Analysis of financial statements for credit apprisal

ISSN 1857-9973 658.14/.17:334.72]:657.37

Aleksandra Dimitrovska [1], Olivera Gjorgieva-Trajkovska [2]

[1]University Goce Delcev Stip, Faculty of Economics, MA student, aleksandra_dimitrovska@hotmail.com

[2]University Goce Delcev Stip, Faculty of Economics, olivera.trajkovska@ugd.edu.mk

Abstract

Most businesses nowadays cannot survive without lending money. In a quest for survival and expansion, companies need to resort to debt as equity alone cannot suffice the requirements. Whether it is financing a new project, meeting working capital or expanding to a new market, a company requires funding at each stage.

Credit analysis is defined as the evaluation of the ability of a company to repay its financial obligations. In our country the credit or debt markets are not as mature as compared to global standards, hence there is excessive dependence on the traditional banking system. However, companies issuing bonds to raise finance is also not uncommon.

Credit default or in simple words, inability to pay the debt, is one of the most dreaded risks in the financial world. A bank should ask for updated firm's financial statements or additional financial information such as working capital, reserves, debtors, creditors, other bank loans etc, and comparative list with the previous year levels.

Key words: company, credit, analysis, financial, statements, obligations

1. Introduction

Crediting of legal entities as part of banking operations is extensive and complex process. When deciding whether to place funds, complex financial analyzes are made and the whole process takes longer compared to the process of crediting individuals.

Often credit analysis is carried out using an objective quantitative credit scoring system. In an accounting based credit scoring system, the credit analyst compares various key accounting ratios of potential borrowers with industry or group standards and trends in these variables. Often the financial model is used to directly provide the inputs to the credit scoring system. However, practitioners are now moving towards a model of more rigorous statistical techniques based on the financial analysis developed.

In this paper we will focus specifically on the financial analysis prepared by the bank commercialist during the initial phase of credit process, also known in banking as balancing.

2. Establishing first contact with the client and collection of the necessary documentation

Once the client approaches the bank as a financial institution with a request for additional financial capital, the banker is taking the space and time to prepare for the initial conversation with the clients. The commercialist will try to get more information about the customer from all available sources, in particular: [1]

- for his previous business cooperation with the bank
- for its operations, including detailed financial data
- for his position on the market
- for his future development plans
- for his management, the owners
- information from the media.

In this paper we are focusing specificallyon the part where the commercialist requests and collects from the customer the information about his work, as well as detailed financial data.

2.1. Documentation that the client should submit to the bank

The complete set of documents that a bank commercialist should have before starting the analysis of the company, as borrower, are: [2]

- Application for a credit - a form given by the bank that the applicant, that is, the person representing the legal entity, will have to fill out;
- Form for credit linked persons - this form should list all credit linked persons with the legal entity that appears as a loan applicant. Credit-related entities are those legal entities that are lending related to the legal entity that requires the loan.
- Type of collateral - as collateral for the loan, several instruments may be encountered, such as bill of exchange, a notarized bill of exchange, pledge of real estate, pledge of equipment,
- Current status issued by Central register, but not older than 6 months.
- Final accounts (a complete set of financial statements) for the last 2 years.
- Final balance list - report for the current year as of the last quarter.
- Analyzes on group accounts 12- Accounts receivables (Receivables from buyers), 22-Accounts payable (Short-term liabilities to suppliers), 16-Receivables on the based on approved credits and 26-Liabilities for credits and loans .
- Analytics of transaction accounts per month per banks.

After obtaining the complete documentation, the commercialist also visits the company in order to directly check the information written in the financial statements, ie the final accounts.

3. Analysis of financial statements

3.1. Balance sheet analysis

When we have already collected all the necessary documentation from the customer, we start with the financial analysis (analysis of the financial statements of a company). [3]

In the first part of the analysis, we analyze the financial statements for the last 2 years, ie the Balance Sheet and the Income Statement more specifically and in detail. We cumulate the data in comparative balances, as shown in figure 1.

Balance Sheet	12	12	12
ASSETS MKD'000	**31.12.2016**	**31.12.2017**	**31.12.2018**
FIXED ASSETS	**13.551**	**14.330**	**14.708**
INTANGIBLE ASSETS	-	-	-
Development costs	-	-	-
Goodwill	-	-	-
Patents and licences	-	-	-
Software and other rights	-	-	-
Advances for intangible assets	-	-	-
Intangible assets in preparation	-	-	-
Other assets	-	-	-
TANGIBLE ASSETS	**13.551**	**14.330**	**14.708**
Lands and buildings	7,282	4,906	5,283
Hardware and tools	6,269	6,106	6,187
Inventory and vehicles	-	3,318	3,238
Biological assets	-	-	-
Tangible assets in preparation	-	-	-
Advances for tangible assets	-	-	-
Other tangible assets	-	-	-
Assets held for rental and investment	-	-	-
LONG-TERM FINANCIAL ASSETS	-	-	-
Investments in related entities	-	-	-
Participating interests	-	-	-
Loans of related entities	-	-	-
Loans of unrelated entities	-	-	-
Other financial assets	-	-	-
LONG-TERM RECEIVABLES	-	-	-
Receivables from related entities sales	-	-	-
Receivables from sales	-	-	-
Other long-term receivables	-	-	-
Differed tax assets	-	-	-
CURRENT ASSETS	**27.525**	**31.906**	**32.971**
STOCKS	**8.088**	**14.050**	**14.314**
Raw materials	1,582	6,257	7,313
Production in progress	64	64	1,350
Merchandise	3,494	3,501	3,218
Finished products	2,948	4,228	2,433
Assets for sale	-	-	-
SHORT-TERM RECEIVABLES	**12.583**	**17.434**	**15.461**
Receivables from buyers	11,433	16,163	14,523
Receivables from related entities	-	-	-
Receivables for prepaid expenses	1,127	1,195	616
Receivables from government	23	76	322
Receivables from employees	-	-	-
Other receivables	-	-	-
SHORT-TERM FINANCIAL INVESTMENTS	**209**	**209**	**259**
Loans given to related entities	-	-	-
Short-ter loans and credits given to others	209	209	259
Other investments	-	-	-
Cash and cash equivalents	**6.645**	**213**	**2.937**
Prepaid expenses and costs	-	-	**196**
TOTAL ASSETS	**41.076**	**46.236**	**47.875**

Figure 1 –Comparative Balance Sheet Assets

In the balance sheet, we pay more attention to the trend of movement of material assets, inventories and Accounts receivables (from buyers). We note whether material assets are rising, remain the same or are decreasing slowly, whether the company stores large inventories, which may mean that there is a problem with the sale and whether there are large amounts of outstanding claims from customers that might threaten the liquidity of the company.

In our example, we can conclude that the land and buildings decreased in the second year, but for that reason, the company bought another inventory and transportation assets, thus the material assets are not reduced as a whole, but they show a small trend of growth which is a good indicator that the customer is stable company and maintains the level of tangible assets intended for smooth operation.

When we analyze supplies, we can see that in the second year, the item for raw materials as well as the item for finished products are drastically increased in relation to the first year, which indicates that the company had a production and sales problem. Raw materials are rising sharply in the second year compared to the first, which may mean that the customer has a production problem, so it can not turn them into final finished products. There is also a growing increase in the stock of finished goods, which in turn can be an indication that the customer has a problem with the sales. But when we take into account the third, that is, the current year, we will notice that between the second and third years there is not a big difference, which may mean that the customer had a problem in the first year, and already in the next two years production has stabilized.

When we move down and we come to receivables from buyers, we notice that the company in the second year in relation to the first has an increase in the demand for close to 50%, which can mean two things: in the first year there are fewer receivables due to the smaller volume of operation and smaller production, while in the second, with the increase in production, the receivables increase or, in the first year, the company had a higher percentage of receivables than in the second year. When discussing with the company's authorities it was determined that this increase in receivables is due to the increased production in the second year, which partially continues in the third year, ie, we notice a slight decrease in the receivables due to the changed policy of the company that credits its customers to a lesser period. By the end of the second year, the deadline for payment of invoices sent to customers was 45 days, while from the 3-rd year, with the decision of the manager of the company, this deadline was reduced to 30 days.

Finally, we must mention the money and cash equivalents in the assets, where we notice a drastic fall in the second year, unlike the first, which is due to the increase of the stocks, and already in the third year we see the growth of the money and cash equivalents at the expense of the fall in the stock of finished products, which means that the company has completed the process and the products have turned into money again.

In the liabilities of the balance sheet (Figure 2 on the next page), we mostly look at the value of equity items, liabilities arising from borrowings and loans and liabilities to suppliers.

In the this case, the amount of the capital is maintained at the same level, which means that the company is liquid and can generate cash inflows to finance its current operations without having to resort to capital sale in order to maintain liquidity.

When we go to the liability item arising from borrowings and loans from banks and other legal entities, we note the same level of borrowing in the first 2 years, while in the third year the liabilities are increased by additional 100.000 euros. This borrowing is due to the costs of building a new production capacity that can be seen in the assets, where in the third year the item for land and buildings is growing.

Finally we analyze the obligations towards suppliers that are increasing by almost 80% in the second in relation to the first year. This is due to the increase of the stocks in the second year, which slowly in the third year are transferred in money and cash equivalents, and in this period, there is a decline in the liabilities.

From all this we can conclude that the company maintains a satisfactory level of liquidity and works on the gradual growth of the business and its expansion.

Balance Sheet			
LIABILITIES AND SHAREHOLDER EQUITIES MKD'000	**31,12,2016**	**31,12,2017**	**31,12,2018**
SHAREHOLDER EQUITY AND RESERVES	**33,843**	**35,469**	**41,215**
Shareholder equity	183	183	183
Premiums of emitted shares	-	-	-
Revaluation reserve	-	-	-
RESERVES	**942**	**942**	**942**
Law reserves	151	151	151
Statutory reserves	-	-	-
Other reserves	791	791	791
Accumulated profit	29,321	32,719	34,344
Transferred loss	-	-	-
Profit for the financial year	3,397	1,625	5,746
Loss for the financial year	-	-	-
LONG-TERM RESERVES	-	-	-
Reservations for employees	-	-	-
Cost reservations	-	-	-
Other reservations	-	-	-
LONG-TERM LIABILITIES	-	-	-
Long-term financial liabilities in related entities	-	-	-
Long-term financial liabilities (loans and borrowings)	-	-	-
Other long-term financial liabilities	-	-	-
Long-term liabilities, advances, deposits and bailouts	-	-	-
Long-term business obligations in related entities	-	-	-
Long-term business obligations to others	-	-	-
Deferred tax liabilities	-	-	-
SHORT-TERM LIABILITIES	**7,233**	**10,767**	**6,660**
Short-term loans and loans from related entities	-	-	-
Short-term liabilities loans and credits	16	16	116
Other short-term financial liabilities	-	-	-
Liabilities from assets held for sale	-	-	-
Short-term liabilities, advances, deposits and bailouts	-	-	-
Short-term liabilities from suppliers	6,601	10,060	5,936
Short-term business obligations in related entities	-	-	-
Short-term liabilities to employees	360	391	406
Short-term tax liabilities	256	300	202
Short-term liabilities resulting from participation	-	-	-
Other short-term liabilities	-	-	-
Accrued expenses	-	-	-
TOTAL LIABILITIES AND SHAREHOLDER EQUITIES	**41,076**	**46,236**	**47,875**

Figure 2 – Comparative Balance Sheet Liabilities and Shareholder Equities

3.2. Income statement analysis

We do not retain too much by analyzing the income statement, although we do not dispute that it is a very important financial statement. The comparative analysis on the income statement has only one goal - to determine if the company operate with profit and if so, the trend of growth or profit reduction (Figure 3 on the next page).

In particular, in our example, we can conclude that from year to year the company's revenues are decreasing, but we also note that operating costs are declining with the same trend, which leads to higher profits. The management of the company has found a way in which with lower costs to achieve greater profit, which is a positive signal and from this we can see their endeavor to be as competitive as possible on the market.

Income Statement			
MKD'000	**31,12,2016**	**31,12,2017**	**31,12,2018**
Income from domestic market	65,345	58,655	56,433
Income from foreign market	-	-	-
Sales revenue	**65,345**	**58,655**	**56,433**
Increase of stocks' value	-	-	-
Reduction od stocks' value	-	-	-
Other income	620	1,579	-
Net revenue	**65,965**	**60,234**	**56,433**
Revenue from investments	-	-	-
Interest revenue	1	1	-
Other financial revenue	49	95	468
Financial revenue	**50**	**96**	**468**
Other revenue	-	-	1,023
TOTAL REVENUE	**66,015**	**60,330**	**57,924**
Cost of goods sold	52,407	48,151	44,693
Expenses for raw materials	4,574	3,954	3,182
Expenses for employees	3,077	3,580	3,680
Depreciation	1,619	1,587	-
Value adjustment of tangible assets	-	-	-
Value adjustment of current assets	-	-	-
Other operating expenses	486	797	525
Operating expenses	**62,163**	**58,069**	**52,080**
Expenses from revaluation and write-off of investments	-	-	-
Interest expenses	1	-	35
Other financial expenses	161	172	63
Financial expenses	**162**	**172**	**98**
Other expenses	-	257	-
TOTAL EXPENSES	**62,325**	**58,498**	**52,178**
Profit before tax	**3,690**	**1,832**	**5,746**
Tax	292	207	
NET PROFIT	**3,398**	**1,625**	**5,746**

Figure 3 – Comparative Income Statement

3.3. Analysis of buyers and suppliers

The third part of the financial analysis is the analysis of buyers and suppliers. We make this analysis by looking at the analytics of accounts from the group 12 - Receivables from buyers and 22 - Liabilities to suppliers.

No.	Buyers (`000 MKD)	Balance 31.12.2018	Participation %
1	Buyer 1	3,907	26.9%
2	Buyer 2	2,386	16.4%
3	Buyer 3	1,748	12.0%
4	Buyer 4	1,027	7.1%
5	Buyer 5	751	5.2%
6	Buyer 6	628	4.3%
7	Buyer 7	569	3.9%
8	Buyer 8	486	3.3%
9	Buyer 9	382	2.6%
10	Buyer 10	378	2.6%
11			0.0%
12			0.0%
13			0.0%
14			0.0%
15			0.0%
16			0.0%
17			0.0%
18			0.0%
19			0.0%
20			0.0%
Others		2,261	15.6%
TOTAL		**14,523**	**100.0%**

Figure 4 – Buyers

No.	Suppliers (`000 MKD)	Balance 31.12.2018	Participation %
1	Supplier 1	2,374	40.0%
2	Supplier 2	685	11.5%
3	Supplier 3	424	7.1%
4	Supplier 4	377	6.4%
5	Supplier 5	329	5.5%
6	Supplier 6	306	5.2%
7	Supplier 7	237	4.0%
8	Supplier 8	228	3.8%
9	Supplier 9	105	1.8%
10	Supplier 10	77	1.3%
11			0.0%
12			0.0%
13			0.0%
14			0.0%
15			0.0%
16			0.0%
17			0.0%
18			0.0%
19			0.0%
20			0.0%
Others		794	13.4%
TOTAL		**5,936**	**100.0%**

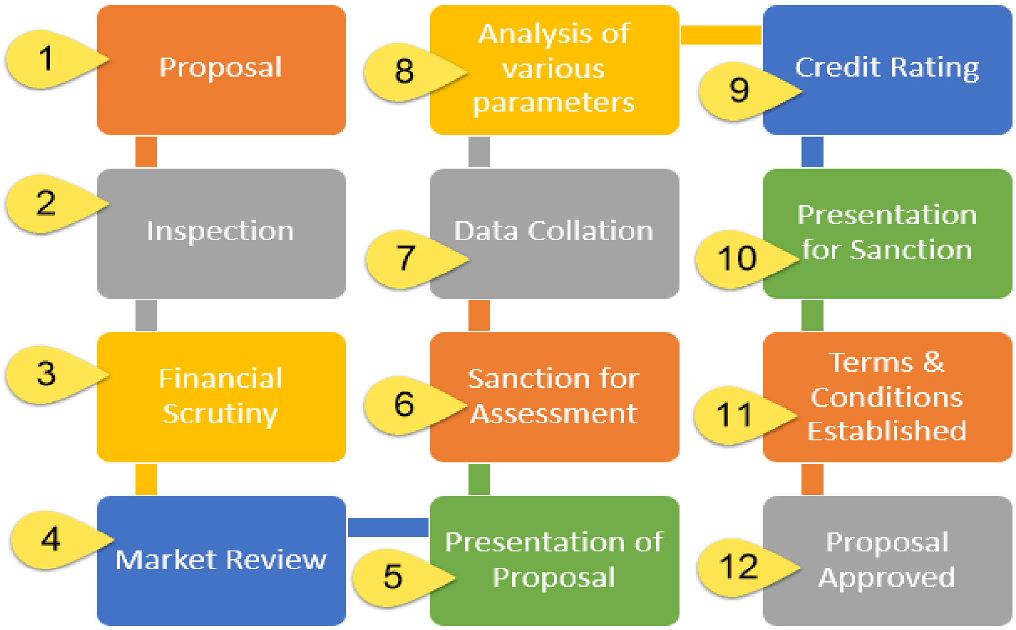
Figure 5 - Suppliers

After a detailed analysis of analysts on accounts from group 12 Receivables from buyers and 22 Liabilities to suppliers, we sort the ten largest buyers and suppliers according to the balance value and enter them into a table where the balance of each buyer and supplier is represented by a percentage. [4]

From the column representing the percentage participation in the concrete example of the buyers, we can conclude that the company has more bigger customers, which is good from the point that if one of them cancels the cooperation, the company will have again partners to sell its products, which means it is not dependent only on one buyer.

While at the table in which we have sorted the suppliers, we detect the risk that if the largest supplier, from wh6ich the company procures 40% of its raw materials, cancel the cooperation of the entity that we need to credit, there may be a slowdown in production, and with in the overall operation of the company.

From the figure 5 we can see the role and place of analysis of financial statements in the whole credit analysis process. [5]



4. Conclusion

The past decade has seen dramatic losses in the banking industry. Banks that had been performing well suddenly announced large losses due to financing / credit exposures that turned sour. In response to this, banks have almost universally embarked on an upgrading of their risk management and control systems whilst having to meet more stringent capital requirements.

It is thus essential for banking executives and managers to equip themselves with the necessary analytical skills to proactively ask the right questions and to learn from the various experiences of banks to-date.

A proper and sound financing / credit appraisal is crucial when presenting financing / credit or business recommendations as well as making important decisions within the bank.

Credit analysis is more about identification of risks in situations where a potential for lending is observed by the Banks. Both quantitative and qualitative assessment forms a part of overall appraisal of the clients. This in general, helps to determine the entity’s debt servicing capacity, or its ability to repay. [6]

Credit Analysis is about making decisions keeping in mind the past, present and the future. As a credit analyst, two days in life are never the same. The role offers opportunities to learn and understand different types of businesses as one engages with a multitude of clients hailing from different sectors.

References

[1] Andover, J.J., Odgoda plaćanja i naplata potraživanja, Potecon, Zagreb, 1998.
[2] "Monetarna ekonomija I bankarski menadzmen", Pr.dr Slobodan Komazec Pr.dr Zarko Ristic Pr.dr Jovan Savic Pr.dr Slavko Vukas, Cacak, 2006
[3] Caouette, J.B., Altman, E.I., Narayanan, P., Managing Credit Risk, John Wiley & Sons, New York, 1998.
[4] Jakovčević, D., Upravljanje kreditnim rizikom u suvremenom bankarstvu, TEB, Zagreb, 2000.
[5] Osmanagić Bedenik, N.: Potencijali poduzeća : Analiza i dijagnoza potencijala u poslovanju poduzeća, Zagreb: Alinea, 1993.
[6] Ross, S.A., Westerfield, R.W., Jordan, B.D., Fundamentals of Corporate Finance, IRWIN, Chicago, 1995.