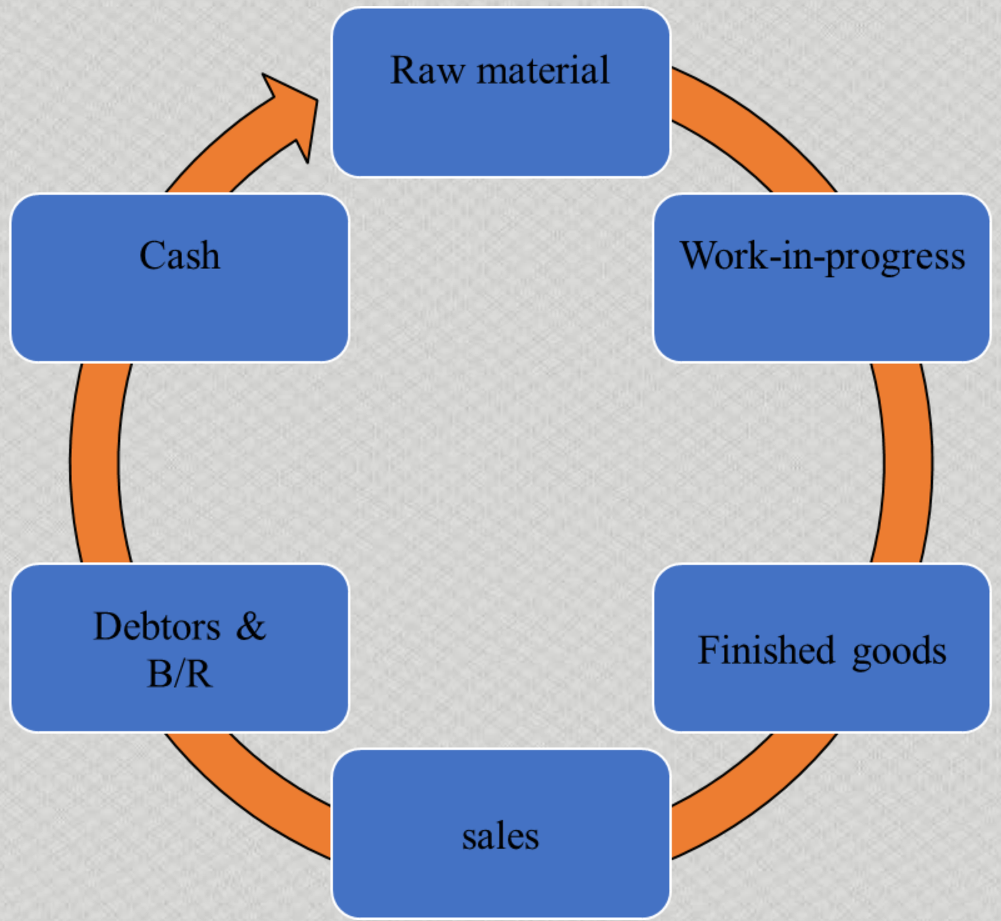
OPERATING CYCLE



OPERATING CYCLE METHOD

- **Operating cycle method** for estimating **working capital is based on the duration of the operating cycle.**
- Longer the period of the cycle, LARGER will be the working capital requirements.

- For calculating the working capital using this method, 3 important things are required, they are the estimated cost of goods sold, operating cycle time, and desired cash levels. The formula is as follows:

Formula

$$\text{Working Capital} = \{\text{Estimated Cost of Goods Sold} * (\text{Operating Cycle}/ 365)\} + \text{Desired Cash and Bank Balance}$$

Calculating ONLY the total working capital will not suffice the purpose. However each component of working capital will have to be known. The estimation of the components need to be calculated as follows:

- Raw Material= Estimated Production Units * Per Unit Cost of RM * (RM Holding Period / 365 Days)

- WIP=Estimated Production * {Per Unit Cost of — RM (100%) + Labor (50%) + Overheads (50%)} * (Work In Progress Period / 365 Days)

- Finished Goods=Estimated Production * Per Unit Cost of Goods Produced * (Finished Goods Holding Period / 365 Days)

- A/Cs Receivable=Estimated Production * Selling Price * (Collection Period / 365 Days)

- A/Cs Payable =Estimated Production * Per Unit RM Cost * (Payment Period / 365 Days)

PROJECTED NET WORKING CAPITAL

- Net Working Capital is a financial measure of a company's liquidity and operational efficiency and its financial health. It represents a company's ability to cover its short-term liabilities with its short-term assets.
- The Formula for Calculating NWC
  = CA –CL
- CA of the company are those which liquidate within twelve months.
- CL of the company are those that the company has to settle within the next twelve months.
- Net Working Capital can either be +ve or –ve.

Turnover Method

- Simplified Turnover Method is used to assess the working capital requirement of any borrower based on the turnover of the business.
- This method was originally suggested by the P.J. Nayak Committee for the Small Scale Industries in India in need of working capital from banks.
- According to this method, the working capital requirement of the MSME unit is calculated at 25% of annual projected turnover. Out of the said Working Capital requirement, 5% requirement to be met by the borrower from his own sources and balance 20% to be financed by lending bank.

- This method was first recommended by the Nayak Committee for Small Scale Industries, up to a maximum limit of Rs 5 crores, based on the projected annual turnover of the company.

- The committee also recommended that in case of technology and software sector, any working capital finance up to Rs 2 crores should be made on the basis of turnover method.

Cash Budget Method

- The bank finance for working capital is assessed on the basis of monthly cash budget and the relative cash deficiency on a monthly basis.
- Under this method, all estimated/projected cash receipts (inflow) on a monthly basis is arranged in a tabular form and the monthly cash outflows are also similarly shown against each month. The deficit or surplus of each month is worked out and the peak deficit amount is considered to be the working capital limit to be provided by the bank.

- In this method credit limits are fixed on the basis of projected monthly cash budget to be received before beginning of the season.
- Therefore the current ratio of this kind of facility is normally 1.33:1 (1.25:1) for MSE as a benchmark. Some banks consider lower ratio on the case to case basis depending upon the components and quality of CA and CL

CREDIT MONITORING AND ITS MANAGEMENT

- Particulars of current & proposed limits:
- The Operating cycle duration –calculate holding period
- Operating statement:Current Sales, profit before & after tax, sales projections, direct & indirect expenses, and profit position for 3 to 5 years.
- Analysis of Balance sheet:comprehensive analysis of current & non-current assets, current & non-current liabilities and cash & bank position of the borrower.
- Comparative statement of Current Asset & Current liabilities
- Ratio analysis
- Fund flow statement

BASE RATE

Definition:

Base rate is the minimum rate set by the Reserve Bank of India below which banks are not allowed to lend to its customers.

The base rate was introduced by the RBI in July 2010 as the standard lending rate for commercial banks.

Since the Base Rate is the minimum rate for all loans, banks are not permitted to resort to any lending below the Base Rate. Banks are required to review the Base Rate at least once in a quarter.

Factors that determine the base rate

- Each bank can determine their base rate in accordance with the norms given by the RBI. According to the RBI, Base Rate shall include all those elements of the lending rates that are common across all categories of borrowers.
- The base rate may differ from one bank to the other. But the following four components usually determine the base rate of particular bank. These components are:

1. Cost for the funds (interest rate given for deposits),
2. Operating expenses,
3. Minimum rate of return (profit), and
4. Cost for the CRR

- The base rate of one bank may differ from another bank due to difference in one these factors most probably due to difference in interest rate.

REFERENCES/WEB LINKS

BOOK REFERNCES

- Gordon & Natarajan “Banking Theory, Law and Practice” edition2009, Himalaya Publication House Pvt. Ltd

- K.P.Kandasami, S.Natarajan, R. Parmeshwaran, “Banking Law and Practice” edition 2018, S. Chand and Company Limited

- Sukhvinder Mishra, “ Banking Law and Practice” edition 2012, S. Chand and Company Limited

WEBLINK

- https://m.rbi.org.in/rbi-sourcefiles/lendingrate/LendingRates.aspx

Thank You