**IOBM**

**CREDIT RISK ASSESSMENT 1 NOV 2015**

**(BANKING DIPLOMA)**

**SUGGESTED SOLUTIONS**

SECTION A

**Q1.**

1. Special credit risks or challenges likely to be faced when making a decision whether or not to lend to a tobacco farmer:

* Unpredictable climatic conditions e.g. wind, hail, rain, drought etc. that could upset both the quality and quantity of the crop
* Unfair manipulation of tobacco prices at the auction floors.

1. Criteria used to classify businesses:

* Forms of ownership
* Nature of activities of the business
* The size of the business.

1. Relevance of the caveat:

* When the relationship overspills, the main danger is that of a likely compromise of a banker in the process of making a decision. Objectivity would be cast aside.
* The banker would be subjected to a quandary: how can he decline a proposal from someone who is very close to him?
* There are so many customers and it is impossible to get close to each one. Time would be wasted in excelling relationships at the expense of essential bank business.

**QUESTION 2.**

1. Three critical factors to be considered when managing bank liquidity:

* **Time:** the longer a bank is permitted to organize and adjust itself when faced with liquidity problems, the better it is. otherwise when pressure escalates, the bank’s position would be in jeopardy
* **Cost;** endeavours intended to manage liquidity have costs attached to it. In an attempt to hold some liquidity assets, some of which may be non-earning or low earning assets, there results the loss of earnings (foregoing profit) to the bank
* **Sources:** the bank must identify reliable and cost-effective sources of its liquidity

1. Functions performed by bank’s liquidity:

* Reassuring creditors that the bank is safe and will always be able to repay all of its deposits or other borrowings
* It serves as a proclamation into the market that the bank is sound, prudent, profitable and well managed
* Liquidity is the measure of the bank’s ability to meet its lending commitments
* Effective liquidity management avoids the unnecessary need to sell the bank’s assets in order to meet liquidity demands
* Good liquidity also avoids the need to borrow in the market at excessive borrowing costs
* Prevents the bank from the embarrassing despair of having to seek rescue from RBM as a lender of last resort.

1. Five major causes of bank illiquidity can be identified as follows:

* Unforeseen or abnormally higher levels of withdrawal of demand deposits
* Lack of or restricted access to funding at the appropriate maturity and interest rates
* Inability to liquidate marketable assets in a timely manner with minimum risk of capital
* Unexpected and/or massive levels of borrowers’ default of loan obligations
* A sudden increase in the demand for loans especially when interest rates, that were deemed punitive, have plummeted.

**QUESTION 3**

1. Carrying excess stock manifests itself in problematic outcomes to any business in the form of:

* It denies the business of the cash that would have been generated if stocks were disposed of
* Unnecessary incurring of costs related to storage i.e. additional space rentals, insurance etc.
* The risk of stock becoming obsolete
* The risk of damage
* Interest costs on O/D or loans as a result of suppression of sales

1. Managing overheads and operational expenses accrues substantial benefits to an organization, among them the following:

* The generation of positive cash flow
* Profitability generation i.e. ceteris paribus, the more the costs, the less the profit and likewise the less the costs the more the profit.

1. Conservative Approach to Working Management has the following:

* ***Advantage:*** provides the business with the assurance and/or ability to secure funds in seasonal upswings as well as the ability to repay
* ***Disadvantage:***  can be an expensive option in terms interest that has to be paid on a long-term obligation especially when it is not utilized to the full or reasonable level.

**QUESTION 4**

Financial stability may be considered from a number of general aspects including Liquidity, Solvency, Profitability, Activity, Cash flow and a number of specific aspects including gearing security and control. With regard to the two companies, observations and/or analysis are as follows:

1. Kanengo Pure Water Ltd seems stronger than Mzuzu Butter Ltd in view of the following:
   1. it has a stronger liquidity ration than Mzuzu Butter Ltd
   2. with a significantly higher current ratio of 2:1 (1:33:1) it appears stronger in terms of solvency
   3. it is low-geared and the charged assets are only 15% of total assets compared with Mzuzu Butters 25%, at least in terms of book value.

(b) Three reservations to the observation in a) above.

1. Ratios are not strictly comparable since their financial activities are dissimilar
2. Mzuzu Butter Ltd is predominantly a cash sales business, and the liquidity ratio does not serve any meaningful purpose.
3. Mzuzu Butter Ltd, without a large debtor portfolio to be funded, could well be “safe” though with a much lower ratio
4. There is inadequate information to produce cash flow statements

c) Kanengo Pure Water Ld seems weaker than Mzuzu Butter td in view of the following:

1. It has a lower profit margin of 4.2% (5%)
2. It has a lower capital turnover of 2.3 times (4.4. times)
3. It has a lower ROCE of a 5% (22%)
4. Its assets are more specific to the trade and therefore, less marketable than Mzuzu Butter.’s.

**SECTION B**

**QUESTION 5**

1. From the bank lender’s perspective, O/T is a cause of discomfort because:

* Frequent excesses over the approved limit
* Requests for drawings in advance in anticipation of monies due in the future
* The inevitable development of a hard-core element on the borrowing
* The risk to the bank (for debt write off) in the event pressure from unpaid supplier culminates into a liquidation petition.

1. When performing financial analysis, these would be the likely indicators of O/T:

* Elongated creditors payment period than industry average
* Shortened debtors collection period than industry average
* Sharp and seemingly unrealistic escalations in sales without a corresponding increase in the level of W/C
* Shrinkage of fixed assets as a result of disposal in order to raise the needed cash
* Sharp escalations in loans from banks and other sources
* Cash flow would splash on the screen a sharp decline in the generation of cash resources.

1. Advices likely to provide to such a customer on how to arrest the O/T situation:

* Injection of fresh capital
* Disposal of excess or idle fixed assets
* Where possible, to enter into a lease back arrangement with regard to the fixed assets
* Disposal of surplus stocks
* Putting a grind on further purchases until the outcome of the above stated actions start making a meaningful impact on the business.

**d. Diagrammatical representation of Type of Financing**

**Kwacha**

SHORT TERM FINANCING

CURRENT ASSETS

LONG TERM FINANCING

FIXED ASSETS

TIME

**Required:**

**a) What type of asset financing is depicted above? (1mark)**

***Aggressive Approach***

1. **Briefly explain how it works and what are its advantages and disadvantages?**

**(8 marks)**

*With this approach all fixed assets and only a part of the permanent current assets are financed by means of long-term finance. The remaining permanent current assets and fluctuating current assets are financed by means of short-term funds as can be seen in Diagram 4. This means the risk of obtaining more short-term funds and being unable to repay it, is higher but the returns are better because of more intensive utilization of assets.*

**QUESTION 6**

1. Justifications for effective management of W/C:

* It results in the generation of needed source of funds for the business
* It provides the mechanism through which liquidity is sustained
* It results in some interest cost savings that are accompanied by excessive borrowings
* Provides an avenue for profit generation when interest charges are avoided
* Further provides opportunity to beef up profits when levels of stocks are kept to meaningfully acceptable levels i.e. would avoid expenses in the form of insurance and rentals for extra space, and security and control expenses as well.

1. Criteria used to determine the ideal level of W/C:

* The level of sales
* The phase of economic/business cycle or rather, the prevailing economic conditions
* Industry seasonal fluctuations
* Risk profile of the business
* Industry W/C norms
* The cost of W/C

1. Four other sources/options of accessing W/C:

* Disposal by sale of fixed assets
* Sale of other investments
* Profits generated by the business
* Access to long term loans
* Fresh capital injection
* Prudent management/control of overhead expenses

**d. CAMPARI is a mnemonic universally recognized and commonly used in assessing loan applications. Briefly explain its meaning? (7 marks)**

* ***Character*** *of the customer. Customer must be honest, reliable and be a person of integrity.*
* ***Ability*** *to borrow and repay. Past track record will give guidance on customers ability.*
* ***Margin*** *of profit. Always remember that you want to lend money to make money.*
* ***Purpose*** *of the loan. The banker must always establish what the customer wants the money for. Money should not be lent for illegal or illegitimate purposes*
* ***Amount*** *of the loan. The amount sought must be sufficient to meet the intended purpose. The bank should not suggest the amount for the customer to borrow.*
* ***Repayment*** *terms – source of repayment need to be established at the outset ie trading profits turned into cash flow, asset disposal, trade sales etc. The source must be identifiable and not a mere promise.*
* *I****nsurance****/* ***security*** *- against the possibility of non-repayment in case something goes wrong.*

**QUESTION 7**

1. Moderate/ Matching Maturities Approach

***Significance***: As stipulate below **(two marks)**

The Approach provides a proper match between asset acquisition and their source of funding i.e. long term assets or short term assets funded by long term or short term finance respectively.

***Merit:*** (Any one) **(One mark)**

* Avoids asset funding mismatch
* Permits efficient timing for asset replacements
* Facilitates reasonable cash flow and working capital management

***Demerit:*** (Any one) **(One mark)**

* Maturity of some assets cannot be precisely timed
* Cost of funds might dictate course of action despite rationality
* Funds availability to match the need

1. Conservative Approach

***Significance:*** (Any one) **(Two marks)**

* Reflects commitment in the business operations by both the shareholders and long term providers of finance
* Eliminates risk of not being able to fund short tem needs as and when they arise, including in times of unexpected upsurge in demand or reaction to competitive forces

***Merit:*** (Any one) **(Two marks)**

* Frees short term funds for working capital
* Cost free if the bulk of funding comprises share capital

***Demerit:*** (Any one) **(Two marks)**

* High cost of finance associated with long term borrowing
* Departs from a proper-match principle for asset acquisition

1. Aggressive Approach

***Significance:*** (As stipulate below) **(Two marks)**

It is a measure of management’s effectiveness to risk.

***Merit:***  (Any One) **(One mark)**

* Better returns
* Intensive utilization of assets

***Demerit***: (Any one) **(One mark)**

* Risk associated with access to short term funds
* Repayment risk

1. Sources of working capital (Any four) **(Four marks)**

* Credit provided by trade creditors or suppliers
* Overdrafts and/or bank short term loans
* Disposal of surplus long term or short term assets
* Shareholders/directors’ loans
* Conversion of long term assets into short term assets
* Profit retentions
* Issue of more shares to raise capital or capital contributions

1. Aspects crucial when managing working capital (Any four)**(Four marks)**

* Cost of working capital
* Level of sales
* Financial discipline by the owners to refrain from diversion or conversion of funds from the business for personal use
* Establishment and Maintenance of a proper level of working capital
* Proper financial planning
* Debtors and creditors control
* Stock control
* Efficient management of overhead and operational expenses
* Efficient cash management

**QUESTION 8**

a) Ntchawaka Ltd Kabunthu Ltd

(K'000) (K'000)

Turnover ….................................. 40,000 60,000

less total operating expenses …... 36,000 55,000

Rate of return on assets 4,000 x 100 = 13.3% 5,000 x 100 = 20%

30,000 25,000

b)

* + 1. Net profit percentage …... 4,000 x 100 = 10% 5,000 x 100 = 8.3%

40,000 60,000

* + 1. Ratio of turnover to total assets... 40,000 = 1.33 60,000 = 2.4

30,000 25,000

Rate of return on total assets........... (i) x (ii) 13.33% 20%

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c) On the basis of the above accounting ratios, Kabunthu Ltd appears to be performing better. The rate of return on total assets is 50% higher than Ntchawaka's , and this is generally regarded as the key measure of corporate finance.

The analysis prepared under (b) shows that each company has a strong and a weak area relative to its 'rival'. Ntchawaka Ltd earns marginally better net profit percentage, but it is not known whether the more favourable margin is due to higher prices or to more effective control of operating costs. Kabunthu Ltd on the other hand, shows a much higher asset utilization indicating that its management is employing available resources in a more efficient manner.

The above accounting ratios provide a useful guide to company performance, but there are other, perhaps more important, factors which potential investors and creditors will wish to consider. Prospective ordinary shareholders will want to know how operating profits are split between providers of equity and loan finance; they will also want to examine the levels of gearing and obtain figures for price/earnings ratios. Prospective loan creditors will similarly be interested in the level of income and capital gearing. They will also require more information concerning available assets security and restrictive covenants contained in the company's articles.

**END OF EXAMINATION PAPER**

1. Objective of financial statements:

* To provide information about the financial position of the business
* To give insight of the business’ performance
* To assess the cash flows of the business.

All the above information would enable an interested stakeholder to make a meaningful decision.

1. It is reasonable to be concerned because qualified opinions reflect reservations with regard to certain aspects in the financial statements that do not meet or are not in conformity with the IFRS requirements.

The qualification signals a caution to those that are likely to be expected to make decisions based on such financial statements.

1. Different stakeholders have different interests in the business when they undertake analysis of financial statements:

* Investors: their main interest lies with the extent to which the business is performing and is able to generate a return on their investments equal to or above the industry average.
* Suppliers: they are more interested with whether it makes business sense to supply; whether the subject is worth his salt in terms of the likely payment terms they might enter into.
* Management: their interest is the assessment of their input in the business in the crucial areas for success i.e. to see the extent to which they have achieved what was planned.
* Employees: quite obviously their interest is in the well-being of the company. Excellent performance impliedly guarantee their continued employment
* Banker: with a special focus on the lending banker; the interest is to ascertain the business’ worthiness from the financial perspective i.e. do the financials suggest strength and ability to pay?

**Q3.**

1. The whole purpose of number crunching is to come up with something that was invisible to the eye.

The symptoms do subject the banker to the pursuit of further inquiry in trying to understand what those symptoms might be translated into.

Without number crunching, those symptoms would not be visible.

1. Yes indeed we perceive things differently and so too with regard to analyses. What’s important to bear in mind here is that there are standards or systematic guidelines which every analyst ought to follow if his analysis, conclusion and decision are to be close to the next person who would also analyse the same set of financials.

The challenge that most bank analysts have to confront themselves with is predicated upon objectivity or the lack of it and possibly the illusory belief that they are the right people for the job when in they might not be.

1. Trends are tracks that one can easily relate with the past and be able to reasonably plot the future (escalation) based on them. They tell a story whose interpretation can easily be associated with the consistence of good or mediocre management decisions. They provide reasonable cause to obtain answers where the pattern appears to have digressed from what has been established as the norm or the expected.

**Q4.**

**SECTION B**

**Q5.** Calculation of rations and provision of meaning and interpretations.

1. Current Ratio: Current Assets

Current Liabilities

This ratio indicates business’ ability or otherwise to meet short term obligations. Quality of the assets is a crucial consideration if meaningful conclusion is to be relied upon.

1. Quick Ratio: Current Assets – Stock

Current Liabilities

This ratio indicates the ability of the business to meet its short term obligations even if stock is not taken into account. It also signals a caution to the business on the need to manage stock so as to provide liquidity.

1. Debtors Collection Period: Debtors x 365

Turnover 1

This ratio indicates the pace/speed it takes to convert the debt book into cash. Another way of looking at it is from the perspective of what can be coined the *‘velocity of credit sales.’*

1. ROCE: Net Profit after Tax x 100

Capital Employed 1

This ratio indicates the effectiveness with which a Kwacha of the investors’ funds and long term loans has been utilized and/or been able to generate the required level of return/profit e.g. 25t profit for every Kwacha deployed in the business.

1. Net Profit Margin: Net Profit before Tax x 100

Turnover 1

Given the total sales or income, this ratio indicates how much remains after all expenses (with the exception of tax) have been met. The more or the less the residue, the more (or otherwise) it speaks of the management’s cost effectiveness.

1. ROI: Net Profit after Tax x 100

Owners’ Equity 1

This ratio tells us (and more in particular, the investors) what the outcome of the investment was during the year under review in terms the residue after all obligations have been fulfilled i.e. how much per Kwacha invested was received as shareholders’ rightful earnings.

1. Debt/Equity Ratio: Long Term Debt x 100

Ordinary Shareholders’ Equity 1

This ratio indicates the extent to which the business relies upon external long term debts in relation to what the owners have put in the business. Simply put, the ratio seeks to assess the level or percentage of the total capital employed that represents long term external source of funding.

1. Times Interest Covered: Earnings before Interest and Tax

Interest Paid

Given interest payable on loans and overdrafts, this ratio indicates the degree with which the business is comfortable with repayments of interest from the pre-tax profits that have been (or will be generated). The outcome is normally expressed as ‘x’ times interest cover, meaning that the earnings/profit can provide accommodation for interest by ‘x’ times.

1. Equity Ratio: Ordinary Shareholders’ Funds x 100

Total Capital Employed 1

In the same manner the Debt/Equity Ratio attempts to express, so too this ratio takes the ordinary shareholders’ investment in the business and relates it to the basket of total funding that supports the operations of the business. Simply put, it asks the question: *‘how much is the business relying (or being supported) by what the owners have at stake?’*

1. Total Assets Turnover: Turnover

Total Assets

This ratio tries to suggest the efficiency or otherwise of how the owners or management have put the assets of the business into use. Simply stated, it tries to explain the number of times the assets have been turned over to generate the level of sales/turnover.

**Q6.**

1. From the bank lender’s perspective, O/T is a cause of discomfort because:

* Frequent excesses over the approved limit
* Requests for drawings in advance in anticipation of monies due in the future
* The inevitable development of a hard-core element on the borrowing
* The risk to the bank (for debt write off) in the event pressure from unpaid supplier culminates into a liquidation petition.

1. From the business owner’s perspective, the indicators that suggest O/T are: (any five))

* Difficulties to pay wages and salaries
* Difficulties to pay creditors within the agreed payment terms
* High rejection rates from other suppliers
* Undue pressure applied on buyers for quicker than agreed repayments, the result of which often leads to loss of customers
* Aggressive threats from Big Brother (Taxman) for payment of arrears in tax
* Indulgence of funds acquisition from Katapila lenders in light of the reluctance by banks to lend or increase their exposures
* Inability to replace old and worn-out machinery and equipment due to the inability to secure funding
* Increased costs to stock replenishment because suppliers are no longer willing to grant discounts
* Meaningless sales margins (or losses) that result when the business is forced to dispose of its stock at ridiculous discounts due to the desperate need for cash.

1. When performing financial analysis, these would be the likely indicators of O/T:

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**Q8.**

1. Relationship between Planning and Budgeting:

* Planning involves the identification of all the activities, time and resources that the business would require in order to achieve desired objectives
* Budgeting is essentially the translation of the plans or planning processes into monetary terms.

1. Value of the Cash Flow to a lending official and the approach when evaluating it.

* Value:

1. It serves as a projection of the expected cash flow of the business
2. It indicates whether the business will have the ability to accommodate debt commitments
3. It indicates the borrowing needs of the customer
4. It also serves to suggest the level of the customer’s planning for the achievement of pre-determined financial objectives.

* Approach to be taken:

1. The budget should not be relied on its face value but should be compared against assumptions based on the financial history of the business and the nature of the business.
2. To seek verifications when items incorporated in the cash flow budget appear not to rhyme properly