# **CREDIT RISK ASSESSMENT 1 MAY 2012 - SOLUTIONS**

**SECTION A**

**Question 1**

## There are mainly two reasons why businesses borrow money, namely to acquire or purchase Fixed Assets and/or Intangible Assets and secondly to finance Working Capital needs.

1. Define Intangible assets. (1 mark)

* Intangible assets refer to the so-called “untouchables” and will include licenses, patent rights, trading rights in certain areas, etc. It is the type of asset purchased by a business that cannot be seen physically.

#### Why are banks in Malawi not keen to provide finance for intangibles? (2 mark)

#### Because it is very difficult to establish a realistic value of the asset.

1. Mbwembwembwe, a renowned tobacco farmer from Kasusu District has approached your bank with a K10 million loan request to purchase tractors for this farming season. Briefly explain six general requirements you would need for such type of an application to be considered for approval. (12 marks)

Solution

General Requirements

* The farmland should not have less than 30 hectares with a cropping programme of not less than 10 hectares
* The farmland should be on lease or freehold with valid title documents.
* Customers should not have carryover debts.
* Latest Farm Report should be available for renewals but for new customer application will be subject to a report by the bank’s Agricultural Liaison Officer.
* Cropping Programme must be viable with realistic yield and price targets in line with customer’s past achievement. (At least three years track record/sellers sheets to confirm past record on yield and prices)
* Satisfactory tobacco management standards (competence/experience)
* Application to be supported by cash flow, latest financial information (Audited Accounts for companies and a Statement of Affairs for Small and Medium size customers)
* Security

- Tobacco Stop Order

- Auction Floors Addendum forms.

- Fire Insurance Policy (With Bank Interest Noted)

- Cash cover (i.e. 40% of total facilities) to be held in the form of Fixed Deposit Receipts.

(Cash cover requirement not normally applicable to large flue cured tobacco growers)

- Charges over properties in towns/cities and mortgages over farmland.

- Letter of undertaking to create further charges.

- Guarantees (Joint and Several Directors’ Guarantees and/or Cross Company Guarantee)

**Question 2**

### Briefly describe five consequences of Overtrading. (15 marks)

* Difficulties to pay wages and salaries.
* Pressure on debtors to pay sooner and this can be harmful to customer relations.
* Difficulties to pay creditors and in the process the obtaining of goods and services for purposes of trade and manufacturing, can be negatively effected.
* Arrears in tax payments can arise and the Receiver of Revenue is not known to be very sympathetic in this regard.
* Special schemes and high interest, unsecured loan are sure signs of problems with cash flow.
* Selling stock at huge discounts to obtain cash.
* Increased costs to buy stock due to only selecting suppliers that provide credit, losing out on special bulk buying opportunities and utilizing discounts for prompt payments.
* Inability to replace old and worn-out machinery and equipment will lead to inefficiency and the eventual loss of customers.
* Overall impact is cashflow problems

## Question 3

## There are a number of Models that are used to forecast financial failures. Briefly explain two advantages and three limitations of these models. (15 marks)

### Limitations of Financial Forecast Models

1. It must be realized that in the process of credit risk assessment the analysis and interpretation of financial statements is only one of the aspects considered. The results obtained from the use of these forecast models must be evaluated within the total context of qualitative and quantitative information on both the financial history and financial budgets and business plans for the future.
2. Most financial models are based on the results of listed companies only and are not representative of the total business sector.
3. Some of these models have been developed and researched some time ago and do not take new trends and changes in recent years within companies into consideration.

### Advantages of Financial Forecast Models

1. The models provide both the banker and the management of the business with a good indication of financial success or failure if the business is to come with its current policies and strategies in the future.
2. The problem area within the business financial strategies and policies can be identified and precautionary measures put in place to rectify it.
3. From the bankers point of view it can form a basis for discussion when interviewing the business customer

**Question 4**

**Wh**y should companies waste their precious time in managing Working Capital? Give three reasons. (6marks)

### The Reasons for Managing Working Capital

1. Working Capital is in fact the measurement if a business liquidity. If you recall the ratios used to analyse the liquidity of the business, it will be seen that they all focus on the current assets and current liabilities of the business.
2. Working Capital is a source of funds to the business if managed correctly. In the example used to explain the CASH CYCLE, we illustrated that if the CASH TURNOVER of a business can be increased it will realize funds at a faster rate, which means more money is available sooner to buy more stock, etc. the need to borrow funds can be reduced or even eliminated in this process and large amounts of money saved for not paying interest on borrowed funds.
3. Working Capital generates for the business. When excessively large amounts of capital are tied up in Working Capital such as stock and debtors, the business is not earning any return on these funds, or if financed by debt, such as a bank overdraft it will attract high interest cost which would reduce the profitability of the business. Other costs are also very definitely involved such as the costs to carry stock in terms of space, risk security and control.

### Briefly explain three common approaches to Financing Working Capital. (9 marks)

Depending on the risk profile of the Management of the business, they will follow one of three possible approaches in practice.

1. The Moderate or Matching Maturities Approach
2. The Conservative approach
3. The Aggressive Approach

**SECTION B**

**Question 5**

Mention five main categories of business ratios and briefly explain their respective meanings. (20marks)

1. Liquidity Ratios - indicate the ability of the business to meet its commitments.
2. Profitability Ratios – How profitable is the business
3. Leverage/Gearing Ratios – Measures borrowing/ownership levels of an organization
4. Activity Ratios – How effective are assets being used
5. Market Value (Investors) Ratios – Returns on investors

**Question 6**

### When doing financial analysis of a company, how would a bank officer know that the company s/he analyzing is overtrading? Give five indicators. (20 marks)

During the process of doing a financial analysis of the business the following signs could be pointers in the direction of overtrading:

* When the Debtors Collection Period is becoming shorter and the Creditors Payment Period longer. A strong trend in this direction must always be of concern to the Banker, especially if the change is quite rapid.
* A sharp increase in sale/turnover/production with no corresponding increase in the level of Working Capital.
* Selling of fixed assets to obtain cash resources.
* Sharp increases in loans and borrowing from the bank, stock and creditors without an increase in turnover.
* A sharp decline in generating cash resources as seen in the Cash Flow Statement.
* If the business is a customer of the bank, it is also possible to detect the following signs from its bank account:
  + Continuous excesses on their cheque account and frequent requests to withdraw money now, on payments to be received in future.
  + When a hard-core balance is developed over time.
  + Monthly accounts/payments are made later in the month.
  + When more and more cash is drawn for payments, as it could signal pressure from suppliers, demanding cash payments instead of cheque payments.

### Question 7

### Explain four most crucial components of Working Capital that must be managed to enable a company remain vibrant? (20 marks)

a) Cash or Bank Overdrafts

The cost involved in keeping too much cash should be self explanatory by now – you do not earn proper returns on it in the process the business is losing potential interest on the funds. The cost involved when insufficient cash levels are maintained could be very high interest rates paid on overdraft facilities especially when they are exceeded. In Malawi we have in the past experienced not only high but fluctuating interest rates to the level of a 40% prime rate. This can be devastating to businesses, which are highly geared and therefore very dependent on borrowed funds. The art of maintaining correct cash balances is not an easy one to acquire, it takes experience and time.

There are some things that a business can do to help the situation, such as:

* Collect money owed to the business faster but not to the detrimental loss of good customers.
* Make use of modern day electronic transfers and Internet Banking facilities.
* Make full use of the periods of credit grated by creditors.
* Compile a cash flow forecast to be able to identify potential cash or overdraft requirements in advance.
* Be sensitive to interest movements when deciding to use short or long term finance options.
* Very good communication between the different departments or sections of the business must be maintained at all times to prevent internal cash flow problems.
* Strict cash control and security measure are required in the environment that business operate in Malawi –cash theft, hi-jacking and fraud are unfortunately very common factors to consider.

b) Debtors and Creditors Control

In our discussion of the liquidity ratios and the cash cycle of a business the importance of shortening the collection period of money owned to the business by its debtors whilst utilizing the payment period provided by creditors to its full, has been covered.

What is important to see is that if a business can collect funds from debtors before paying the creditors within reasonable time, it can save on cash required but also earn interest on the money in the process. The factor that must be considered in such a situation is the potential loss of discounts by not paying the creditors sooner. The most profitable options must be chosen in such cases.

1. Stock Control

Carrying stock can be very expensive to any business undertaking. The problem is once again that both carrying too much stock and being out of stock can have detrimental effects for the business. Large volumes of stock do not only strip he business of cash, it costs money to provide the space for storage, it involves the risk of stock becoming technologically outdated and/or damaged, it costs interest on overdraft facilities and if not financed by loans, it means the opportunity cost of losing interest on money that could otherwise have been invested.

Businesses are also faced with the problem of determining what is the most economic quantity to order. Often business prefer to carry a safety level/or minimum level of stock to ensure that they will not run out of stock. In such a case it will obviously contribute to the cost of carrying stock for the business

1. Managing the Overhead and Operational Expenses

It is very simple to see that if the operational costs of a business such as salaries rent, electricity, interest paid, etc, can be managed efficiently it will not only save the business money, but also make it much more profitable.

Question 8

As an experienced Credit Officer at your bank, you have been requested to train a new officer who has been attached to your department. One of the areas to tackle with the new officer is Cash-flow Budgets. Briefly explain the general guidelines you would tell the new officer to be following when interpreting Cashflow Budgets. Explain four guidelines. (20marks)

1. Always evaluate the Cash Flow Forecast against the NATURE OF THE BUSINESS. When dealing with a business experiencing seasonal / fluctuating sales this should be apparent in the projected sales figures.
2. Compare the projected debtors collection, creditors payment and stock turnover periods with that in the ratio analysis for the previous years – that is of course if it is an existing business with historical financial statements. If the trends as seen in the ratio analysis, are totally different from what is projected in the Cash Flow Forecast, the matter needs to be taken up with the customer. Always remember that businesses tend to be over optimistic about the future, especially when compared to the past financial performance. Cash Flow Forecast is often drawn up by customers to present a favourable cash flow situation and is not based on the realities of the situation the business finds itself in. In this regard the trends as determined in the ratio analysis can prove to be very valuable and provide the important questions that need to be asked of the customer in the process of credit risk assessment.
3. Remember that the Cash Flow Forecast is based on assumption and projections, which on its part should be derived from past experience as well as the BUSINESS PLAN for the future. When the growth in projected sales exceeds the trends of the past, projected costs are not in line with expected sales, or the commitments of the business in terms of such Balance Sheet items as outstanding creditors, tax payable, dividends payable etc are not taken into consideration, it will make the Cash Flow Forecast unrealistic and not suitable to evaluate the customer s future ability to repay debt.
4. Where the banker deals with new businesses with no financial history, as our case study example, it is essential to obtain a VIABILITY STUDY from the customer to see if the business can survive in the market.

**THE END**