bank guarantees, (ii) letters of credit.

(i) Bank Guarantees (BG)

For assessing bank guarantee required by a borrower, details such as the nature of guarantee, its purpose, the particulars of the contract period and the amount for which the guarantee is sought are collected and assessed from the aspect of creditworthiness of the customer and his relationship with the bankfor sanctioning the guarantee facility. Appropriate conditions with regard to cash margin and security, registration of charge with ROC, in case the customer is a corporate, are laid down in the sanction to protect the interestsof the bank, in the event of a default of the customer to fulfill his part of the obligation of the contract relating to which the bank guarantee has been issued and the liability thereon likely to be crystallized on the banker.

There could be occasions when the customer needs a limit in case of guarantees. This is similar to Cash Credit or Overdraft Limits. The customer has to operate within the limit so approved and the limit, like all bank facilities is subject to yearly review. The assessment of regular Bank Guarantee Limits would depend upon the nature of activity of the borrower, the nature, purpose and type of guarantees required in such an activity and the duration of such guarantee.

Bank must clearly understand various types of guarantees required in the line of activity and classify them into Financial and Performance guarantees. The nature, amount and period of bank guarantee required depends on the purpose for which the guarantee is to be issued. Hence, to determine the bank guarantee limit required by a customer it is important to assess various purposes for which the borrower would require guarantees. Some of the purposes for which guarantees are usually required are enumerated below.

(i) ***Permanent Guarantees:*** It is important to identify and segregate those guarantees which are likely to be required on a fixed basis and will be outstanding as long as the unit is in operation or the bank finance is outstanding. For example, a guarantee in favour of State Electricity Board in lieu of security deposit/ for regular payment of electricity bill will be required as long as the firm is functioning. Such guarantees are essential for the normal operation of the unit. In the case of electricity dues the amount of the guarantee is related to the connected load and the optimum power utilization by the firm.

(ii) ***Business Activity Related Guarantees:*** The limit for guarantees related to the main business activity of the firm is a function of the volume of activity proposed and the duration of such guarantees. For example earnest money guarantee will depend upon the number and value of tenders to be applied for by the company, the percentage of success in getting the tender awarded and the duration of such guarantees.

(iii) ***Guarantees for Export Quota:*** Similarly in case of guarantees issued favouring Apparel Export Promotion council for release of garment export quota, the guarantee amount is related to the value of quota applied and allotted, which in turn will depend upon the level of exports proposed in the ensuing year and other factors.

(iv) ***Guarantees for Tax Liabilities:*** In certain cases the borrower may require guarantees to be issued favouring Excise, Income-Tax authorities against disputed liabilities. Requirement of such guarantees is ascertained based on the level of such disputed liabilities and the demand made by the concerned departments.

(v) ***Guarantees for Import of Capital Goods:*** The borrower may also require guarantees for import of capital goods on concessional import duty under various schemes of Government, whose requirement can be determined on a case to case basis.

(vi) ***Guarantees for Advance Payments:*** Wherever the borrower is accepting advance payment from purchasers and is required to furnish bank guarantees in lieu thereof, the amount of such guarantees will be proportional to the amount of such advance payments that will be outstanding, which in turn will be dependent on the level of sales.

The cumulative requirements will indicate the amount of Bank Guarantee limits for various purposes.

Illustration

PQR Ltd. undertakes government contracts for fabrication of bridges. Its bank guarantee requirements are broadly for the following purposes:

(a) Guarantees in lieu of Security Deposit for electricity, etc.
(b) Bid bond Guarantees for Government tenders
(c) Advance Payment Guarantees for payments received in stages for the contract
(d) Retention Money Guarantees for release of retention money for the project completed
(e) Performance Guarantee for completion of the project for which contract is awarded
(f) Guarantee for Import of Hydro Platforms
(g) Guarantee for GST claims by CBIC

The company has provided the following information about its activities:

(a) Its electricity bill is around `10 lakh per month, and the electricity distribution company has demanded security deposits equivalent to 2 months' supply. At present the company has provided to the electricity distributor a bank guarantee for `7 lakh.

(b) Projected to bid for 5 tenders of aggregate value of `10,000 lakh. The practice of the Government departments is to ask for Bid Bond equivalent to 1% of the Tender value.
(c) Five contracts of the aggregate value of `20,000 lakh are in hand at various stages. It expects to receive payments aggregating `2,000 lakh against these.
(d) It has recently completed 2 projects of the aggregate value of `2,500 lakh. Retention amount held by the concerned Government Departments is 5% of the contract value.
(e) It expects to be awarded with contract for 3 out of the 5 bids to be submitted, as stated above. Performance Guarantee of 20% of the contract value is to be furnished.
(f) It will be importing 5 Hydro Platforms @ `10 lakh each. The payment for these will be made over the next 24 months.
(g) GST claim for `20 lakh has been disputed by it for which it is required to furnish a guarantee pending decision on its appeal.
(h) It expects to receive back guarantees of aggregate value of `3,000 lakh from the beneficiaries as there is no claim against these guarantees.

The present outstanding guarantees issued on behalf of the company are of the value of `8,000 lakh.

Based on the above information the Bank Guarantee requirements are worked out as shown below.

	Purpose of Guarantee	Assessment of Guarantee Amount	Amount ` in lakh
I.	**Assessment of Amount of Fresh Guarantees Required**		
a)	Guarantees in lieu of Security Deposit for Electricity	Security Deposit Required - 2 month's supply 2 x ₹10 lakh = ₹20 lakh	20
b)	Bid Bond Guarantees	Aggregate Value of 5 tenders - ₹10,000 lakh @ 1% of Value = ₹10,000 lakh x 1%	100
c)	Advance Payment Guarantees	Expected Receipts for running contracts - ₹2,000 lakh	2000
d)	Retention Money Guarantees	Projects completed – 2 nos. Value - ₹2,500 lakh Retention Amount @ 5% = ₹2,500 lakh x 5%	125
e)	Performance Guarantee	Expected Contract Awards – 3 nos. Aggregate Value = ₹10,000 lakh x (3/5) = ₹6,000 lakh Performance Guarantee required @ 20% Guarantee amount - ₹6,000 lakh x 20% = ₹1,200 lakh	1200
f)	Guarantee for Import	Import of 5 Hydro Platforms @ ₹10 lakh each Total Value = ₹10 lakh x 5 = ₹50 lakh	50
g)	Guarantee for GST claims by CBIC	Disputed amount - ₹20 lakh	20
h)	*Total Expected Amount of Fresh Guarantees*	Sum of (a) to (g)	3515

(*Continued*)

	Purpose of Guarantee	Assessment of Guarantee Amount	Amount ` in lakh
II	**Estimated Total Guarantee Limit**		
i)	Present Outstanding Guarantees		8000
j)	Less: Expected Cancellations		3000
k)	Balance Current Guarantees	(i) - (j)	5000
l)	Fresh Guarantee Requirements	(h)	3515
m)	**Total Guarantee Limit Required**	(k) + (h)	8515

The Bank Guarantee Limit required by the Company is `8515 lakh say `8600 lakh.

(ii) Letters of Credit (L/C)

A letter of credit (L/C) is a written but a conditional undertaking given by the issuing bank on behalf of its customer, to the beneficiary that it will pay him the amount stated in the credit provided documents specified in the letter of credit are drawn and presented in strict conformity with the terms and conditions of the credit. In order for the payment to occur, the seller has to present to the bank the required documents as per the L/C terms. An L/C is used for purchase of goods either locally or through imports. An L/C may provide for payment terms as DP (Documents against Payment) or DA (Documents against Acceptance) depending on whether the purchase is on credit or cash terms.

For assessing the letter of credit limit for the purchase of raw materials, the banker collects from the borrower following particulars:

(a) Projected value of raw material consumption in the ensuing year
(b) Projected value of raw material purchase on credit (out of the above)
(c) Time taken for advising the letter of credit to the beneficiary
(d) Time taken for shipment and the consignment to reach the customer's destination
(e) Credit period (usance period) agreed between the beneficiary and the customer
(f) Credit period projected and reckoned for calculation of the maximum permissible bank finance (MPBF) while sanctioning the funded limits to the borrower customer

The cycle of operation of an L/C from its issuance to the payment under it comprises the following:

(i) Time taken for advising the letter of credit to the beneficiary
(ii) Time taken for shipment and the consignment to reach the customer's destination
(iii) Credit period agreed between the beneficiary and the customer (where the payment terms are on credit)

Based on the above information the letter of credit limit is assessed as explained in the following illustration.

Illustration**:**

PQR Ltd. enjoys working capital facilities with Bank A. It has approached the bank for LC limit for purchase of raw materials. The relevant information provided is as given below.

(a) Projected value of raw materials consumption: ` 3,600 lakh
(b) Projected value of raw material purchase on credit: ` 2,400 lakh
(c) Time taken for advising L/C: 10 days
(d) Time taken for shipment and transit period: 20 days
(e) Credit period agreed upon between the seller and the customer OR the projected available credit period (as given in CMA format) for calculation of MPBF for funded limits, whichever is less: 30 days

Assessment of LC Limit

(i) Time required for one cycle of operation of L/C will be 10 + 20 + 30 = 60 days.
(ii) Number of cycles in a year (assuming 360 days in a year) = 6
(iii) Projected value of raw material purchase on credit during the year is ` 2,400 lakh.
(iv) The value of L/C per cycle is -

$$\frac{\text{`2400 lakh}}{6} = \text{`400 lakh}$$

The letter of credit limit required would be ` 400 lakh.

A banker should ensurethat the stocks procured through the L/C are taken under hypothecation, but are not included in the value of stocksfor calculation of amount of drawals permitted for the fund based limits granted to the customer. The capital goods purchased under L/C are also covered by hypothecation charge.

23.6 ASSESSMENT OF TERM LOAN

A term loan is granted for the purpose of acquisition of capital asset such as Land, Building, Plant & Machinery, Modernisation,Renovation or Rationalisation of Plant. Term loans are also extended for acquisition of a capital asset like machinery, equipment, factory or office premises, vehicles, etc. on standalone basis. Repayment of a term loan comes from the future earnings of the unit (i.e. cash surplus generated out of the business), in contrast to the working capital facility that is paid out of sales realisation from the operating stocks. Normally, the term loans are repayable in instalments over a period ranging from 3 to 10 years. The credit risk, therefore, is greater in case of term loan than in case of working capital finance.

Where a term loan is considered for a new business to be established, it requires assessment of project cost and means of finance. While in case of term loan for standalone acquisition of a capital asset would require assessing the cost of acquisition of that asset. In both cases, it is necessary to assess the future cash surplus from the business operations that would be available to service the term loan viz. for meeting the interest and repayment instalments for the term loan.

23.6.1 Cost of Project and Means of Finance

Assessment of project cost requires estimating the cost of acquisition of capital assets, cost of construction of building, and any other related expenditure. Besides, in the project cost the amount of working capital margin required is also included as this is also to be funded from long term sources. Assessment of funding of a project requires determination of various funding sources that are available to the entrepreneur and estimating the amount of funds expected from these. A typical statement of the Cost of the Project and Sources of Finance is tabulated as shown below.

Cost of the Project	Sources of Finance
(a) Land acquisition	(a) Share Capital
(b) Site development, building, and other civil works	(b) Reserves and Surpluses, retained earnings/ internal cash accruals, etc. (for an existing business)
(c) Plant & Machinery	(c) Capital Subsidy
(d) Miscellaneous assets	(d) Long term loan for equity funding
(e) Electrical fittings	(e) Term Loans from FIs etc.,
(f) Preliminary & pre-operative expenses	(f) Unsecured loans (from friends and relatives) or Public deposits
(g) Contingencies	
(h) Working capital margin	
Total Cost of Project	*Total Sources of Finance*

Besides, technical study, the processing officer has to verify the above items meticulously as technical appraisal examination is on technical angle while he has to verify each of the above heads on financial angle. Banks do not finance all items of cost of project. For instance, preliminary and pre-operative expenses are not funded by banks but are required to be met from the entrepreneur's own sources. Secondly, for the assets that are funded by banks through the term loans, they require a part of the cost to be met by the borrower's own fund as margin contribution. Thus, the total margin requirement for various assets funded through term loans from bank will also need to be met by the borrower from own funds. Bankers also look at the debt-equity structure in case of a project to satisfy about the level of leveraging being within reasonable range.

23.6.2 Assessment of Term Loan Limits

It will be noted that for determining the term loan requirement of a borrower the bank needs to assess the total project cost first. This requires estimating for each of the items the requirements. This exercise needs an understanding of the nature of each of these items connected with setting up of the project.

(i) Land & site development: adequacy, lease or free hold, reasonability of estimates for civil works, etc. The cost of land & site development is the sum of the following:-

a. Basic cost of land including conveyance and other allied charges
b. Premium payable on leasehold and conveyance charges
c. Cost of levelling and development
d. Cost of laying approach roads and internal roads
e. Cost of compound wall and gates
f. Cost of tube wells, etc.

The cost of land varies considerably from one location to another and it may be very high in urban and even semi-urban locations, it is relatively low in rural locations. Likewise, the expenditure on site development too varies widely depending on the location and topography of the land.

(ii) Building: Buildings of different types such as factory, administrative, godown, canteen, time house, guest house, staff quarters, silos, tanks, wells, chests, garages, sewers, other civil engineering works, etc. may be required depending on the type, size and location of the plant. The need for each type of buildings needs to be examined. Estimates should be based on plinth area, the rates for various types of structures, the types of materials to be used, etc. The costs must be reasonable, and duly certified by approved architect. These rates, of course, vary with the location to some extent. Approval of plan layout is to be obtained from the competent authority, etc.

(iii) Plant & machinery: The cost of the plant & machinery is typically the most significant component of the project cost. It consists of the following:-

a. The cost of imported machinery: sum of FOB value
b. Shipping, freight, and insurance cost
c. Import duty
d. Clearing, loading & unloading, and transportation charges, etc.

The costs should be based on latest available quotations/invoices adjusted for possible escalation from reputed suppliers/manufacturers and machinery should be standard. Whether all machineries are included e.g. cost of generator, water treatment plant, balancing machinery, etc. included? Whether the proposed machinery is second hand and if so chartered engineer's certificate, etc. should be obtained.

(iv) Technical know-how and engineering fee: Often it is necessary to engage technical consultants or collaborators from India and/or abroad for advice and held in various technical matters like preparation of the project report, choice of technology, selection of the plant and machinery, detailed engineering, and so on. These expenses are in fact components of project cost, the royalty payable annually, which is typically a percentage of sales, is an operating expenses taken into account in the preparation of the projected profitability statements.

(v) Expenses on engaging foreign technicians and training of Indian technicians abroad: Services of foreign technicians may be required in India for setting up the project and training Indian technicians. Expenses in connection with this are also to a part of project cost and they are also treated as operating expenses.

(vi) Miscellaneous assets: Fixed assets and machinery which are not part of the direct manufacturing process may be referred to as miscellaneous fixed assets. Furniture & fittings, electrical fittings, laboratory, work shop equipments, effluent treatment plants, firefighting equipments, and so on. All these items are properly and reasonably assessed with quotations.

(vii) Preliminary & pre-operative expenses: Preliminary expenses are expenses before formation of the company (preliminary/feasibility study, legal expenses, travelling expenses, etc.). The pre-operative expenses are those incurred between the formation and commencement of commercial production. Expenses borne in connection with the raising of capital from the public are referred to as capital issue expenses. The major components of capital issue expenses are: underwriting commission, brokerage, fees to managers and registrars, printing and postage expenses, advertising and publicity expenses, listing fees, and stamp duty. It may be ascertained whether interest cost during the construction period is arranged by the borrower or is it also forms a part of the cost.

(viii) Contingencies: Expenses in connection with cost escalation because of unexpected reasons such as increase in excise duty, sales tax duty, general inflation, etc. to estimate the provision for contingencies, project cost items may be divided into two categories such as: "firm" cost items and "non-firm cost" items. The "firm cost items" are those which have already been acquired or for which definite arrangements have been made. Generally, a contingency provision of 5 to 10% of the estimated cost of non-firm costs items if the implementation period is less than 1 year. For every additional 1 year, make additional provision of 5%.

(ix) Margin for working capital: The principal support for working capital is provided by commercial banks and creditors. However, a certain part of the working capital requirement has to come from long-term sources of finance. This is referred to as "margin money for working capital" and is an important element of the project cost. The margin money may sometimes be used for meeting overruns in the project cost. This leads to a working capital problem (sometimes a crisis) when the project is commissioned. To mitigate this problem, financial institutions stipulate that a portion of the loan amount, equal to the margin money for working capital, be blocked initially so that it can be released when the project is completed. It is the NWC available in the system from long term sources.

(x) Initial cash losses: Most of the projects incur cash losses in the initial years. Yet, the promoters typically do not disclose the initial cash losses because they want the project to appear attractive to the financial institutions and investing public. Failure to make adequate provision for such cash losses in the project generally affects the liquidity position and impairs the operations. Hence prudence calls for making a provision, overt or covert, for the estimated initial cash losses.

The next stage is ascertaining various sources of finance including both equity and borrowings including term loans from banks/ financial institutions.

(xi) Sources of Finance: To meet the cost of the project, the following sources of finance are available:

- Share capital
- Term loans
- Debenture capital
- Deferred credit
- Incentive sources
- Miscellaneous sources

(a) *Share capital* may be equity (owners and equity shareholders) or preference capital.

(b) *Term loans* are provided by banks and financial institutions. They may be in Indian rupees or in foreign currency loans. Rupee loans are given for financing land, building, civil works, indigenous plant and machinery, and so on while foreign loans are considered for meeting foreign currency expenditures towards the import of equipment and technical know-how.

(c) *Debentures* are debt instruments and they are convertible and non-convertible debentures. Convertible debentures are likely to be converted to equity wholly or partly as per the conversion rates fixed in advance. Non-convertible debentures normally carry fixed rate and having maturity period of 5 to 9 years.

(d) *Deferred credits* are credits offered by the suppliers of plant & machinery and the payments can be made over a period of time as per the terms.

(e) *Incentive sources* include financial support as an incentive from government and other agencies to certain types of promoters or for setting up industrial units in certain locations. These incentives may be in the form of Seed Capital Assistance or capital subsidy (to attract industries) or tax deferment or exemption (particularly from GST) for a certain period.

(f) *Miscellaneous Sources*: A small portion of the project finance may come from miscellaneous sources like unsecured loans, public deposits, and leasing and hire purchase finance, etc.

Out of the total resources required, the quantum of equity financing and debt financing will be regulated by the debt-equity norm/promoters' contribution stipulated by financial institutions. Decision to raise resources from any source would require careful planning and cost benefit analysis. These will be, of course, subject to regulatory approvals as necessary from SEBI etc. in case of raising debt or equity from the public.

Illustration

XYZ Ltd. is setting up a project for manufacturing plastic moulded goods. The estimated costs for various assets are shown below. The company desires to maintain debt-equity ratio at 2:1. It proposes to raise debt from banks/ financial institution, and unsecured loans from friends, relatives and deposits from public. The shareholders will contribute equity capital of `350 lakh. It proposes to raise funds through long term debentures for meeting shortfall in Equity. The unit is eligible for Capital Subsidy under the Central Government's 'Make in India' Scheme. The subsidy amount available is 10% of the cost of fixed assets to be acquired except electrical fittings. The margins required for term loans from banks/ financial institutions are:

Site Development, building, and other civil works – 50%

Plant & Machinery – 25%

Miscellaneous assets – 40%

Electrical fittings – 50%

Banks/ financial institutions will not fund the cost of land.

Based on these the total cost of project and the source of finance are worked out as shown below.

Cost of the Project	Margin	Bank Borrowings ` in lakh	Amount ` in lakh
(a) Land acquisition	*100%*	Nil	200
(b) Site development, building, and other civil works	*50%*	125	250
(c) Plant & Machinery	*25%*	225	300
(d) Miscellaneous assets	*40%*	30	50
(e) Electrical fittings	*50%*	20	40
(f) Preliminary & pre-operative expenses	*100%*	Nil	80
(g) Contingencies	*100%*	Nil	50
(h) Working capital margin	*100%*	Nil	250
Total Cost of Project			**1220**
Sources of Finance		**Basis**	**Amount ` in lakh**
(a) Share Capital	*Equity*	Debt: Equity Ratio – 2:1	350
(b) Reserves and Surpluses, retained earnings/ internal cash accruals, etc. (for an existing business)	*Equity*	Not available in New Unit	0
(c) Capital Subsidy	*Reckoned as Equity*	10% of cost of fixed assets except electrical fittings (i.e. (a) to (d))	80
(d) Long term loan for equity funding (including debentures from public, etc.)	*Reckoned as Equity*		180

(*Continued*)

(e) Term Loans from banks/ FIs etc.,	*Debt*	Bank loans for fixed assets except land (i.e. (b) to (d)) (125 + 225 + 30 + 20)	400
(f) Unsecured loans (from friends and relatives) or Public deposits	*Debt*		110
Total Sources of Finance			**1220**

23.6.3 Assessing Viability and Debt Servicing Capacity

Term loans and other long term borrowings are expected to be serviced from the income to be generated from the business operations of the enterprise. It is therefore important to assess the viability of the business activity of the unit of generating profits. To assess the debt servicing capacity the amount of cash surplus expected over the tenor of various long term loans is required to be estimated.

These should be adequate to meet the annual loan instalment obligations. This is usually expressed as *Debt Service Coverage Ratio*.

(a) ***Viability of Business Activity:*** Assessing the viability of any business activity is essentially an exercise of working out projected sales and costs of production and cost of sales, etc. In other words, it is preparing projected financial estimates for operations, as done for assessing the working capital requirements. The objective here is to determine the profits and the cash surplus generated from the operations. While for working capital assessment the projections for the following year are adequate, for term loan appraisal purposes such estimates are required for the entire tenor of the term loans.

Typically, the profit can be estimated from the estimates of the cost of production and cost of sales and the expected sales. The data elements that are required for this purpose are enumerated below:

- Installed capacity
- Number of shifts per day and number of working days
- Capacity utilisation plans
- Product mix
- Quantity and price of input
- Quantity and price of output
- Unit cost of production
- Labour costs
- Repairs and maintenance costs
- Plant overheads
- Administrative expenses
- Packing cost
- Selling expenses
- Financial expenses
- Depreciation
- Income tax
- Price rise and inflation, etc.

Based on these data elements and detailed working of each cost item the cost of production and cost of sales statement is prepared. Based on the expected sales projections the profit from sales is arrived at. The net profit is determined after providing for taxes and any other non-business costs and provisions for likely bad or doubtful debts.

Typical summarised cost of production and profits statement will look as shown in the illustration below.

Illustration

ABC Ltd. is setting up a plant for manufacturing electric fans. Its detailed estimated cost of production, sales and profits has been worked out. Based on that the summarised position for the first year is as shown below.

Costs	Amount ` in lakh	Revenue	Amount ` in lakh
(a) Opening Stock	0	(i) Value of Electric fans sold	200
(b) Cost of Electric Fans Produced (includes Depreciation ₹10 lakh)	150	(ii) Closing Stock (at cost of production)	30
(c) Expenses (other than production costs) (Includes interest on term loans ₹5 lakh)	30		
(d) Provisions for bad or doubtful debts	10		
(e) Total Costs ((a) to (d))	190		
(f) Profit before Tax ((iii) – (e))	40		
(g) Total ((e) + (f))	230	(iii) Total Revenue ((i) + (ii))	230
(h) Tax	10	(iv) Profit before Tax	40
(i) Profit after Tax	30		
(j) Total ((h)+(i))	40	(v) Total	40

From the above statement following parameters can be worked out:

Parameter	Basis	Working	Value
(I) Profit Margin on sales	Profit Before Tax (f)/Value of Electric Fans Sold (i) (as percentage)	(40/200)*100	20%
(II) Net profit Margin	Profit After Tax (i)/Value of Electric Fans Sold (i) (as percentage)	(30/200)*100	15%
(III) Cash Profit	Profit after Tax (i) + Depreciation + Provisions	30+10+10	₹50 lakh
(IV) Net Profit (before finance cost)	Profit after Tax (i) + Interest on Term loans	30+5	₹35 lakh
(V) Cash Profit (before finance cost)	Profit after Tax (i) + Interest on Term loans + Depreciation + Provisions	30+5+10+10	₹55 lakh

(b) ***Debt Service Coverage Ratio (DSCR)***: DSCR indicates the ability of a concern to service its term liabilities. The ratio is applied while appraising all term loans proposals. DSCR measures whether interest and instalments can be paid out of internal generation of funds. It is calculated as the cash profit generated plus provision for interest divided by total payment commitment.

DSCR is computed as:-

$$\text{DSCR} = \frac{\text{Net profit + Depreciation + Other Non – Cash Expenses + Interest on term loan}}{\text{(Interest on term loan + Instalments of term loan)}}$$

For assessing the debt servicing capacity for the entire tenor of the term loan the estimated profitability statements for the entire loan period are prepared. DSCR is estimated for each year. The average DSCR (i.e. the average of DSCRs calculated for the repayment period of the loan) of 1.50 is considered reasonable. This ratio indicates that after payment of the loan instalment and interest something will be left over. This margin of safety is what the lender looks for.

It will be noticed that DSCR is a function of the liability on account of the instalment and interest payment obligations. Lower payment obligations will result in higher DSCR, indicating that the surplus generated covers the payment obligations to a greater degree.

It happens usually that in the initial years DSCR is less than 1.50. For providing some relief in these years, the instalments at the beginning are kept lesser, and increased in later years as the income and profitability improves. Alternatively, a longer repayment period can be considered. A higher DSCR of above 2 indicates higher repayment capacity. In such cases, the instalment may be increased i.e. ask the borrower to repay the loan in an accelerated manner.

Illustration

ABC Ltd. in the preceding Illustration has borrowed term loans as indicated below:

(i) Term Loan for Plant and Machinery - `500 lakh for 50 months – Monthly instalment of `10 lakh
(ii) Term Loan for Site Development and Building - `420 lakh for 84 months – Monthly instalment of `5 lakh
(iii) Term Loan for Miscellaneous assets - `72 lakh for 36 months – Monthly instalment of `2 lakh

The financial projections for seven years are given below. Based on these the DSCR is calculated as indicated below.

Parameter	Working	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Total
	Amount (`in lakh)								
(a) Profit After Tax		210	325	345	355	365	380	390	2370
(b) Depreciation		30	23	18	15	14	13	12	125
(c) Provisions for bad and doubtful debts		10	12	15	15	17	19	21	109
(d) Interest on Term Loans		70	53	38	23	18	8	4	214
(e) Term Loan Instalment		204	204	204	180	80	60	60	992
(f) Repayment obligations for Term Loan (including interest)	d+e	274	257	242	203	98	68	64	1216
(g) Cash Surplus	a+b+c	250	360	378	385	396	412	423	2604
(h) Cash Surplus (before Term Loan Interest)	a+b+c+d	320	413	416	408	414	420	427	2818

(*Continued*)

		Ratio							
(i) DSCR (for TL instalment)	g/e	1.2	1.8	1.9	2.1	5.0	6.9	7	2.6
(j) DSCR (for TL interest and instalment)	h/f	1.2	1.6	1.7	2.0	4.2	6.2	6.7	2.3

It will be observed that the DSCR varies from year to year. In the instant case the DSCR for the first year is below 1.5 the desired minimum level, but is above 1 leaving some cushion. There are two options available:

(i) To accept DSCR of 1.2 that indicates that there is some surplus available after meeting term loan obligations, although the margin of safety is little lower. In absolute terms, considering total obligations (including interest on Term Loans) of `274 lakh a surplus of `46 lakh is available out of cash surplus of `320 lakh.

(ii) To modify the repayment schedule either with a moratorium period of say 3 months or so that will result in reducing the instalments amount for the first year of operations and hence increase DSCR for the first year. Alternatively, the instalment amount for the first year can be reduced.

It will also be observed that DSCR in the last three years are quite high, clearly indicating that there is scope for accelerating the repayment a little. However, while doing so the average DSCR over the total repayment tenor will also be kept in view.

23.7 LET US SUM UP

Credit appraisal is a process of critical evaluation of a loan request by a prospective borrower. An appraisal is undertaken for ensuring that a credit is good. It measures the risk inherent in the proposal and comes to judgment to sanction or reject the proposal based on the assessment of the information, the applicant and the project. Verification and validation are necessary to check out the facts. Bank should be able to distinguish between relevant and irrelevant pieces of information. Default can occur because of business failure or because the borrower's willful actions. The latter is a question of integrity of the borrower. At times less than optimal financial assistance by the lender or over financing could all lead to problems. Credit risk rating or credit rating is one of the credit appraisal tools.

The credit decision for sanction or rejection of a proposal basically is based on: credit rating score; purpose of the loan; concentration limits etc. There are seven aspects (7 C's) for ascertaining - Creditworthiness, Character, Capacity, Capital, Collateral, Conditions, and Cash flows. Assessment of loans for different purposes is done in different manner as the factors affecting these differ in several respects.

The capital required for a business enterprise can be classified under two main categories viz. (i) Fixed Capital; (ii) Working Capital. There are two concepts of working capital: (i) Gross working capital; (ii) Net working capital. Working Capital Gap is the difference between total Current Assets and Current Liabilities, other than bank borrowings. Banks try to fund the gap or extend need based financial assistance. The duration from the purchase of raw materials through production to finished goods to sales and sales realisation is the time period for which working capital funds are required.

Banks may adopt one of the following four methods for assessment of working capital requirements of their clients - (i) Turnover Method; (ii) Operating Cycle Method; (iii) Maximum Permissible Bank

Finance (MPBF) Method (Projected Net Working Capital); and (iv) Cash Budget Method. The assessment of the working capital requirements of a firm must be preceded by a detailed appraisal of the past and future viability of the firm's planning, operations and financial position. Many banks continue to follow the method of MPBF based on CMA (Credit Monitoring Arrangement) formats.

The non-fund based limits are normally of two types: (i) bank guarantees and (ii) letters of credit. For assessing bank guarantee required by a borrower, details such as the nature of guarantee, its purpose, the particulars of the contract period and the amount for which the guarantee is sought are collected and assessed from the aspect of creditworthiness of the customer and his relationship with the bank for sanctioning the guarantee facility. A letter of credit (L/C) is a written but a conditional undertaking given by the issuing bank on behalf of its customer, to the beneficiary that it will pay him the amount stated in the credit provided documents specified in the letter of credit are drawn and presented in strict conformity with the terms and conditions of the credit. A banker should ensure that the stocks procured through the L/C are taken under hypothecation, but are not included in the value of stocks for calculation of amount of drawals permitted (drawing power) for the fund based limits granted to the customer.

A term loan is granted for the purpose of acquisition of capital asset such as Land, Building, Plant & Machinery, Modernisation, renovation or rationalisation of plant. Term loans are also extended for acquisition of a capital asset like machinery, equipment, factory or office premises, vehicles, etc. on standalone basis. Normally the term loans are repayable in instalments over a period ranging from 3 to 10 years. The credit risk, therefore, is greater in case of term loan than in case of working capital finance. Assessment of project cost requires estimating the cost of acquisition of capital assets, cost of construction of building, and any other related expenditure. Besides, in the project cost the amount of working capital margin required is also included as this is also to be funded from long term sources. To meet the cost of the project, the following sources of finance are available: Share capital; Term loans; Debenture capital; Deferred credit; Incentive sources; Miscellaneous sources. It is important to assess the viability of the business activity of the unit of generating profits. To assess the debt servicing capacity the amount of cash surplus expected over the tenor of various long term loans is required to be estimated. Debt Service Coverage Ratio (DSCR) is the principal parameter to assess the debt servicing capacity.

23.8 KEYWORDS

Credit Appraisal; Validation; Credit Risk; Credit Risk Rating; Creditworthiness; Character; Capacity; Capital; Collateral; Conditions; Cash Flows; Assessment; Fixed Capital; Working Capital; Gross Working Capital; Net Working Capital; Working Capital Gap; Stock in Process; Work-in-Process; Working Capital Cycle; Operating Cycle; Raw Material (RM) Storage Period; Average Stock; Annual Cost of Production; Average Annual Consumption; Annual Cost of Sales; Average Collection Period; Average Payment Period; Average Daily Credit Purchases; Turnover Method; Operating Cycle Method; Maximum Permissible Bank Finance (MPBF) Method; Cash Budget Method; Credit Monitoring Arrangement; Cash Deficit; Permanent Guarantees; Advance Payment Guarantees; Bid Bond Guarantees; Advance Payment Guarantees; Performance Guarantee; Retention Money Guarantees; Cost of Project; Means of Finance; Margin money for Working Capital; Deferred credits; Viability; Debt Service Coverage Ratio.

23.9 CHECK YOUR PROGRESS

1. In banker's parlance, credit risk in lending refers to_____.
   (a) default of repayment by a borrower
   (b) default of bankers in maintaining SLR
   (c) default of a banker to release credit to a borrower
   (d) None of above
2. Net working capital means_____.
   (a) Current assets – Current Liabilities
   (b) Owned funds – Goodwill
   (c) Use of assets + Sources of funds
   (d) None of the above
3. What are the sources of working capital?
   (a) Trade credits + Unsecured loans + Deposits
   (b) Bank borrowings + Advance payments
   (c) Net working capital
   (d) All of above
4. Term loans mean loans_____.
   (a) payable over a period of one year to ten years
   (b) repaid in installments over a period
   (c) utilised for acquisition of fixed assets
   (d) All of the above
5. Advantages of cash budget could be_____.
   (a) borrower has to plan the cash requirements
   (b) banker can spot a danger signal quickly
   (c) banker can plan his resources to meet credit demands.
   (d) All of the above.

23.10 ANSWER TO 'CHECK YOUR PROGRESS'

1. (a), **2.** (a), **3.** (d), **4.** (d), **5.** (d).