

DP03

Principles Of Lending

13 OCTOBER 1999

1. Time allowed : Three (3) hours
2. Total number of questions : Four (4) questions on 2 pages
3. Number of questions to be answered : All four (4) questions
4. Show details of workings, where appropriate. Silent, non programmable calculators may be used.
5. Begin each answer to a new question on a fresh page.
6. Answer **all** questions in **English**.

ANSWER ALL FOUR (4) QUESTIONS

1. Credit analysis is concerned with the following:

- risk identification;
- risk analysis; and
- risk mitigation.

Describe your understanding of the above.

(Total:25 marks)

2. Financial distress and corporate failures are reasons for non-performing loans.

Describe the warning signs (red flags) which a loan will exhibit prior to it becoming a non-performing loan.

(Total:20 marks)

3. Terms and conditions in legal documentation are part of the credit structuring process.

Explain the purpose of a Loan Agreement and outline the standard contents of such an agreement.

(Total:20 marks)

4. The following are financial statements of the Thai-British Security Printing Public Company Limited. The company is involved in the printing of security documents which include cheque books, share certificates, credit cards, debit cards etc.

**BALANCE SHEETS
AS AT 31 DECEMBER 1997 AND 1998**

Items	1998 (RM)	1997 (RM)
Assets:		
Current assets:		
Cash-in-hand and at banks	30,420,524	17,794,007
Accounts receivable	49,087,143	61,175,607
Inventories	62,627,660	66,775,438
Other current assets	6,341,972	9,503,539
Total current assets	148,477,299	155,248,591
Fixed assets	280,152,739	325,318,728
Other assets	4,611,029	2,030,625
Total assets	433,241,067	482,597,944
Liabilities and shareholders' equity:		
Current liabilities:		
Bank overdraft and loans from bank	-	18,042,295
Accounts payable-trade	20,656,752	22,983,555
Current portion of long-term loans	-	7,806,536
Other current liabilities	9,665,051	16,328,954
Total current liabilities	30,321,803	65,161,340
Long-term loans	-	11,450,000
Total liabilities	30,321,803	76,611,340
Shareholders' equity:		
Share capital	110,000,000	110,000,000
Share premium	165,000,000	165,000,000
Legal reserve	11,000,000	11,000,000
Retained earnings	116,919,264	119,986,604
Total shareholders' equity	402,919,264	405,986,604
Total liabilities and shareholders' equity	433,241,067	482,597,944

**PROFIT AND LOSS ACCOUNTS
FOR THE YEAR ENDED 31 DECEMBER 1997 AND 1998**

Items	1998 (RM)	1997 (RM)
Income:		
Sales	351,760,616	347,917,139
Other income	2,745,740	2,162,562
Total income	354,506,356	350,079,701
Expenses:		
Cost of sales	272,429,673	256,588,107
Selling and administration	64,347,754	58,897,695
Interest	2,498,246	5,284,860
Directors' remuneration	459,600	925,000
Total expenses	339,735,273	321,695,662
Profit before tax and extraordinary item	14,771,083	28,384,039
Income tax	6,838,423	8,487,991
Loss on exchange rate	-	8,363,915
Net profit for the year	7,932,660	11,532,133

Required:

- (a) Calculate the following ratios for financial years ending 1997 and 1998:
- (i) Current ratio [2]
 - (ii) Quick ratio [2]
 - (iii) Gearing (defined as total liabilities to shareholders' equity) [2]
 - (iv) Return on equity (after tax) [2]
 - (v) Return on assets (after tax) [2]
 - (vi) Return on sales (after tax) [2]
 - (vii) Asset turnover ratio [2]
- (b) Based on the above accounts, identify and name **one** extraordinary item. [1]
- (c) What is the importance of ratio analysis in the credit assessment process? [15]
- (d) Explain what is the "Rule of Strict Proportionality" in ratio analysis. [5]

(Total:35 marks)

OUTLINE ANSWERS

Question 1

Only a small portion of candidates managed to pass the question on credit analysis. Here, candidates were required to describe risk identification, risk analysis and risk mitigation. Unfortunately, some candidates erroneously thought that the question was referring to the 5Cs of credit.

Credit analysis is also known as credit evaluation. This is a process in which lending officers evaluate an applicant as to its creditworthiness to establish the likelihood of debt repayment. The process involves input of external factors as well as internal factors.

Risk identification then relates to the determination of possible areas of credit weaknesses likely to impair the repayment ability.

Risk analysis relates to the comprehensive assessment of risk areas being identified both qualitative and quantitative and forming an opinion or making a decision to accept or reject the credit.

Risk mitigation is the analytical process of seeking or structuring terms and conditions to reduce or balance the risk areas such that a default likelihood is minimised.

The work of a credit analyst or lending officer is essentially to combine successfully the three activities above. The process should eventually lead to classifying a credit into an appropriate risk category. The acceptance or rejection of a credit will then be matched against the financial institution's credit policy and lending criteria for a decision.

Question 2

Candidates excelled in the question on non-performing loans. Almost all candidates scored above average marks allocated for the question.

The warning signs or 'red flags' may be categorised into 3 areas, covering:

- (a) operations of the account;
- (b) operations of the business; and
- (c) threats in the environment.

Briefly, they are as follows:

- (a) delay in debt servicing, recurring incidents of bounced cheques, failure to comply with covenants, delay in accounts submission and communication difficulties.
- (b) no management succession, one person management, frequent changes to auditors, no proper accounting records being maintained, manipulation of accounting information, increase in period for asset conversion, declining profit trend, increasing debts and gearing levels and increasing bad debts.
- (c) legislation affecting business operations, changing demand, breakdown in barriers to entry, global shift, changes in taste and consumer pattern, changes in technology and emerging of newly merged mega-entities.

Question 3

Most candidates had a sound understanding of the contents in a loan agreement, which led to them scoring above average marks for this particular question.

A loan agreement forms the set of agreed formal terms and conditions governing a credit transaction between lender and borrower. This document evidences a contract between lender and borrower but more clearly it

intends to spell out the obligations of the borrower during the tenure of the loan. Its contents cover :

- purpose of loan
- borrowing details, loan amount, currency, interest rates and fees
- repayment terms
- prepayment conditions
- costs and expenses
- conditions precedent
- positive and negative covenants
- events of default
- covenants and undertakings
- representations and warranties
- governing law and jurisdiction

Question 4

Generally, candidates were competent in the computation of ratios. Nevertheless, a few candidates were confused with the Asset Turnover Ratio computation. The right calculation is Sales to Total Assets, yet quite a number of candidates got it the other way around. Only a few candidates were able to identify the extraordinary items in the accounts. This shows that candidates do not have sufficient depth in analysing accounts other than memorising the ratio calculations.

(a)	Ratios	1998	1997
(i)	Current	$= \frac{148,477,299}{30,321,803}$ = 4.9	$= \frac{155,248,591}{65,161,340}$ = 2.38
(ii)	Quick	$= \frac{148,477,299 - 62,627,660}{30,321,803}$ = 2.83	$= \frac{155,248,591 - 66,775,438}{65,161,340}$ = 1.35
(iii)	Gearing	$= \frac{30,321,803}{402,919,264}$ = 0.075	$= \frac{76,611,340}{405,986,604}$ = 0.188
(iv)	ROE (%)	$= \frac{7,932,660}{402,919,264} \times 100$ = 1.96	$= \frac{11,532,133}{405,986,604} \times 100$ = 2.84
(v)	ROA (%)	$= \frac{7,932,660}{433,241,067} \times 100$ = 1.83	$= \frac{11,532,133}{482,597,944} \times 100$ = 2.38
(vi)	ROS (%)	$= \frac{7,932,660}{354,506,356} \times 100$ = 2.23	$= \frac{11,532,133}{350,079,701} \times 100$ = 3.29
(vii)	ATO (times)	$= \frac{351,760,616}{433,241,067}$ = 0.81	$= \frac{347,917,139}{482,597,944}$ = 0.72

- (b) Loss on exchange rate
- (c) The importance of ratio analysis was tested in Libby's experiment which concluded that it use could play an important role in helping credit officers to make correct credit decisions. Ratio analysis allows for company comparison as a measurement of performance. It can give sufficient trend data, be used to predict tomorrow's results. Ratios are used to qualify and quantify company's performance in respect of their profitability, their ability to generate income for debt repayment and risk assessment.
- (d) This rule states that there must exist a constant relationship between two numbers when they are used together as a ratio for meaningful analysis. In other words, the numerator and denominator must be proportionate to each other. Based on this rule, the same ratio when plotted for a time series of a company should exhibit a linear pattern when a line of best fit is drawn.