ISSN (Online) 2249 - 054 X

International Journal of Computing and Corporate Research

Specialized and Refereed Journal for Research Scholars, Academicians, Engineers and Scientists

http://www.ijccr.com

VOLUME 2 ISSUE 1 JANUARY 2012

THE MONEY BANK LTD CASE

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ABSTRACT

There are several RBI guidelines and internal rules and regulations in every bank for the sanction of loans. Notwithstanding such guidelines and rules, we find that the total Non Performing Assets of banks are on the rise. The reason for this could be that the banks, due to business exigencies, sanction proposals that perhaps were not worthy of being sanctioned.

The Money Bank Ltd case is based on an actual proposal received by a Bank in Rewari from a proprietorship firm. This case presents a proposal where Metals and Metals has applied to Money Bank Ltd for a working capital loan of Rs 25 lacs and a term loan of 12 lacs. The bank

ISSN (Online) 2249 - 054 X

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has sanctioned an overdraft facility with a limit of Rs. 15 lacs and a 60 months term loan of Rs 12 lacs. A perusal of the information submitted would indicate that it is incomplete and therefore requires completion after making the necessary assumptions. The students are asked to analyse the information submitted and the need for the credit limit sanctioned as well as to comment on the decision of the bank.

The depreciation and income tax rates used in the case are as applicable to the years under study. The faculty can use recent years as the years of study after making necessary changes to the tax and depreciation figures.

This case has been designed for MBA students, who have opted for the Working Capital Management elective course and seeks to test their knowledge of financial statement analysis and credit appraisal. It involves a critical evaluation of the proposed credit needs of the firm, as approved by the bank, having regard to the extant RBI regulations, and a thorough review of the financial statements of the firm, past, present and estimates of the future.

Executive Summary

Organisation studied:

While this case uses actual data from a working capital finance proposal of a proprietorship firm approved by a Bank in Rewari, all names have been changed and any resemblance to actual persons or companies was purely coincidental. Some of the figures have been adjusted for the purpose of reconciliation.

The name of the bank and/or the client cannot be disclosed for confidential reasons.

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International Journal of Computing and Corporate Research
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Requirements:

A working knowledge of financial accounting, financial statement analysis and working capital management is required in order to work on this case. For meaningful class discussion, the students would be required to thoroughly analyse the case and come prepared to present their issues.

Brief summary:

Working capital management is an important elective for students of MBA program majoring in Finance. It is useful in enabling them to round of their study of financial management of investments in short term assets of a firm as well as the management of the funding of those investments. The case deals with the latter aspect of funding and seeks to highlight the processes and the problems involved in trying to arrange for funds from banks for working capital. Students are made aware of the process of submitting working capital proposals to banks, having regard to extant rules and regulations of the RBI. As the amount of funding required is small, the firm being in the small scale sector, students have to be aware of the recommendations of the Nayak Committee applicable to such proposals.

The firm has provided a set of financial statements and details of its current credit exposure with other banks. Some of the information provided is incomplete and students are required to complete the same from the information given, making necessary assumptions, wherever required. In view of paucity of data, the case provides a good opportunity to students to hone their financial accounting skills, to re-work the financial statements to provide the missing figures required for making the proposal. Keeping in mind the requirements of the Nayak Committee recommendations, they have to analyse the financial statements, understand industry dynamics from an analysis of the industry data and analyse raw material consumption and other manufacturing cost that enter production to assess whether the sanction by the bank was proper and in its best interests. The case provides the students with an opportunity to carry out an in-depth analysis of the existing proposal submitted to the bank with a view to understanding and commenting on the rationale adopted in approving the proposal.

In addition to providing students with an understanding of the basic requirements of banks while assessing such proposals, students are also made aware of the procedural requirements in terms of submission of documents in order to ensure completion of a proposal application.

Each element of the financial statements (Balance Sheet and Profit and Loss Account) is separately analysed in the teaching notes giving a complete picture to the students. The depreciation and income tax rates used in the case are as applicable to the years under study. The faculty can use recent years as the years of study after making necessary changes to the tax and depreciation figures.

Keywords: Working capital management, Nayak Committee recommendations, working capital proposal, credit appraisal, financial statement analysis, proposal documentation

ISSN (Online) 2249 - 054 X

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THE CASE

Introduction

Metals and Metals was a proprietorship firm manufacturing sheet metal components for motor cycles and mopeds since 1990. The products included sheet metal components, parts of motor cycles and mopeds, etc. The major customers of the applicant were big two wheeler companies like Owa India and Speed. The unit was located on an ancestral property belonging to the proprietor, George Hanuman.

Exhibit 1: Current credit exposure

Description	Rate of interest	Limit (Rs. In lacs)	Balance as on 31-03-2000	Primary Security
Tata Sumo Car loan with Money Bank Ltd (34 months loan, payment started on 6.7.1999, last payment due on 6.4.2002)	16.83%	3.00	2.20	Hypothecation of the vehicle and co-obligation of Mr. George Hanuman
Santro Car loan with Green Bank (34 months loan taken on 06.05.1999, last instalment was due on 6.4.2000)	16.75%	2.10	2.21	Hypothecation of the vehicle
CC limit with Shining Bank		6.00	6.56	Hypothecation of stocks and book debts

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Term loan with Shining Bank		2.50	2.48	Mortgage of machinery

The current credit exposure of the firm is given in Exhibit 1. All the loans were regular. In addition to the above, Metals and Metals was maintaining a current account with the Money Bank Ltd, Rewari Branch since 09-09-1998 and the performance of the account was satisfactory. The cost of acquisition of Tata Sumo was Rs. 4.29 lacs and that of Santro car was Rs. 3 lacs. Both the cars were acquired in May-June, 1999.

The Proposal

Date of the loan application: 21.5.2000

Date of receipt at head office: 30.5.2000

Date of last clarification: 31.5.2000

The head office of the Money Bank Ltd received a proposal from its branch in Rewari for sanction of a limit of Rs 15.00 lacs for overdraft and Rs. 12.00 lacs for term loan for M/s. Metals and Metals. Metals and Metals had agreed to close the CC and Term Loan accounts with Shining Bank before sanction of the new limits. The CC account with Shining Bank was being maintained for the convenience of depositing monthly cheques received from Owa India. The firm had agreed to shift all business dealings to the Rewari branch of Money Bank Ltd except for a current account with Shining Bank for the limited purpose of realising the cheques of Owa India. The Rewari branch of Money Bank had to advise the firm regarding the use of Shining Bank Current Account for realizing the cheques of Owa India and transfer of funds to the branch.

Mohandas, deputy general manager of Money Bank Ltd at its head office, had gone through the Statement of the CC account with Shining Bank and had not come across any adverse features in the conduct of the account.

Though the Shining Bank sanction letter was not available, George Hanuman promised to obtain a no due certificate from the said bank on closure of liabilities.

The firm proposed to purchase plant and machinery costing Rs. 17.70 lacs for increasing the installed capacity and product range. The details of the plant and machinery are given in Exhibit 2.

Exhibit 2: Details of plant and machinery

1. Power Press: 8 Nos.
2. Electric Panel: 3 Nos.
3. 125 KVA DG Set: 1 No.
4. Milling Machine: 1 No.
5. Lathe Machine: 1 No.
6. Surface Grinder: 1 No.

Security offered

The firm was offering hypothecation of stock and book debts considered good for the overdraft facility and equitable mortgage of plant and machinery costing Rs. 17.70 lacs to be purchased for term loan facility, as primary security.

George Hanuman had mortgaged an agricultural land belonging to him as collateral security for the loans with Shining Bank. For the present proposal, he was offering as collateral security, a

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vacant residential plot with an area of 605.42 sq. yards at Bhawani Nagar belonging to his son's father-in-law, James Hanuman. The plot was valued at Rs. 41.87 lacs as per valuation report dated 22.05.2000. A legal opinion and a non-encumbrance certificate on the property had been obtained by Money Bank Ltd.

Existing plant and machinery with a book value of Rs. 6.54 lacs as on 31.3.1999 was also offered as collateral security. George Hanuman had agreed to give a personal guarantee for the loan. His net worth as on 31.3.2000 was Rs. 22 lacs.

The existing factory land and building, being ancestral property, was not offered as part of collateral security.

Other information:

1. As per RBI guidelines, based on the recommendations of the Nayak Committee, working capital requirements of the company was to be assessed at 25% of the projected annual sales turnover for fund based limits upto Rs. 400 lacs, of which, 20% was to be financed by bank and 5% was to be contributed by the borrower towards margin.
2. As per extracts from CMIE's Monthly Review of the Indian Economy (Issue: May 2000; Page 66), two-wheeler production grew 12% and sales grew by 11% during 1999-2000 over the previous year. Amongst the three segments of this sector, motorcycles led growth with production rising 29.3% and sales growing by 28.7%. Mopeds also recorded growth, although at a modest pace, with production growing at 7.8% and sales at 6.5%.
3. The bank had obtained copies of the following in respect of the firm:
    a. SSI registration certificate issued by the District Industries Centre

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   b. Sales tax assessment orders for the assessment years 1995-96, 1996-97 and 1997-98 and sales tax returns for the assessment years 1998-99, 1999-00 and 2000-01.
   c. Income tax return filed on 31-12-99 for the assessment year 1999-2000.
4. On 17.05.2000, Kandamuthu, the branch manager of Rewari branch of Money Bank Ltd visited the unit of Metals and Metals and reported that the unit was working satisfactorily.

Apart from the financial statements and other information discussed earlier, George Hanuman gave the following clarifications to the bank:

1. The unsecured loans were from members of his family and friends.
2. He believed in acquiring raw material in cash for securing better deals and reducing creditors.
3. There had been an increase in statutory liabilities like sales tax and other liabilities like audit fees, bonus and salaries as on 31.03.99.
4. The debtors collection system of the firm was efficient.
5. The good quality of his products enabled him to secure favourable terms from customers.
6. The market for his products was very competitive.
7. His product mix had changed and hence, the raw material required too had changed.
8. The firm had entered into a wage agreement with the employees which had resulted in an increase in salaries and wages for the year ending 31.3.2000.

Terms and conditions

The head office, on 10th June, 2000, advised the Rewari branch to sanction an overdraft facility with a limit of Rs. 15 lacs and term loan of Rs. 12 lacs with the following terms and conditions:

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1. Rate of interest shall be 17% p. a. for both the loans.
2. Margin:
    a. 30% on stocks and 50% on book debts considered good and not more than 90 days, for overdraft
    b. 30% for term loan
3. Primary Security:
    a. Hypothecation of stock and book debts considered good
    b. Equitable mortgage of plant and machinery to be purchased for Rs. 17.70
4. Collateral Security:
    a. Mortgage by deposit of title deeds of plot situated at No. 1035, Bhawani Nagar, Rewari, owned by James Hanuman valued at Rs. 41.87 lacs as per valuation report dated 22.05.2000.
    b. Co-obligation/guarantee of George Hanuman S/o Bill Hanuman
    c. Mortgage of plant and machinery with a written down value of Rs 6.54 lacs as on 31.3.99
5. Mode of repayment:
    a. Overdraft: on demand
    b. Term loan: 60 monthly instalments of Rs. 20000 each plus interest as and when debited.
6. Before disbursement, ensure that the Shining Bank term loan and CC liabilities are closed, and satisfactory confidential opinion and no due certificate from Shining bank was obtained and forwarded to head office.
7. Before disbursement, ensure that satisfactory confidential opinion from Green Bank was obtained and forwarded to head office.

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8. Monthly statement of stocks and book debts in the prescribed formats should be obtained in time and submitted to the head office regularly. Drawing in the overdraft account should be allowed strictly against stocks and book debts position, keeping prescribed margin.
9. All the conditions related to equitable mortgage of the properties as per the legal opinion should be complied with before releasing the loan.
10. The firm should submit declaration that unsecured loans from friends/relatives will not be withdrawn during the currency of the bank's credit facilities.
11. Consent of the borrower(s)/co-obligant(s) shall be obtained to disclose their names in the event of their becoming defaulters in the prescribed format as per circular HO:ADV:GEN:RBI:DIR:GF 14B:20:1999-2000 dated 17.11.99.
12. The proceeds of the term loan along with the margin money collected from the borrower shall be remitted directly to the suppliers of the machinery and related stamped receipt/invoice to be obtained and held.
13. In case of foreclosure of the term loan, the firm shall pay foreclosure (premium) charges @ 1.5% p.a. on the amount so prematurely repaid from the date of such premature foreclosure payment to the due date for repayment of such amount.
14. The firm should submit audited financial statements as at 31.3.2000 as and when ready.
15. Guarantor, George Hanuman's latest net worth details should be furnished to head office.
16. All other terms and conditions as per head office circulars and manual of instructions should be complied.

Financial data

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The audited and provisional (prov.) financial statements provided by Metals and Metals are given in Exhibit 3.

Exhibit 3

INCOME STATEMENT (Rs. In lacs)

	31.03.98	31.03.99	31.03.00
	Audited	Audited	Prov.
INCOME			
Sales (Gross)	163.44	241.28	445.36
Closing stock difference	5.51	1.84	1.00
	168.95	**243.12**	**446.36**
EXPENDITURE			
Raw material purchased	129.31	180.55	278
Excise duty	0.00	0.00	32.02
Salaries and wages	8.98	12.83	32.25
Other manufacturing expenses	16.03	23.44	51.71
Selling and administration expenses	10.84	18.92	39.72
Interest and finance charges	1.48	2.89	4.76
Depreciation	1.29	3.02	6.14
	167.93	241.65	444.6
Profit before tax	1.02	1.47	1.76
Provision for taxation	0	0	0
Profit after tax	1.02	1.47	1.76

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BALANCE SHEET (Rs. In lacs)

	31.03.98	31.03.99	31.03.00
	Audited	Audited	Prov.
LIABILITIES			
Capital account	3.73	6.45	7.46
Long term loans	2.88	2.38	6.88
Unsecured loans from others	9.27	16.09	29.98
Cash credit from banks	3.37	5.37	6.56
Sundry creditors (raw materials)	22.98	41.52	23.60
Other liabilities	0.78	5.75	5.69
TOTAL LIABILITIES	43.01	77.56	80.17
ASSETS			
Fixed assets	6.22	11.12	22.55
Non-current assets	0.07	0.07	0.17
Current assets			
Inventories	9.52	11.37	12.36
Sundry debtors	21.93	51.65	39.58
Cash and bank balances	2.57	1.72	5.28
Loans and advances	2.70	1.63	0.23
TOTAL ASSETS	43.01	77.56	80.17

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The projected income statements for the next four years provided by Metals and Metals are given in Exhibit 4.

Exhibit 4

INCOME STATEMENT (Rs. In lacs)

	31.03.01	31.03.02	31.03.03	31.03.04
	Proj.	Proj.	Proj.	Proj.
INCOME				
Sales (Gross)	550	575	600	600
Material	342.05	357.60	373.15	373.15
Labour	39.83	41.64	43.45	43.45
Other expenses	154.20	162.25	169.13	169.13
Interest on term loan	2.89	2.02	1.22	0.07
Interest on working capital	2.55	2.55	2.55	2.55
Depreciation	6.51	5.2	4.16	3.33
TOTAL EXPENSES	548.03	571.26	593.66	591.68
Operating profit	1.97	3.74	6.34	7.66
Provision for tax	0.58	1.12	1.91	2.33
Profit after tax	1.39	2.62	4.43	5.33

Cash accruals computed by the firm are given in Exhibit 5.

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Exhibit 5

(Rs. In lacs)

	31.03.01	31.03.02	31.03.03	31.03.04
Net profit	1.39	2.62	4.43	5.33
Depreciation	6.51	5.2	4.16	3.33
Interest on term loan	2.89	2.02	1.22	0.07
Cash accrual	10.79	11.15	12.16	12.54

The firm had projected the build-up of current assets and current liabilities as on 31.3.2001 as in Exhibit 6.

Exhibit 6: Build-up of current assets and current liabilities (Rs. In lacs)

CURRENT ASSETS	
Raw material (monthly consumption)	14.25
Stock in process (one month's cost of production)	4.53
Finished goods (one month's cost of sales)	4.53
Consumables	2.00
Receivables	45.83
Advance for raw material	0.80
Cash and bank balance	3.24
TOTAL	**75.18**
CURRENT LIABILITIES	
Sundry creditors	28.50

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Statutory liabilities (sales tax)	2.00
TOTAL	**30.5**

Exhibit 7 contains the repayment and interest schedule provided by Metals and Metals.

Exhibit 7: Repayment and interest schedule

(Rs. In lacs)

	‘2001	‘2002	‘2003	‘2004
Principal				
Term loan instalment (proposed)	2.00	2.40	2.40	2.40
Term loan instalment (Shining Bank)	2.48	0.00	0.00	0.00
Term loan instalment (Money Bank Ltd)	1.20	1.00	0.00	0.00
Term loan instalment (Green Bank)	0.84	0.84	0.53	0.00
	6.52	4.24	2.93	2.4
Interest				
Interest on term loan (proposed)	1.88	1.50	1.09	0.70
Interest on term loan (Shining Bank)	0.07	0.00	0.00	0.00
Interest on term loan (Money Bank Ltd)	0.64	0.29	0.04	0.00
Interest on term loan (Green Bank)	0.30	0.23	0.09	0.00
	2.89	2.02	1.22	0.7

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Requirement and discussion

Analyse the past, current year and projected financial statements of Metals and Metals with the other data provided in the case and answer the following:

1. Are the projections realistic, reflecting the dynamics of the firm's operations?
2. Analyse how accurately the firm has projected its need for working capital.
3. Was the sanction by the head office in order and in the best interests of the bank?

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TEACHING NOTES

Case abstract

There are several RBI guidelines and internal rules and regulations in every bank for the sanction of loans. Notwithstanding such guidelines and rules, we find that the total Non Performing Assets of banks are on the rise. The reason for this could be that the banks, due to business exigencies, sanction proposals that perhaps were not worthy of being sanctioned.

The Money Bank Ltd case is based on an actual proposal received by a Bank in Rewari from a proprietorship firm. This case presents a proposal where Metals and Metals has applied to Money Bank Ltd for a working capital loan of Rs 25 lacs and a term loan of 12 lacs. The bank has sanctioned an overdraft facility with a limit of Rs. 15 lacs and a 60 months term loan of Rs 12 lacs. A perusal of the information submitted would indicate that it is incomplete and therefore requires completion after making the necessary assumptions. The students are asked to analyse the information submitted and the need for the credit limit sanctioned as well as to comment on the decision of the bank.

The depreciation and income tax rates used in the case are as applicable to the years under study. The faculty can use recent years as the years of study after making necessary changes to the tax and depreciation figures.

This case has been designed for MBA students, who have opted for the Working Capital Management elective course and seeks to test their knowledge of financial statement analysis and credit appraisal. It involves a critical evaluation of the proposed credit needs of the firm, as approved by the bank, having regard to the extant RBI regulations, and a thorough review of the financial statements of the firm, past, present and estimates of the future.

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Case overview

The case involves an actual proposal for working capital finance from Metals and Metals which has been sanctioned by Money Bank Ltd. Metals and Metals has provided a set of financial statements (historical as well as projected), and details about the current credit exposure with several banks. Some of the information provided by the proprietorship firm was incomplete and students are required to compute the same from the information given, duly making the necessary assumptions, where required.

This case involves a critical evaluation of the proposed credit needs of the firm, as approved by the bank, having regard to the extant RBI regulations and the Nayak Committee recommendations as applicable to the proposal. The total working capital requirement would be considered to be 25% of the proposed turnover. Of this, 20% would have to be financed by the bank and 5% by the client.

Given the existing details, the students are required to thoroughly rework the proposal and comment on the same. They have to analyse the financial statements provided and have to assess whether the sanction by the bank was proper and in its best interests. Students are also required to analyse the industry data to have an idea of the industry dynamics and raw material consumption and other manufacturing costs for a complete understanding of the rationale adopted in approving a proposal. A working knowledge of financial accounting, financial statement analysis and working capital management is required in order to work on this case.

Learning objectives

The learning objectives of this case are to help the students to:

1. Appraise the working capital proposal of the borrower from the Banker's perspective.

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2. Understand the procedural requirements in terms of documentation for application for appraisal and sanction of working capital credit limits with the bank.
3. Understand the errors that can be made by a lending bank in assessing credit proposals.
4. Understand how incomplete information may hamper and delay the sanction of a loan.

Classroom use

This case is designed to be used in Working Capital Management Elective course in an MBA classroom where the students have been introduced to financial statement analysis and credit appraisal.

For meaningful discussion in class, the students would be required to thoroughly analyse the case and come prepared with their issues.

Some Lead Questions for class discussion

1. Analysis of the income statement – How do we check whether projections for sales revenue and costs are realistic? [20 minutes]
2. Analysis of the Balance Sheet – Check whether the inventory, debtors and other current assets shown in the projections are realistic. [30 minutes]
3. How do you verify the depreciation expense and the interest expense charged to the income statement? [15 minutes]
4. How and why do you calculate cash accruals from the projected financial statements? [20 minutes]
5. Prepare a fund flow statement for the projected financial statements. [20 minutes]

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6. Ensure that the working capital funds are to be utilized for operating activities. [15 minutes]
7. Analyse the working capital requirement of the firm. [20 minutes]
8. Do we need to check the working capital ratios in this case?[15 minutes]

Suggested solution:

The operating statements (actual and projected) are analysed item by item for the trend in sales, other income, operating expenses and the computation of profit. Some of the questions that are raised in the process are:

- Are the projections of sales correct?
- Do the operating expenses reflect the dynamics of the business?
- Are the expenses all related to sales in the projections?
- How much margin has been generated in the business?
- What are the industry trends?
- What are the details of the non-cash expenditures and have they been properly computed? (Please note that the net cash flows are an important indicator of the liquidity of the firm)

An assessment of the working capital needs of an organization primarily requires an in-depth analysis of the Income Statement and the Balance Sheet. The Income Statement is analysed to check the veracity of the projection of sales, and the projections of cost production, cost of sales and net profit therefrom. The latter provides the margins required by the Bankers for lending funds. The Balance Sheet is analysed for assessing the current asset projections, especially,

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inventories and debtors and for concluding whether the build-up is in line with current projections of sales and production requirements, after duly considering the past trends.

As the working capital requirement in the given case is below Rs 5 crores, the assessment of the case would be as per Projected Annual Turnover Method as per RBI instructions effective from 28-10-1993 and as recommended by the Nayak Committee. Accordingly, the working capital limit should be fixed on the basis of 25% of the Projected Annual Turnover, with the unit bringing in 5% of the Projected Annual Turnover as margin and the bank providing the balance as credit.

Comparing the actual with the projected data shows how the client has made its case for funding requirement. If the client has brought a higher margin in the past, it cannot ask for funding that will be used to repay the extra margin brought in earlier (as per Nayak Committee recommendations). The bank shall cover only the incremental asset needs arising due to increase in inventory and debtors.

Analysis of the financial statements

Profit and loss statement

1. The provisional **sales** figures for the year 1999-00 can be compared from the sales stated in the copies of the sales tax returns available.
2. The trend of sales with respect to working capital can be analysed as under:

	97-98	98-99	99-00	00-01	01-02	02-03
Sales (Rs. In lacs)	163.44	241.28	445.36	550.00	575.00	600.00
%age increase	---	47.62	84.58	23.50	4.54	4.35

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Current assets (Rs. In lacs)	36.72	66.37	57.45	75.18		
Current liabilities (Rs. In lacs)	23.76	47.27	29.29	30.50		
Net current assets (Rs. In lacs)	12.96	19.10	28.16	44.68		
% age increase	---	47.38	47.43	58.67		

Note that the projected balance sheets have not been provided and the details of projected current assets and current liabilities have been provided only for 2000-01.

As per the CMIE data available, the two wheeler industry has been growing at an average of 11% during 1999-2000. However, the client is supplying parts for motorcycle and mopeds segments, sales of which have grown by 28% and 6%, respectively. Compared to this, the sales of our client have increased by 85% during the same year. This is a phenomenal increase and should be compared with the audited financial statements once they are made available. The bank should verify the feasibility of such growth with the client.

The trend of funding of net current assets has been as under:

Net current assets funded by:	97-98		98-99		99-00		00-01	
	Rs. In lacs	%	Rs. In lacs	%	Rs. In lacs	%	Rs. In lacs	%
Cash credit from banks	3.37	26	5.37	28	6.56	23	15.00	34
Unsecured loan	9.27	71	13.73	72	21.58	77	29.68	66
Capital and long	0.32	3	---	---	---	---	---	---

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term loans								
	12.96	100						

As we can see from the above analysis, 71%-72% of the funding of net current assets has been through unsecured loans in 97-98 and 98-99. However, the %age of unsecured component shot up to 77% in 99-00. On the other hand, the projected figures show a steep decline with only 66% of projected current assets being funded by unsecured loans, the balance being funded through the cash credit from Money Bank Ltd. Also, the projected increase in sales in 2001 over the previous year is 24%, whereas the projected increase in cash credit from banks for the same period comes to 128%. The given increase in sales does not warrant the increase in working capital finance of this magnitude in respect of year 2000-01.

The analysis should be seen in the light of the analysis of term loans as appearing in the balance sheet.

3. The closing stock difference for the audited and provisional financial statements cannot be related to the projected closing stock for 2000-01 due to lack of details of closing stock break-up in the former. We may predict that the client is able to sell whatever he produces as there is no closing stock difference in the projected financial statements and the client also claims that his goods are of superior quality.
4. There has been a steep fall in the cost of raw material purchased when compared to total expenditure or percentage of adjusted value of production. As per the client's statement, this could be because of getting better deals in the purchases due to immediate cash payments. Looking at the data available and believing that the fall in raw

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material cost is only because of availing cash discount, we can compute the cash discount availed by the firm.

Year	Raw material purchased (Rs. In lacs)	Cost component or adjusted value of production (%)
97-98	129.31	77.00
98-99	180.55	74.72
99-00	278.00	62.53

If the rate of 74.72 was maintained in 1999-2000, adjusted value of production of Rs. 446.36 lacs would require a raw material of Rs. 333.29 lacs. This would mean that the firm received a cash discount of Rs. 55.29 lacs which works out to be 17%. As the average credit period sought to be maintained is one month, the discount given by the suppliers would be prohibitively expensive to them and seems unrealistic.

The client has claimed that his product mix has changed due to which the raw material required has also changed. The firm manufactures sheet metal products for motor cycles and mopeds. Its product range at present and proposed is not given. However, considering the fact that the requirement of such components in a motor cycle or moped is limited, the likelihood of there being an extensive variety of such components with widely varying raw material requirement to impact costs would be highly unlikely.

The loan proposal states that the term loan is for the purchase of plant and machinery to expand capacity and product range. This purchase would take place once the term loan is sanctioned. Hence, it is unlikely that the raw material cost reduction took place due to a change in product mix even before the plant and machinery was purchased. Moreover, since no figures of the

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quantity of raw material usage are available, we are unable to make any comment in this regard.

5. While the income statement of 1999-2000 separately shows excise duty (full excise duty is applicable for units with turnover in excess of Rs. 3 crore), the projected income statements do not show the excise duty separately. This could be because the client has omitted excise duty or has included it in the cost of raw materials purchased. If the latter were true, it would imply that the cost of raw material purchased as a percentage of adjusted cost of production, without including excise duty, would further come down with respect to earlier years. This again leads us to enquire into the steep decline in the raw material cost.
6. Salaries and wages as a percentage of production cost has increased to 7% in 1999-00 from 5% in previous year. The percentage change in salaries has been 43% in 1998-99, 151% in 1999-00 and 23% in 2000-01. Although details of the staff strength have not been provided, being a small firm with limited capital and turnover, the strength may be limited. In such cases, normally, the salaries and wages expenditure is relatively fixed in nature. Perhaps, the huge increase during 1999-00 needs to be rationalised. Perhaps a substantial portion of the salaries is drawn by the proprietor. The wage agreement referred to by George Hanuman is not available for verification by the bank.
7. The reason for steep rise in other manufacturing expenses during 1999-00 needs to be looked into.
8. Overall comparison of expenditure can be made as under:

	1998-99	1999-00	2000-01
Opening balance of debtors	21.93	51.65	39.58
Add: sales	241.28	445.36	550.00

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Less: closing balance of debtors	51.65	39.58	45.83
Cash collected	211.56	457.43	543.75
Incremental collections	---	245.87	86.32
Incremental selling and distribution	---	21	22

George Hanuman has talked about an efficient collection system. From the above, we find that the firm has been able to collect 245.87 lacs with an incremental selling and distribution of 21 lacs, while only 86.32 is projected collection in 2000-01 with an incremental expenditure of 22 lacs. The heightened collection efforts do not seem to bring in substantial additional benefits.

9. The details of additions to fixed assets during the three years and the break up of the written down value of fixed assets of Rs. 22.55 lacs as on 31.3.2000 has not been given. These details have been computed in point (1) to the Balance Sheet part of these teaching notes.

   The net value of additions computed in (1)(b) to the Balance Sheet part during 1999-00 is Rs. 14.21 lacs. The break-up of this amount into different assets is computed as under:

Plant and machinery From 01.04.99	8.34
From additions during 99-00	
If depreciated at income tax rates:	
Plant and machinery (10.28 less 25%)	7.71
Car (7.29 less 20%)	5.83
WDV of additions	13.54
However, the net value of additions is	14.21

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Apportioning accordingly, we get:	
WDV of plant and machinery additions	8.09
WDV of car additions	6.12

The projected depreciation for 2000-01 can be analysed from the above calculations as under:

Depreciation during 2000-01	
Plant and machinery (8.34 + 8.09)	16.43
Less: depreciation @ 25%	4.11
WDV as on 31.03.2001	12.32
Cars	6.12
Less: depreciation @ 20%	1.22
WDV as on 31.03.2001	4.9
Total WDV of fixed assets as on 31.03.2001	17.22
Total depreciation on existing assets during the year	5.33
Depreciation as per projections	6.51
Depreciation on additions during the year (6.51-5.33)	1.18
Total machinery intended to be purchased	17.70
Depreciation as a % of cost of plant and machinery	6.67%
Depreciation as per income tax rate	25%

Hence, the 6.67% depreciation is for approximately four months. Two questions then arise in this regard:

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a. If the income tax method of depreciation is adopted, then depreciation as projected vis-à-vis depreciation as calculated does not tally. This would definitely need more scrutiny as depreciation is a major source of cash flow to the firm. As per income tax method, depreciation is charged for the full year on assets purchased before October and for 6 months for assets purchased thereafter.

b. If the income tax rates are adopted, the depreciation seems to have been charged only for 4 months. This would raise the question as to how the projections are being made given that the loans are being availed during the beginning of the year and that repayments are projected for 10 months during 2000-01 and for 12 months thereafter.

10. No interest has been calculated on unsecured loans. As the details of interest and finance charges for the audited and provisional income statements are not available, it needs to be verified whether the unsecured loans are interest free or has there been an error in preparing the projections. The calculation of interest on term loans includes an interest amount beside the heading "interest on term loan (existing)". This seems to be an error as all the existing term loans (from Shining Bank and Green Bank) have already been considered in the table.

11. The calculations for cash accruals have ignored the tax deductibility of interest on loans. The addition to net profit should be limited to interest(1-tax rate). Here, the tax works out to be approximately 30%.

Balance Sheet:

1. Fixed Assets

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a. Figures of original cost of fixed assets are not available. Hence, the figures have to be reworked to arrive at the original cost in order to ascertain the additions/deletions to the assets. (Rs. In lacs)

	31.03.98	31.03.99	31.03.00
Fixed assets (net block)	6.22	11.12	22.55
Add: Depreciation during the year	1.29	3.02	6.14
WDV of the gross block	7.51	14.14	28.69

As can be seen from the above table, there have been additions to fixed assets during the three years.

b. The rates for depreciation of fixed assets for proprietorship firm are as prescribed under the Income Tax Act. As Metals and Metals is a propreitorship firm, we presume that such rates have been applied for depreciation of fixed assets. As per income tax laws, the depreciation rate on plant and machinery is 25% and on motor cars is 20%. Using these rates, we compute backwards to find the value of additions to fixed assets.

(Rs. In lacs)

For the year ended 31.3.1999	
WDV of fixed assets as on 31.03.1999	11.12
Less: WDV of plant and machinery (as per statement of collateral for loan)	6.54
Balance (Other assets)	4.58

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WDV of fixed assets as on 1.04.1998	6.22
Less: depreciation @ 25% (assuming that all the assets are plant and machinery)	1.56
WDV as on 31.3.1999 (ignoring additions)	4.66
Actual WDV as on 31.3.1999	11.12
Net additions during 1998-99	6.46
Depreciation on additions (3.02-1.56)	1.46
Gross value of additions during 1998-99	**7.92**

For the year ended 31.3.2000	
WDV of fixed assets as on 1.04.1999	11.12
Less: depreciation @ 25% (assuming that all the assets are plant and machinery)	2.78
WDV as on 31.3.2000 (ignoring additions)	8.34
Actual WDV as on 31.3.2000	22.55
Net additions during 1999-00	14.21
Depreciation on additions (6.14-2.78)	3.36
Gross value of additions during 1999-00	**17.57**
Less: Cost of vehicles purchased during the year (Tata Sumo 4.29 + Santro 3.00)	**7.29**
Balance is addition to Plant and Machinery	**10.28**

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2. Preparation of fund flow statement

The fund flow statement will reveal whether the funds at the disposal of the client are being utilized properly. (Rs. In lacs)

For the year ended 31.3.1999		
SOURCES:		
Fund flow from operations:		
Net Profit	1.47	
Add: Depreciation	3.02	4.49
Addition to Capital:		
Closing balance	6.45	
Less: Opening Balance	3.73	
Net Profit	1.47	1.25
Term loans inflow:		
Closing balance	18.47	
Less: Opening Balance	12.15	6.32
Working capital inflows:		
Decrease in cash and bank balances	0.85	
Decrease in loans and advances	1.07	
Increase in cash credit	2.00	
Increase in sundry creditors	18.54	27.43
Total cash inflows		**39.49**
APPLICATION:		
Working capital outflows:		

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Increase in inventory	1.85	
Increase in debtors	29.72	31.57
Purchase of fixed assets (as per 1(b) above)		7.92
Total cash outflows		**39.49**

An analysis of fund flow statement reveals that:

a. Additions to fixed assets (Rs. 7.92 lacs) have been funded as follows:
   i. Term loan: 6.32 lacs,
   ii. Capital inflow: 1.25 lacs and
   iii. Profit: 0.35
b. Addition to current assets (Rs. 29.65 lacs) have been funded as follows:
   i. Current liabilities: 25.51
   ii. Operating flows: 4.14

For the year ended 31.3.2000		
SOURCES:		
Fund flow from operations:		
Net Profit	1.76	
Add: Depreciation	6.14	7.9
Term loans inflow:		
Closing balance	36.86	
Less: Opening Balance	18.47	18.39
Working capital inflows:		

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Decrease in sundry debtors	12.07	
Decrease in loans and advances	1.40	
Increase in cash credit	1.21	14.68
Total cash inflows		**40.97**
APPLICATION:		
Decrease in Capital:		
Closing balance	7.46	
Less: opening Balance	6.45	
Profit	1.76	0.75
Increase in non-current assets		0.12
Working capital outflows:		
Increase in inventory	0.99	
Increase in cash and bank	3.56	
Decrease in sundry creditors	17.92	
Decrease in other liabilities	0.06	22.53
Purchase of fixed assets (as per 1(b) above)		17.57
Total cash outflows		**40.97**

An analysis of fund flow statement reveals that:

a. Additions to fixed assets have been funded by a portion of term loans i.e. Rs. 17.57 lacs
b. Capital withdrawn (Rs. 0.75 lacs) has been funded by operating cash flows.

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c. Additions to non-current assets have also been funded by the operating cash flows.
d. Decrease in sundry creditors (Rs. 17.92 lacs) has been funded by:
    a. Decrease in sundry debtors: Rs. 12.07 lacs
    b. Increase in cash credit from banks: Rs. 1.21 lacs
    c. Decrease in loans and advances: Rs. 1.40 lacs
    d. Operating cash flows: Rs. 3.24 lacs
e. Decrease in other liabilities (Rs. 0.06 lacs) has been funded by term loan funds.
f. Operating cash flows has funded increase in inventory (Rs. 0.99 lacs)
c. Addition to cash and bank balances (Rs. 3.56 lacs) has been funded as follows:
    i. Term loan: Rs. 0.76 lacs
    ii. Operating cash flows: Rs. 2.80 lacs

The above analysis shows that the long term funds have been used for long term purposes. Hence, there is no diversion of funds.

3. *Loans*
    a. The long term loans have increased from Rs. 2.38 lacs on 31.03.99 to Rs. 6.88 lacs on 31.03.2000 as the client has taken additional term loans during the year.
    b. The unsecured loans have increased by 73% (16.09 from 9.27) in 98-99 and by further by 86% (29.98 from 16.09) in 99-00.

Since the unsecured loans are persisting during the three years and have been used for sourcing fixed assets, they have been presumed to be long term sources. These increases in long term funds have been used for funding fixed assets.

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4. *Creditors'* velocity has been 2.13 for 97-98, 2.76 for 98-99 and 1.02 for 99-00. The drastic reduction in sundry creditors in 99-00 could be because of George Hanuman's intention of securing raw materials with cash for better deals.
5. *Debtors'* velocity has been 1.61 for 97-98, 2.57 for 98-99 and 1.07 for 99-00. While the debtors were increasing earlier, they drastically dropped from 51.65 to 39.58 lacs. The figures as on 31.03.00 are only provisional and need to be compared with actual audited figures once they are available. From the funds flow statement, we understand that the funds released by the reduction in debtors have been utilised to pay off creditors. While the reduction in creditors has been explained as arising due to cash purchases, the reduction in debtors has been attributed to an efficient debtors' collection system of the firm. This seems to be improbable if we look at the statement of George Hanuman hinting towards heavy competition in the market. Thus, the reduction in debtors needs all the more to be looked into once the audited financial statements of 1999-00 are available. In competitive markets, the customers try getting more credit as they have higher bargaining power.
6. The break-up of *inventory* is not made available in the actual and provisional financial statements of three years.

Projections:

The firm has not made available the projected balance sheets. However, the build-up of current assets and current liabilities is provided as on 31.03.2001. From the information available, the projected balance sheet as on 31.03.2001 can be prepared as under:

(Rs. In lacs)

		31.03.01

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LIABILITIES		
Capital account		
Opening balance	7.46	
Add: Profit after tax	13.9	8.85
Long term loans (due after more than 1 year)*		8.13
Unsecured loans from others		29.98
Cash credit from banks		15.00
Portion of term loans due within 1 year*		4.24
Sundry creditors (raw materials)		28.50
Other liabilities		2.00
TOTAL LIABILITIES		96.70
ASSETS		
Fixed assets*		33.74
Non-current assets		
Current assets		
Inventories		25.31
Sundry debtors		45.83
Cash and bank balances		3.24
Loans and advances		0.80
TOTAL ASSETS		108.92
Difference between total assets and total liabilities due to lack of information		12.22

*Notes:

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The balance in fixed assets has been arrived as under:

Opening balance	22.55
Add: Purchases during the year	17.70
	40.25
Less: Depreciation (as per Projected Income Statement provided by the firm)	6.51
WDV as on 31.03.2001	33.74

The balance in long term loans has been arrived as under:

	Balance as on 31.3.00	Repayment during 00-01*	Balance as on 31.3.01	Repayment during 00-01*	Balance as on 31.3.02
Shining Bank loan	2.48	2.48	0.00	0.00	0.00
Green Bank loan	2.21	0.84	1.37	0.84	0.53
Money bank loan	2.20	1.20	1.00	1.00	0.00
Proposed loan (12 lacs)		2.00	10.00	2.40	7.6
Total			12.37	4.24	8.13

* as per repayment schedule provided by the client

Analysis of the build-up of current assets and current liabilities as projected for 31.03.2001:

1. Raw material Inventory turnover = 342.05/14.25 = 24. Number of days = 360/24 = 15 days.

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2. Stock-in-process turnover = (342.05+39.83+154.20+6.51)/4.53 = 119.78. Number of days = 360/119.78 = 3 days.
3. Finished goods turnover = (342.05+39.83+154.20+6.51)/4.53 = 119.78. Number of days = 360/119.78 = 3 days.
4. Consumables turnover = (342.05+39.83+154.20+6.51)/2 = 271.30. Number of days = 360/271.30 = 1.33 days.
5. Receivables turnover = 550/45.83 = 12. Number of days = 360/12 = 30 days.
6. Sundry creditors turnover = 342.05/28.50 = 12. Number of days = 360/12 = 30 days.

Since, the break-up of current assets and current liabilities for 1999-00 has not been provided, we are unable to assess the feasibility of the net working capital arrived at on the basis of above ratios.

We can try to get a break-up of the inventory holdings for the previous years as under:

The projections for 2000-01 do not show a closing stock difference. This means that the opening and closing stock of finished goods are the same. In the table of build-up of current assets and current liabilities for 2000-01, the finished goods are at a month's cost of sales amounting to Rs. 4.53 lacs. Hence, we can compute closing stock of raw materials, stock-in-process and consumables for the year ending 31.03.2000: (Rs. In lacs)

Total inventories	12.36
Less: closing stock of finished goods	4.53
Closing stock of raw materials, stock-in-process and consumables	7.83

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Closing stock of raw materials, stock-in-process and consumables for the year ending 31.03.1999: (Rs. In lacs)

Total inventories (A)	11.37
Less: closing stock of finished goods for the year ending 31.3.2000	4.53
Closing stock difference for the year ending 31.3.2000	1.00
Closing stock of finished goods for the year ending 31.3.1999 (B)	3.53
Closing stock of raw materials, stock-in-process and consumables (A)-(B)	7.84

Closing stock of raw materials, stock-in-process and consumables for the year ending 31.03.1998: (Rs. In lacs)

Total inventories (A)	9.52
Less: closing stock of finished goods for the year ending 31.3.1999	3.53
Closing stock difference for the year ending 31.3.1999	1.84
Closing stock of finished goods for the year ending 31.3.1998 (B)	1.69
Closing stock of raw materials, stock-in-process and consumables (A)-(B)	7.83

Assuming that even with a change in the product mix, there will not be any substantial change in the number of days of stock-in-process (3 days), the figures of stock-in-process for the three years can be computed as under:

For the year ending 31.3.2000

Closing stock-in-process	400.12/360*3 = 3.33
Stock of raw materials and consumables	7.83-3.33 = 4.50
Turnover	400.12/4.5 = 88.92

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Number of days	360/88.92 = 4.05 days

For the year ending 31.3.1999

Closing stock-in-process	219.84/360*3 = 1.83
Stock of raw materials and consumables	7.84-1.83 = 6.01
Turnover	219.84/6.01 = 36.58
Number of days	360/36.58 = 9.84 days

For the year ending 31.3.1998

Closing stock-in-process	155.61/360*3 = 1.3
Stock of raw materials and consumables	7.83-1.3 = 6.53
Turnover	155.61/53 = 23.83
Number of days	360/23.83 = 15.11 days

From the above we can see that the number of days of raw materials and consumables inventory is showing a declining trend which, perhaps, may justify the firm's claim for additional working capital finance. However, a working of the working capital gap would seem to show a different picture as under:

Analysis of working capital required

The working capital gap as on 31.3.2001 can be computed as under:

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	31.03.2000	31.03.2001	Incremental
Current assets			
Raw material	12.36	14.25	12.95
Stock in process		4.53	
Finished goods		4.53	
Consumables		2.00	
Receivables	39.58	45.83	6.25
Advance for raw material		0.80	0.80
Cash and bank balance		3.24	
Total current assets (A)		75.18	
Current liabilities			
Sundry creditors	23.60	28.50	4.90
Statutory liabilities		2.00	
Term loan due in 1 year*		4.24	
Total current liabilities (B)		34.74	
Working capital gap (A)-(B)		40.44	
Margin @ 5% of projected turnover		27.50	
Maximum permissible bank finance (20% of projected turnover)		110	

The bank finances only the incremental inventory and debtors, net of creditors, which comes to Rs. 15.1 lacs from the above table.

(Rs. In lacs)

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Incremental sales in 2000-01	104.64
25% of incremental sales	26.16
5% to be brought in by the client as margin	5.25
Balance to be funded by the bank	20.91

Calculating as per Nayak Committee's recommendations, the firm is eligible for a working capital loan of Rs. 20.91 lacs. However, it has projected a working capital gap of only Rs. 15.10 lacs. Given these projections, the bank could have sanctioned a working capital limit of upto Rs. 9.85 lacs (15.10 less 5.25 margin money). Both the projections by the firm and the sanction by the bank seem to be unjustifiable.

Conclusion

Analysis of the proposal

1. The investment in plant and machinery for the purpose of increasing capacity and for changing the product-mix does not seem to reflect in the sales projections.
2. The following projections seem highly unlikely:
    a. Steep decline in raw material consumption after an enormous build-up in 1999.
    b. The enormous increase in salaries and wages in 1999-2000.The increase in other manufacturing expenses
    c. The increase in selling and administration expenses
3. The firm seems to be selling most of what it produces, as the finished goods closing stock differential is marginal in the three years ended 31.3.2000 and has declined from year to year.

ISSN (Online) 2249 - 054 X

International Journal of Computing and Corporate Research

Specialized and Refereed Journal for Research Scholars, Academicians, Engineers and Scientists

http://www.ijccr.com

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4. Comparing the change in sales to the change in, working capital and inventory, as per the table given below the following was noted:

Year ending	Change in sales (%)	Change in working capital (%)	Change in inventory (%)
31.3.1999	32.26	43.17	19.4
31.3.2000	45.82	57.32	8.7
31.3.2001	23.59	106.85	104.77

The increase in inventory has been disproportionate to the increase in sales during the three years. Inventory has been projected for the year ended 31.03.2001 at Rs. 25.31 which is more than double the previous year's inventory holding of Rs 12.36 lacs whereas the corresponding increase in sales is only Rs 104.64 lacs or 24%.

5. The firm could make do with only Rs. 6 lacs increase in overdraft to fund a 46% increase in sales in 2000. Therefore, the demand for Rs 15 lacs overdraft (Rs. 9 lacs after netting off the existing CC from Shining Bank) to fund an increase in sales of only 24% needs to be further investigated. The fund flows analysed earlier show that outside unsecured loans have been primarily used to fund working capital requirements.
6. Looking at the actual and projected inventory holdings, we find that after a declining trend through years 1998-2000, there has been a 105% leap in the projected figures. This indicates that a major chunk of the additional borrowings is sought to be utilized for increased inventory holdings, especially, inventory of raw materials and consumables.
7. From the calculations of turnover of raw materials and consumables, we notice a declining trend:

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Year ending	Number of days
31.03.1998	15.11
31.03.1999	9.84
31.03.2000	4.05

Hence, the projections of raw material inventory of 15 days holding period for the year ending 31.03.2001 seems to be out of sync with the past trends. As per the trends, the projections for 2001 with a holding period of 4 days would have been 342.04*4/360 = Rs. 3.8 lacs. This figure is much below the projected Rs. 14.25 lacs. The reason for the need to increase the stock of raw materials and consumables stock holding period to 15 days from 4 days needs to be investigated, especially, given the fact that the client is making cash purchases and raw materials are in adequate supply.

8. Calculation of cash accruals is incorrect due to omission of tax shield on interest.

It can thus be concluded from the data provided that Metals and Metals is going to utilize a major chunk of the cash credit obtained from Money Bank Ltd to finance its raw material inventory. It is doubtful whether the firm requires so much of credit since it seems to be in a position to finance its needs using internally generated funds. Hence, it is unclear whether the bank's goal of need-based financing is being satisfied with the sanction of this loan application. We feel that the bank has shown too much of haste while passing the sanction order. Further data should have been called for and analysed.

Documents and reports required by the bank

For appraisal of a similar loan proposal, a bank generally requires the following documents to be submitted by the bank:

1. Audited financial statements for the previous three years
2. Estimated financial statements for the current year
3. Projected financial statements for next two years
4. Properly filled in appropriate format for the proposal (Nayak Committee format in this case)
5. Details of existing loans (amount, repayment schedule, security, etc.) with copies of relevant documents
6. Title deeds of the property to be offered as security
7. No encumbrance certificate
8. Sales tax and income tax returns

In the current case, the bank does not seem to have taken latest audited balance sheets of the company. Basic accounting policies like the depreciation method adopted would have been clear from the audited financial statements.

The following additional details are required for analysis:

1. Details of interest and financial charges for audited and provisional financial statements
2. Details of calculation of depreciation. The calculations done by us are based on logical assumptions.
3. Projected balance sheet for the next three years.

Some of the Errors by the lending bank in this case

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VOLUME 2 ISSUE 1 JANUARY 2012

1. Calculation of funding requirement of the firm
2. Taking all relevant documents from the firm for loan appraisal
3. Checking the feasibility of projections vis a vis the dynamics of the firm's operations
4. Checking the calculations done by the client, especially, with respect to depreciation, cash accruals and interest.