

"FINANCIAL STATEMENTS
AS ONE OF THE TOOLS
FOR CREDIT APPRAISAL"

A Paper Submitted to the
School of Accountancy, Institut Teknologi MARA
In Partial Fulfillment of the Requirements for
Advanced Diploma In Accountancy.

Date: 18th May, 1985

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PREFACE

HISTORICALLY, it is believed that the credit analysis function is the initial force that dominated the development of financial statement analysis as banks began using financial data on a large scale. In addition, the fast increasing role of financial institution, as the major suppliers of capital for business expansion and operation require a formal evaluation system of borrowers' credit worthiness.

THE above convincing ideas added with belief that it is a practical advantage for an accountancy student (presumably have acquired the knowledge of how an accountant sets about constructing financial statements) to assume a profession as banker, have prompted me to produce this write-up on how financial statements are interpreted for decision making purposes, and its viewpoint is that of a lending (commercial) banker.

IT would obviously be impossible to reproduce actual financial statements and the circumstances of real banking problems for discussion. This project is carried out to achieve an academic objective, that is, to meet partial fulfillment of the requirement for ADIA and it is done while undergoing practical job attachment. As such, it is highly appreciated if readers can exercise wise judgement should the attempt at realism is largely by demonstrating theoretical points.

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1.0 INTRODUCTION

1.1 An Overview

Financial statements are historical records. They tell the story of the past experience of the business - its past operations and financial condition. This information is of great value as it helps to forecast the future.

A financial statement is probably an organised collection of data prepared according to generally accepted accounting principles and procedures. Its purpose is to convey an understanding of the financial aspect of a business firm. It may show a position at a moment in time, as in the case of a balance sheet or may reveal a series of activities over a given period of time, as in the case of the profit and loss account.

Users of the financial statements are decision makers concerned with evaluating the economic situation of a given firm and predicting its future course. The major groups of users are shareholders/ investors for making portfolio decisions, management for performance evaluation labour unions, regulatory agencies, researchers for studying behaviour and lenders for determining the credit worthiness.

In itself, a financial statement has little significance while it cannot be usefully interpreted by means of a formula. Nevertheless, it has been long established that financial statements are the main and prime source of credit information. Until today it is still a practice to require a business concern to submit financial statements in giving loans and advances and extending lines of credit.

1.2 Methodology

As the subject matter of the project paper has already been adequately explored, the data were mainly from search made on books, published materials, journals, library reference materials etc. and views from personnel dealing in credit lending (commercial banks) as well as from those with sound accounting background. These views were on recent development of the subject and improvement in the presentation of the paper. Special references were also made from confidential internal circulars of one of a leading commercial banks.

The search for data and the preparation of the paper which were done in evenings and weekends while holding 'a full time job' and the requirement of '5,000 words in length' are the major factors that contribute to the limitations of the study.

1.3 Limitations Of The Study

A notable feature of the project paper is financial statements are one of the tools used to evaluate the risks involved in loan proposals and to arrive at a sound credit decisions. This process of evaluating the risks and making a decision is termed as 'credit appraisal' by the financiers.

As the words 'financiers' and 'credit appraisal' tends to be very wide a scope, the coverage of the paper will be narrowed down or limited to a commercial banker of view in assessing applications for business loans. Again, the financial needs of a business concern which are broadly classified to finance working capital and