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Abstract of Doctoral Dissertation

Borrowing as a Source of Financing Working Capital in The Corporate Sector in India: An Empirical Analysis*

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WORKING CAPITAL IS taken to be the life -blood of a business. Lack of working capital may lead a business to "technical insolvency" and utimately to liquidation. That is why, the working capital management of a firm is considered to be one of the most important tasks of financial managers. Working capital management involves decisions relating to current assets including decisions about how these assets are to be financed. Decisions regarding the volume of current assets has its own importance no doubt, but the question of financing is, in fact, the key area of working capital management. We have therefore felt it pertinent to estimate the financing pattern of working capital that prevails at present in the Indian corporate sector. In particular, the role of borrowings has been dealt with herein, as major share of working capital finance do come from borrowings.

With an attempt to know the pattern of financing the corporate working capital in India, we have analysed in our study ten years' (from 1981 to 1990) balance sheets of 20 companies- 10 from private sector and 10 from public sector. In addition, we have processed the relevant figures of a good number (ranging from 534 to 641 units) of public limited companies whose results have been published in the RBI (Reserve Bank of India) Bulletins during the period under study. While processing the figures so obtained, we have taken help of some accounting as well as statistical tools e. g. current ratio, debt-equity ratio, standard deviation, co-efficient of variation and test of significance.

In the process of the study we have seen that the working capital of each firm is constituted by several types of sources like bank borrowings, public deposits, trade credit, long-term borrowings and equity capital. Hence, at the outset, we have tried to find out the reasons behind uitlising several sources instead of relying upon one or two best-suited sources. What appears therefrom is that, since working capital needs are partly fixed and partly

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fluctuating, the companies cannot but resort to sources of different types and terms. Moreover, whereas short-term borrowings offer the benefit of reduced cost due to reduction of idle capital, the use of long-term borrowings has also the necessity on many ground. Long- term borrowings are less risky than short-term borrowings and the firms would not have to meet the cash obligations off and on. Not only the long -term borrowings, but the equity capital has also its role to play in the financing of working capital in Indian corporate sector. At the intitial stage of a firm, fixed assets as well as current assets have to be financed by this equity capital, since other sources may not be easily available at that time. Subsequently, when the firms get momentum, several lenders may stretch their hands for advancing loan, but the importance of equity capital does not end altogether. On the ground of stability and security, each firm is to maintain "equity-cushion" throughout its life time. In view of this, it has been deduced in our study that there is need for financing working capital from various sources.

Of different sources, bank credit has been working since long as a major source of working capital in India and abroad. In 1970s the use of bank credit in Indian corporate sector became so excessive that the desired correlation between bank credit and the holding of inventory and book debt was hampered in most cases. Hence, attempt was intitiated to bring in a 'check' on the use of bank credit and several study groups (Dehejia Study Group, Tandon Study Group, Chore Study Group, Marathe Committee, Chakraborty Committee etc.) were set to find out a way in this regard. All the study Groups gave recommendations in favour of providing a 'restraint' on the use of bank credit, and the Tandon Study Group prescribed some definite norms to that effect. Suggesting a limit on the holding of inventory and book debt, the Tandon Study Group prescribed three methods (methods I,II &III) to be implemented one after another, with a view to reducing the share of bank credit in the working capital. Applying the prescribed (prescribed by Tandon Study Group) norms for holding inventory and bank credit we have seen in our study that there has been a positive impact of the Tandon Study Group recommendations on the use of bank credit by Indian companies. That means, the desired correlation between bank credit and the holding of inventory and receivables has now been mostly established. Notwithstanding, the share of bank borrowings to total borrowings in public limited companies is 20% in average during the period 1981-90, and that to current assets is 22-25%. The yearly scores during the decade of eighty are also in agreement with the average results, and hence the standard deviations calculated thereon have been very low. In government companies, the combined scores in relation to total borrowings as well as to current assets are only 5-6% no doubt, but in six out of ten government companies the individual scores range from 17% to 31%. In view of this, it may be said that the role of bank borrowings in working capital financing in Indian corporate sector is still immense.

Then, we have analysed in our study the role of public deposit as a source of working capital in Indian corporate sector. This source emerged in

India in 1930s. In 1950s, there became a downfall in the use of it. In 1970s it again came into prominence.

Use of public deposit may frustrate the Government's policy of clannelising the flow of funds to industrial sector according to planned priorities. Moreover, it is said that the unwary depositors may come into the trap of unscrupulous depositee- companies, by lending their hard-earned money as public deposit. But from the standpoint of depositee companies, public deposit can be said to be a viable source of finance in many respects. The most important argument in favour of its use is that it is cheaper than bank borrowings and many other sources of finances. Now, government has imposed some regulation and as a result the interest of innocent investors has been protected to an extent and the flow of public deposit has also been restrained in the interest of planned economy. It is thus expected that the investors will now accept the offer for public deposit more freely and the firms, due to its cost advantage, will utilise this source upto at least the permissible limit. But what we see is that the share of public deposit to total borrowings is, on an average, only 6% in public limited companies, and this is as meagre as

0.08% in government companies. Share of public deposit to current assets is also only 7% in public limited companies and 0.08% in government companies. The individual results as to the use of public deposit are, however, widely scattered, and this is substantiated by the high co-efficient of variation (108%) of the scores. Nevertheless, it is evident from the combined results that the role of public deposit as a source of working capital is not significant in the decade of eighty, though in 1970s its role had been better to some extent.

Long-term borrowings like debenture, institutional loan and government loan have also a contribution to working capital financing, since, a part of current assets is usually covered by long-term funds. The corporate practices as to these of different types of long-term sources reveal that the position of debenture in corporate finance is almost equal to that of institutional loan. In RBI sample, both hold individually 14% of total borrowings. In case of ten selected public limited companies their individual scores are 7% and in case of government companies their scores are only 0.1% - 0.3%. Government loan, on the other hand, occupies as much as 66% share of total borrowings in government companies, though its position in public limited companies is really insignificant.

Sometimes long-term borrowings may occupy important role in total borrowings, but that does not mean that contribution of long-term borrowings to working capital will also be significant. If current liabilities cover the current assets in full, the long-term sources, whatever may be their position to total borrowings, will have to be presumed to be used for financing the fixed assets only. From this view point, we have computed the extent of gap between current assets and current liabilities of the selected companies, and have presumed that the gap has been financed by long-term sources as a whole. Multiplying the gap with the ratio of each long-term source to total long-term funds, we have estimated the share of different companies of long-term borrowings, viz, debenture, insitutional loan and government loan, in the context of working capital. The results so obtained reveal that the individiual share of institutional loan and debentures towards financing working capital is 2%-5% in case of public limited companies and 0.05% - 0.16% in case of government companies. Thus, it appears that the role of debenture and institutional loan in working capital finance is almost an exercise of paper only. Position of government loan is also disappointing in public limited companies. But in government companies its contribution is remarkable. This is quite expected as government companies have developed a practice of banking upon 'easily-available' government loans. However, the position of government loan as a source of finance is gradually decreasing even in government companies. On the other hand the position of debenture is gradually improving both in private as well as in public sector. Institutional loan exhibits a fluctuating trend during the decade of eighty, although ultimately its position has improved to an extent.

Another viable source of working capital is trade credit, which is considered to be a formality-free, security-free and interest-free source of finance. Due to the above advantages, trade credit has been practically a common source of working capital to almost all enterprises; notwithstanding the fact that there is some implicit cost associated with trade credit and the explicit cost is also originated when cash discount offered is foregone. During 1980s, 30% of current assets and 25% of total borrowings of public limited companies have come from trade credit and in case of government companies the scores have respectively been 8. 3% and 8.8%. As such, it may be stated that the role of trade credit is equally important during the period under study. However, its contribution in public limited companies is higher in comparison with that in government companies.

One of the important factors determining the feasibility or otherwise of a particular source of finance is stated to be the cost. Hence, we have attempted to see thereafter how far the cost actually play the decisive role in the selection of sources.

With an attempt to estimate the effect of cost on their selection, we have computed the specific costs of some sources. Trade credit has been taken to be less costly source of finance, although there are some implicit costs of trade credit over and above the cost of foregoing cash discount. Bank borrowings, on the other hand, appear to be costliest of the three sources. Thus, on cost consideration, it is natural that share of bank borrowing in working capital finance will be much lower than that of trade credit. But the corporate practices reveal that ratio of bank borrowings, to trade credit is, on an average, 88%, that is, bank borrowings do not lag as much behind the trade credit as it should be from the view point of cost of finance. Then, coming to the comparative position of bank borrowings and public deposit we find that, throughout the decade of eighty, the cost of public deposit had always been lower than that of bank borrowings. But during the period, the use of bank borrowings was approximately four times of public deposit. Moreover, it has been revealed that the cost of public deposit, contrary to general expectation, has gradually come down. Had the cost been a factor for the use of public deposit, its share to current assets would have been higher over time due to gradual reduction in cost. Reversely, we see a decreasing trend in the use of this source. In view of all these, we have come to the conclusion that effect of cost on the selection of sources of working capital is not at all significant.

Finally, we have observed that in public limited companies in India the current ratio is only 1.38:1. From this, it appears that they have adopted aggressive policy for working capital finance. This policy has its merits no doubt, but for the purpose, Settlement Earning Capacity (SEC) of the firms should have been adequate. Our study reveals that SEC of Indian public limited companies is 688 days in the year 1988, 629 days in 1989 and 505 days in 1990. This indicated that existing earning capacity of the companies is not sufficient to settle net current liabilities within one year (i. e. 365 days). Hence, we have suggested to discourage the aggressive policy. Rather, it will be better if the companies resort to medium and long-term loan instead of banking upon current liabilities. This practice will not be harmful as the debt-equity ratio of the firms is now very low (only 0.56:1).

Position of government companies is completely reverse. Current ratio there is 4. 32:1. Such a conservative policy may be desirable from liquidity point of view. But this risk-aversion may result in higher cost. They resort to long-term borrowings like government loan, and hence their debt -equity ratio has been higher (1. 11:1) to an extent. As such, problem of idle capital may crop up there. This may be one of the reasons due to which most of the government companies have been showing minus figures in profit and loss account year after year. It has been suggested therefore that the government companies should resort more to short-term and less costly sources like public deposit. Government being the guarantor, the availability of public deposit may also be sufficient there.